INTEGRITY ISSUES ASSOCIATED WITH RAISING THE GST RATE AND/OR INTRODUCING MULTIPLE RATES

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Underlying principles of the GST system in New Zealand

New Zealand's GST is a multi-stage indirect tax which is charged on supplies in New Zealand of goods and services by a registered person in the course or furtherance of a taxable activity carried on by that person. Registered persons are able to claim back GST paid on purchases used to make taxable supplies.

New Zealand's GST applies to a very broad range of goods and services. New Zealand adopts the "destination" principle for GST, whereby GST is charged on goods and services consumed in New Zealand. Since exported goods and services are generally consumed outside of New Zealand, they are generally zero-rated. Zero-rating allows suppliers of goods and services to charge GST at zero percent while retaining the ability to claim back GST paid on purchases.

As a result of the application of the destination principle, goods and some services imported for consumption in New Zealand are taxed at the standard rate (either on physical import or through the use of the reverse charge mechanism for services). If the goods or services are imported by a registered person for the principal purpose of making taxable supplies, the person may be able to claim an input tax deduction in respect of the import.

Owing to the broad and comprehensive GST base, New Zealand has been able to sustain a single and relatively low rate (by international standards) of 12.5%.

Potential integrity impacts of increasing the GST rate

Any increase in the GST rate may lead to changes in taxpayers' behaviour and affect the integrity of the GST system. These integrity risks are discussed below.

Risk of increased consumption of goods and services that are outside of the GST base

Risk

An increase to the standard rate of GST would result in a corresponding increase in prices of goods and services that are subject to the GST, while the costs of goods and services that were outside the GST base would remain the same (everything else being equal). As a result, people would have an increased incentive to consume goods and services that were outside the GST base.

Goods

Imported goods are only subject to GST at the border if their value exceeds a de minimis threshold of $399 per package. Therefore, an increase to the rate of GST could give consumers greater incentive to import goods from outside the tax base. For example, this could be done either by purchasing goods from overseas providers via the internet or by physically importing certain goods in person.

A number of factors may limit the practical use of these avenues:

- goods purchased from abroad are normally subject to international shipping fees, which may increase the overall value of the purchase to such extent that it would be equal to the value of a similar good in New Zealand;
- the practicality of the importation – it would not be practical to import many types of perishable goods, such as food;
- the value of goods that could be purchased would need to be limited to $399 per package. The value takes into account the purchase price of the goods, the shipping costs, and any importation duties.

Services

The risk of an increased incentive to acquire from overseas will be even greater in respect of services that can be imported, such as IT programming services, architect's services, legal services, and so forth. For the purposes of the GST Act, "services" also include digitally transmitted products, including digitally downloaded music and movies. A New Zealand resident is required to self-assess and account for GST on imported services (under the "reverse charge" mechanism) when:

- they are GST-registered or are a private consumer who is required to register for GST as a result of the value of imported services supplied to that person bringing them over the GST registration threshold of $60,000;
- the services would be subject to GST if supplied in New Zealand; and
- the recipient makes more than a minimal level of exempt or other non-taxable supplies.

Therefore, unless an unregistered private consumer is required to register for GST as a result of exceeding the $60,000 registration threshold, they may consume services acquired from overseas without paying GST on those services.

Even if a person is required to self-assess GST on imported services, monitoring the compliance may be difficult owing the fact that they can be easily received in digital form.

Options for limiting the risk

Goods

The existence of the risk that New Zealand residents would acquire goods from overseas is dependant on the fact that certain goods would not be subject to GST when imported. Therefore, the risk could be prevented by lowering the de minimis threshold for imposing GST on imported goods.

The disadvantage of this option is that it would substantially increase the compliance costs of taxpayers who would be required to account for GST on all their overseas purchases. Similarly, the administration costs of the tax would increase as the Customs Service would be required to identify and charge tax on all importations, however small, including mail items.

It should also be noted that the Customs Service is being regularly lobbied to increase the de minimis threshold. A similar threshold in Australia is A$1,000.

