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WEEKLY COMMENT: FRIDAY 23 JANUARY 2015

1. This week I am going to look at 2 recent GST cases:

   (a) The High Court judgment dated 5 September 2014 in *Concepts 124 Limited v Commissioner of Inland Revenue* [2014] NZHC 2140, concerning whether a company owned by a trust was associated with a company owned by the shareholder of the trustee company; and

   (b) The Taxation Review Authority decision dated 20 November 2014 in *TRA 008/14*, [2014] NZTRA 15, concerning whether the input tax deduction restrictions on supplies between associated persons applied to a supply of a dwelling which became subject to GST due to the changed definitions from 1 April 2011.

Concepts 124 Limited

2. The *Concepts* case was an appeal from the Taxation Review Authority decision *Case 11/2013* [2013] NZTRA 11, (2013) 26 NZTC 2-010, which I discussed in Weekly Comment 18 April 2014. In *Case 11/2013* the TRA had found that control through a corporate trustee of a company that was a trust asset constituted control "by any other means whatsoever", which was sufficient to create an association with another company that was not held through the trust.

3. The facts in the case were that the taxpayer, Concepts 124 Ltd ("Concepts") had claimed a GST input tax deduction based on the price of $8,034,750 paid to Ormiston Residential Ltd ("Ormiston"), a company 75% owned by a trust, the Flatbush Holdings Trust ("FBH Trust"). Ormiston was not registered for GST. It had acquired the property for $847,000, including GST of $94,111.12.

4. The corporate trustee of the FBH Trust was Flatbush Holdings Limited ("Flatbush"). Mr. Cummings owned all the shares in Flatbush. He also owned all the shares in Concepts, and he was the sole director of both companies.

5. The Commissioner argued that Concepts and Ormiston were associated persons and, therefore, the GST input tax deduction could only be claimed on the price originally paid by Ormiston of $847,000.

6. Two companies will be associated under s. 2A(1)(a) of the *Goods and Services Tax Act 1985* ("the GST Act") if a group of persons:

   (i) Has voting interests in each company of 50% or more; or

(ii) Has market value interests in each company of 50% or more, if a market value circumstance exists; or

(iii) Has control of each company by any other means whatsoever.

7. Before the TRA it was acknowledged by both the Commissioner and the disputant that, because of the existence of the Trust, Concepts and Ormiston could not be associated under s. 2A(1)(a)(i) because Mr. Cummings did not hold 50% or more of the voting interest in both companies. FBH Trust owned 75% of the voting interest in the seller, Ormiston. The Commissioner accepted that the beneficial ownership of the seller company's shares had been separated from the legal ownership, which altered the capacity in which the trustee company, Flatbush, held the shares and made them trust property.

8. Clifford J, in the High Court, disagreed and his analysis may be summarised as follows:

(a) Section 2A(1)(a)(i) makes no reference, directly or indirectly, to shares held on trust;

(b) The phrase "voting interests" defined in sections YA 1 and YC 2(1) of the Income Tax Act 2007 means shareholder decision-making rights "held" by the person, and "held" is not qualified by reference to whether the shares are legally owned only (as when held in trust) or legally and beneficially owned (as when held personally);

(c) The "economic interests" concept under which ownership by a trust is distinguished from ordinary direct ownership does not apply to the determination of control;

(d) For the purposes of the continuity provisions (i.e. the ability to carry forward and use tax losses) the trustees of a trust are treated, under s. YC 9, as the same notional single person (other than a company) with the effect that, in the case of a corporate trustee, there is no "look-through" to the shareholders of the corporate trustee;

(e) However, this modification did not apply to the general rule defining when two companies are associated – in Clifford J's view this was a deliberate approach because economic interests are not relevant to determining control of a company, therefore, the notional single person rule applied only to attribute economic interests, and not to the attribution of control, which rested with the shareholders in the corporate trustee.

9. Clifford J found that Concepts and Ormiston were associated because there was a group of persons (Mr. Cummings qualified as a "group of persons") who had voting interest in each company of more than 50%. Mr. Cummings' voting interest in Ormiston could be traced through the corporate trustee in which he held all the shares.

10. With the greatest of respect, I find this reasoning ignores the rule of association between a trust and a company that it owns.

11. For income tax purposes, under s. YB 3(5) of the Income Tax Act 2007, for the purposes of determining the association between a company and a person other than a company, "a person other than a company includes a company acting in its capacity as a trustee of a trust".

12. Therefore, Flatbush is, for income tax purposes, in relation to its shareholding of 75% in Ormiston held on behalf of the FBH Trust, a person other than a company. In that capacity, Flatbush is associated with Ormiston for income tax purposes.