The second option for dealing with the risk is to only increase the GST rate for those goods and services that are less likely to be directly imported, such as food (perishable) and more expensive luxury items (above the de minimis threshold).

The disadvantage of the second option is that it would require making a value judgement about the type of goods that warrant a lower rate of tax. It will also create a problem of requiring businesses and tax officials to be able to identify boundaries between different types of supplies, therefore increasing the compliance and administration costs. The disadvantages of multiple GST rates are discussed in more detail later in this paper.

Services

It would be difficult to find a practical method to limit the risk of private persons acquiring their services from abroad.

Services are supplied in intangible form. This creates border control issues, and it would be very difficult for customs and revenue authorities to monitor the importation of services. Therefore, a law that would, for example, require a wider range of private persons to register and account for GST whenever they import services is in practice difficult to enforce.

Migration of suppliers overseas

Risk

Some New Zealand businesses may decide that it is economically viable to continue making supplies to New Zealand from overseas rather than from within New Zealand. As long as these suppliers operate from within jurisdictions that allow for zero-rating of exports and assuming that goods and services sold by them would not be taxed in New Zealand (because, for example, they fall under New Zealand's de minimis threshold for imported goods), New Zealand recipients would be able to acquire such goods free of GST.

Options for limiting the risk

Similar to the risk regarding the possibility of increased consumption of goods and services from outside of New Zealand, the risk of suppliers migrating overseas to subsequently supply goods in New Zealand would be limited by a number of natural factors:

- the value of goods would need to be limited to $399;
- the relative prices of goods would likely be increased by international shipping fees; and
- the nature of the goods must be such that it is practical to deliver them to overseas destinations.

Similarly, two legislative fetters that could be used to limit the risk would be:

- the lowering of the de minimis threshold for importation; and
- introducing multiple standard rates, with higher rates targeting goods that are not likely to be imported from overseas.

The disadvantages of these options have been described in the previous section.

The increased risk of fraudulent behaviour

Risk

The collection of GST in New Zealand is modelled on the "credit-invoice" method. Under this model, a liability for GST arises every time goods and services are supplied by a GST-registered person in the course of a taxable activity. GST is also imposed on imported goods and services. Tax is therefore paid throughout the production and distribution chain, but because GST-registered persons are able to deduct GST paid, the tax is ultimately passed on to the final consumer.

GST presents an inevitable risk to the government as refunds are issued for input tax that may not be offset by the payment of GST. This can occur for legitimate reasons, in the case of liquidations or bad debts of the type that can be faced by any business. However, there are other reasons when this offset does not occur – for example, if timing mismatches created by the choice of accounting bases and filing frequencies is exploited or if “phoenix” entities are used to create tax advantages.

This risk is already present in the current GST system. An increase in the GST rate would mean, however, that the GST component of any transaction is larger and potentially more attractive as it provides a greater return on such fraudulent activities.

The increased risk of fraudulent activities would require tax authorities to dedicate more resources to monitoring and identifying tax aggressive arrangements. This could potentially increase the cost of administering the tax system and place strains on Inland Revenue’s existing resources.

The following three examples illustrate schemes where the issue of refunds from input tax deductions that may not be offset by the payment of GST.

Timing mismatches

What is referred to as “timing mismatches” involves a GST-registered person who accounts for GST using the payments basis making a supply to a GST-registered person who accounts for GST using the invoice basis. The payment basis supplier provides the invoice basis purchaser with a tax invoice. The purchaser claims an input tax deduction following receipt of the tax invoice, but payment of GST is deferred. In some cases, payment may be deliberately deferred for a significant period of time or even indefinitely.

Missing trader fraud

Missing trader fraud is a simple form of fraud and involves a GST registered entity selling goods inclusive of GST and deliberately failing to account for that GST. The loss to the revenue and the benefit to the entity is the unaccounted output tax from the transaction.

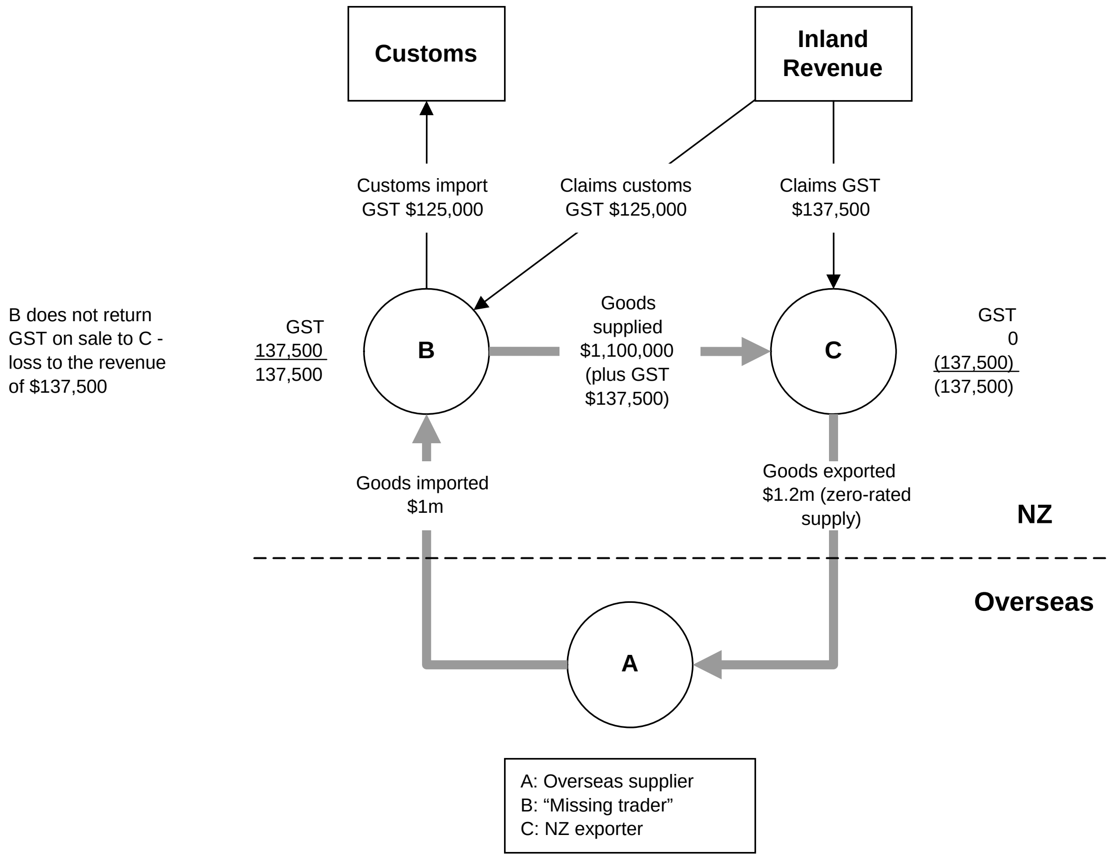
Carousel fraud

Carousel fraud is a more complex form of missing trader fraud and uses the zero-rating provisions that apply to exported products. Carousel fraud involves the repeated import and export of a set of goods with a gain being made through exploiting the GST refund system. Each cycle of the carousel results in a further loss to the revenue. The goods involved are often small, high value electronic goods such as mobile phones and computer chips because of lower associated transport costs. While carousel fraud usually involves the physical movement of goods, it can be achieved using ‘paper’ trades thereby removing transport costs.

The output tax which the missing trader fails to return to Inland Revenue is in most cases paid from another member of the fraud group and, therefore, does not provide the group with any external income. It is only when the final member receives a refund (on the purchase of the goods) and exports the goods (zero-rated) that the fraud is crystallised with cash from outside the group. The group can then retain the goods by exporting to an offshore member, who can begin the carousel again.