13. Section YB 3(5) is not referred to in the GST Act. However, Clifford J's analysis traces the legislative history of income tax provisions in order to arrive at the conclusion that it is

possible to trace through a corporate trustee to determine control by its shareholders. If, for income tax purposes, Flatbush is associated with Ormiston under a separate rule of association between a company and a person other than a company, Ormiston cannot be associated with Concepts, for income tax purposes, under the 50% or more commonality of shareholding rule.

14. It is difficult to see why there would have been a different intention on the part of legislators for GST purposes. The omission of any reference to s. YB 3(5) appears to have been an oversight. (Incidentally, the arguments in the case involved s. YC 9, which is also not referred to in the GST Act.)

15. In any case, Clifford J agreed with the TRA that Mr. Cummings controlled Ormiston through his holding the power of appointment and removal of trustees of the FBH Trust. Interestingly, the income tax rule of association between a trustee and person with the power of appointment is also missing from s. 2A of the GST Act. Otherwise, Ormiston and Concepts would have been associated under the tripartite rule, through their common association with Mr. Cummings.

Input tax deduction not available despite dwelling becoming a taxable supply

16. The issue in *TRA 008/14* was whether a disputant company could claim an input tax deduction of $119,628.07 in respect of a property that had become a taxable supply from 1 April 2011 due the changed definitions of "dwelling" and "commercial dwelling".

17. The facts were that Mr. X, who owned 99% of the shares in the disputant company, initially purchased the property in February 2005 from an unregistered person for $635,000. Mr. X himself was not GST-registered. After making substantial capital improvements in excess of $300,000, Mr. X sold the property in 2007 to the disputant company for $1,100,000. The purchase price was supported by an independent valuation.

18. The property was used to provide short-term rental accommodation. The property was treated as a "dwelling" for GST purposes and the supply of the property was, therefore, GST-exempt prior to 1 April 2011. The supply of the property became a taxable supply from 1 April 2011 because it was not principally used as someone's residence.

19. The disputant company claimed an input tax deduction under s. 21HB, which allows an input tax deduction to the extent a deduction was not made under the rules that previously applied. The Commissioner disallowed the deduction under the rule that restricts input tax deductions on supplies made between associated persons.

20. The Commissioner's view is that the transfer of the property from Mr. X restricts the input tax deduction, under s. 3A(3)(a) to the amount of GST included in the original cost of the property to Mr. X. As there was no GST charged on the supply to Mr. X, the disputant company cannot claim any input tax deduction.

21. An input tax deduction is permitted by s. 21HB(2) and (3) which state that:

"(2) Input tax in relation to the acquisition referred to in subsection (3) may be deducted under section 20(3C) to the extent to which a deduction has not been made under the old apportionment rules.

(3) The person must treat the goods or services as acquired on 1 April 2011 at the original cost of the supply."

22. These provisions were interpreted differently by the Commissioner and the disputant:

    (a) The Commissioner contended that they meant that the original acquisition transaction is treated as having occurred on 1 April 2011; but

    (b) The disputant maintained that s. 21HB(3) implies that there is a deemed supply on 1 April 2011 and the cost of the original supply is a GST-inclusive consideration for the purposes of the deemed supply.

23. Judge AA Sinclair agreed with the Commissioner for the following reasons:

    (a) The reference to "the supply" in s. 21HB(3) is a reference to the original acquisition transaction;

    (b) Hence, the original acquisition transaction is "the supply" in relation to which it is necessary to determine the amount of the input tax deduction available;

    (c) The reference in s. 21HB(2) to "to the extent to which a deduction has not been made" lends support to the view that "the supply" is the original supply;

    (d) If it was intended that s. 21HB(3) was meant to refer to a different supply, that would have been explicitly stated;

    (e) Input tax on an acquisition from an associated person is restricted to the lesser of the input tax on the original supply and the input tax on the sale transaction; and

    (f) There was no evidence to support the view that Parliament had intended to change this approach in relation to properties that became subject to GST because of the changed definitions of "dwelling" and "commercial dwelling".

24. An amendment to s. 21HB(1) contained in s. 192(2) of the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014* appears to lend support for the Commissioner's and Judge AA Sinclair's interpretations. As stated on page 101 of Tax Information Bulletin Vol. 26, No. 7, August 2014:

    "However, an unintended effect of the transitional rule was that suppliers affected by the definition changes could arguably claim input tax deductions for accommodation acquired before the introduction of GSRT on 1 October 1986. This is contrary to the policy rationale underlying the rule as this outcome would allow suppliers to claim input tax for property acquired when no GST was incurred."

25. The amendment limits the input tax that may be claimed to costs incurred between 1 October 1986 and 1 April 2011. This amendment implies that it is the original supply in relation to which it is necessary to determine the GST input tax deduction available.

26. The disputant complained about, and Judge sympathised with, the fact that the subsequent sale of the property would attract output GST. Apart from anything else, the case once again shows that transactions between associated persons can give rise to inequitable results, and that is within the legislative design to protect the tax base.

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