Carousel fraud is generally successful because outwardly the activities appear legitimate. It is only when revenue authorities are able to see the arrangement in its entirety, having identified all the parties involved, that the revenue loss is revealed. One of the main problems in detecting the fraud is the way that revenue systems are not directed at tracking the movement of goods.

To make the fraud harder for revenue authorities to detect, other entities - known as "buffers" - may be used to disguise carousel transactions as legitimate business transactions. More often than not, these buffer entities are oblivious to the fact that they are being used for this purpose.



1. The first resident entity (B) imports the goods from an overseas country and is required to pay Customs GST to have the goods released. The amount paid is claimed back from Inland Revenue through a GST return.

2. (B) then sells the goods to a second entity (C) and charges GST on the transaction. Entity (B) immediately disappears with the full consideration. This entity is often referred to as the 'missing trader'.

3. Entity (C) will claim an input tax deduction and export the goods back to the supplier (A) possibly through another country or countries.[1]

4. After being exported the same goods will be imported again and the cycle repeated, hence the name 'carousel fraud'. The United Kingdom experience with this type of fraud has shown that sophisticated examples of carousel may involve 40 entities domestically and internationally, and in some cases the cycle can be completed over 30 times before it is detected.

The issue of carousel fraud has been prevalent in many overseas jurisdictions, especially the European Union countries, and has accounted for billions of dollars of revenue losses. While no specific instances of carousel fraud have yet been identified in New Zealand, technically, it is possible for carousel fraud to occur in New Zealand. Increasing the GST rate would increase this risk.

Options for limiting the risk

Inland Revenue officials are currently considering a number of mechanisms by which the risk of fraud may be reduced in transactions involving land and high value assets (for more information, see Inland Revenue's issues paper *Options for strengthening GST neutrality in business-to-business transactions* from June 2008). One mechanism considered is a "domestic reverse charge", which involves shifting the obligation to charge GST from the GST-registered supplier to the GST-registered recipient. It would require the recipient of the goods and services, who would need to be registered for GST at the time of supply, to self-assess GST on the purchase and deduct, if entitled to do so, input tax in the same taxable period.

The advantage of domestic reverse charging for Inland Revenue would be that the risk of refunding an input tax deduction on a transaction, when there is a risk that GST output tax will not be paid, would be reduced.

The limitation of a domestic reverse charge would be that it would only apply to transactions involving land and high value assets.

A similar system has recently been implemented in the United Kingdom to deal with fraudulent transactions involving the supply of mobile telephones, computer components and other electronic goods.

[1] In practice, the goods may be sold a number of times within New Zealand before being exported.

Increase costs to exempt taxpayers

Risk

A GST-registered person may only claim input tax deductions in respect of acquisitions made for the principal purpose of taxable supplies.

The provision of financial services to non-business consumers is an exempt supply. Therefore, financial institutions, such as banks, are not able to deduct input tax in relation to goods and services acquired to enable them to make supplies of financial services to non-business consumers.

An increase in the GST rate would raise the cost of those non-deductible inputs and the exempt nature of financial services would mean that these higher costs could not be recovered by the financial institutions.

Options for limiting the risk

It should be noted that the current rules give suppliers of financial services an option to zero-rate financial services supplied to other GST-registered businesses. By selecting to zero-rate such supplies, banks and other similar institutions may claim deductions in respect of those supplies, therefore offsetting the cost of GST on their purchases. Supplies to consumers remain exempt, however, and no input tax deductions are allowed on domestic purchases and imports made for the purpose of making exempt supplies to consumers.

Simplification

The fraction of the current GST rate in a GST inclusive value of goods and services is 1/9th. This is a convenient fraction and simplifies tax calculations. This is of particular benefit to small to medium sized businesses.

A different GST rate would change the fraction and may, therefore, could affect the simplicity of tax calculations.[2]

Potential impacts of multiple tax rates

The earlier discussion on limiting risks associated with increasing the GST rate has mentioned the potential for introducing different rates for different types of goods and services. The application of different rates of GST is also often raised in the context of necessities – such as food.

[2] Other “convenient” rates are, e.g. 16 2/3% = 1/7; 20% = 1/6.

This section discusses the potential impacts of having multiple GST rates.

Discriminate between different types of supplies

Introducing different tax rates for different goods and services requires value judgements about what goods and services consumed by taxpayers deserve special treatment and of the relative importance of those goods and services to taxpayers.

There are different views about which goods and services merit a lower rate of GST. A healthy individual may be unaffected by an increase in the GST component of medical services and would prefer a lower rate on food products. However, while food products may be a priority for some, medical services (or education services, etc) may be a priority for others. A concession for one type of good would inevitably result in requests to consider concessions for other goods and services and it may be difficult to justify why such a concession should not be given.

Creates complex boundary problems

New Zealand's broad base and the single GST rate are often mentioned as the main factors that make the New Zealand's GST system one of the most comprehensive, yet simple, in the world.

In New Zealand, a supply may be either standard-rated, zero-rated, or exempt. If a GST-registered taxpayer determines that a supply does not fall under the limited application of zero-rating and exempt provisions in the GST Act, the standard rate of 12.5% is charged.

Many other countries have different rates for different types of food. Australia, for example, removes certain foodstuffs from the GST base. This has a negative effect on the simplicity of their GST system. For instance, there is likely to be uncertainty about whether certain items of food should be classed as GST free or taxable or at 10% rate, and has resulted in increased compliance costs for businesses. Similar problems exist in the United Kingdom and many other jurisdictions. This uncertainty affects the ongoing acceptance of the tax by businesses and will likely lead to costly and regular tax disputes, as has been the case in the United Kingdom and Australia.

For example, in 2008 the European Court of Justice accepted that Marks and Spencer was entitled to a £3.5 million rebate for incorrectly charged VAT on their teacakes. Under UK tax rules, most traditional bakery products such as bread, cakes, flapjacks and Jaffa Cakes are zero-rated, but the standard rate is payable on cereal bars, shortbread and partly-coated or wholly-coated biscuits. Although Marks and Spencer's teacakes were initially classified by tax authorities as "biscuits" and subject to full VAT, it was accepted, decades later, that they were in fact chocolate cakes and should be zero-rated for VAT purposes.

Although not related to multiple GST rates, the issue of the complexity in identifying boundaries between different types of supplies has been seen in New Zealand in relation to the supply of accommodation. In New Zealand, a supply of accommodation in a "commercial dwelling" is a taxable supply, whereas a supply of accommodation in a residential "dwelling" is an exempt supply. Notwithstanding the provisions in the GST legislation that provide definitions and examples of what constitutes a "dwelling" and a "commercial dwelling", the issue of what category a particular type of accommodation falls under regularly arises. The complications that arise from this uncertainty have lead some to submit on Inland Revenue's issues paper *Options for strengthening GST neutrality in business-to-business transactions* that all types of accommodation be included in the GST base (thereby removing the boundary between exempt and taxable accommodation).

In addition to complicating the GST system, the boundary uncertainties created by multiple rates may be used to create revenue leakages. Some taxpayers may use the uncertainty to categorise goods and services under a specific category in order to be able to charge a lesser rate of GST when supplying goods and services to consumers.

Effects on consumption and production decisions

Different rates of GST, especially if they vary greatly, may affect consumption and production decisions.

Consumption decisions

In a world without a consumption tax or with a single tax rate, people would spend their money on the consumption of a certain basket of goods and services. With the introduction of a consumption tax that has multiple rates, the relative prices of goods and services would be altered which could distort the taxpayer's decision as to what goods and services to include in their consumption basket.

This risk could potentially be avoided if rates were set by reference to the elasticity of different goods and services. However, this would be problematic given the difficulty of measuring the elasticity of each good and service and having to regularly monitor changes in the elasticity of different goods and services.

Production decisions

Production decisions are made on the basis of consumption decisions. If consumption decisions are distorted as described above, the production decisions may also similarly be affected.