

## **GST TREATMENT OF COURT AWARDS AND OUT OF COURT SETTLEMENTS**

Unless otherwise stated, all references in this interpretation statement are to the Goods and Services Tax Act 1985 (“GSTA”).

### **Summary**

Out of court settlements or court awards might arise as a result of a dispute regarding an earlier supply, and in some cases a new supply might arise such as a transfer of property in return for payment where ownership is in dispute. For GST to be payable upon a payment arising from a court award or out of court settlement the payment must be consideration for a supply, or an adjustment to consideration for an earlier supply. In order for a supply to be subject to GST, the Commissioner considers that some element of reciprocity should be present to link a consideration to that supply.

Whilst the definition of “consideration” in section 2 of the GSTA is broad, the Courts have noted that it does not dispense with the requirement that there is a linkage between the consideration and the supply. In *New Zealand Refining v CIR* (1997) 18 NZTC 13,187, Blanchard J stated that despite the wide definition of consideration, there was a “practical necessity for a sufficient connection between the payment and the supply.” (p. 13,193)

In order for a “sufficient connection” to be present, both the High Court and Court of Appeal have in recent cases emphasised the specific need for an element of “reciprocity” between parties in order for a consideration to be linked to a supply. In *Taupo Ika Nui Body Corporate v CIR* (1997) 18 NZTC 13,147 (HC), Gallen J stated that whilst the statutory definition of consideration in the GSTA was indeed broad, the definition did not remove the requirement for an element of reciprocity within a transaction for a payment to be consideration for a supply:

The question arises therefore, whether the definition is so worded that there is no need for an element of reciprocity. With some hesitation I have come to the conclusion it does not. (p. 13,150)

In *Chatham Islands Enterprise Trust v CIR* (1999) 19 NZTC 15,075 there was a stronger emphasis upon reciprocity. Blanchard J stated that: “the payments were not made pursuant to any covenant by the Crown involving reciprocal obligations enforceable at law”. He then concluded that the Trust in this case was not making a supply (to the Crown or third parties) as there was “an absence of reciprocity in the relationship” (at p.15,079). Tipping J agreed with the judgment of Blanchard J, and additionally stated:

When coupled with the definitions of taxable activity and consideration, to which I shall come, and in spite of the width of those definitions, the concept of supplying services has a reciprocal connotation. It is not apt to catch the fulfilment by trustees of their duties as such, albeit that such fulfilment will necessarily, in a direct or indirect way, be of benefit to the beneficiaries and the settlor. (p. 15,081)

Subsequent cases (discussed in the item below) have also used a framework based on elements of reciprocity to identify a nexus between a supply and a consideration.

In order for a payment to be for a supply pursuant to section 8 of the GSTA, an identifiable supply must have been made (or agreed to) by one party and there must be an element of reciprocity in the obligation by another party to make payment for that supply. Tenuous and unrealistic connections are not sufficient to evidence the link required for a payment to be consideration for a supply. Reciprocity is evidenced by legally enforceable obligations between the payer and supplier which may arise as a result of the agreement of the parties, or be imposed between the parties by a court. Obligations may be legally enforceable via statute, common law or in equity. A payment will therefore only be consideration for a supply where such an element of reciprocity exists, and the payment is for the supply or is an adjustment to the consideration for a previous supply. Payments that *relate* to a supply, but are not *for* that supply will not be “consideration”.

- If the payment is consideration for a supply, the supplier will be liable to GST if the supply was made in the course or furtherance of a taxable activity.
- If the payment is a variation of the previously agreed consideration and within the scope of section 25 GSTA, a GST adjustment may need to be made by the relevant parties.
- If a global award is made by the court and part of the award is payment for a taxable supply, apportionment must be undertaken pursuant to section 10(18) GSTA and the amount properly attributable to the taxable supply ascertained.
- If the payment is within the scope of section 20A(4) of the GSTA (being the recovery of a sum expended in determining liability to tax as defined in section 20A(2)) the Act operates to deem the payment to be in return for taxable supplies, and output tax is payable.

## **Background**

### *The 1990 TIB item*

An interpretation statement regarding the GST treatment of damages and out of court settlements was published in the Tax Information Bulletin (TIB) Vol 1, No 11, June 1990. This item stated that whether sums paid in settlement of a claim were GST inclusive was determined by the nature of the award or the underlying transaction.

The item raised the following questions and proposed the relevant treatment to be applied:

- Where there is an out of Court settlement and all or part of the settlement can be connected back to the original taxable supplies, does GST apply? If so, how is the GST calculated?

The proportion of the settlement connected to the supply of the original taxable supplies would be subject to GST.

- Where there is an unscheduled global payment in full and final settlement of prior legal proceedings it may not be possible to connect this back to the original supply. Does GST still apply?

Details of the facts of each particular case would need to be examined to ascertain whether a GST liability exists. If it is established that part of the payment relates to the original supply an apportionment may be required if the amount relating to the supply is not specified.

- Where there were no taxable supplies in the first instance, does GST apply to the settlement?

No. There must be a supply of goods or services before GST can apply.

The Commissioner decided to review the above item owing to the development of case law since the publication date. This statement replaces the item published in the TIB in June 1990.

## **Legislation**

Under section 8 of the GSTA GST is charged on supplies made by a registered person in the course or furtherance of their taxable activity:

### **8 Imposition of goods and services tax on supply**

- (1) Subject to this Act, a tax, to be known as goods and services tax, shall be charged in accordance with the provisions of this Act at the rate of 12.5 percent on the supply (but not including an exempt supply) in New Zealand of goods and services, on or after the 1st day of October 1986, by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.

A taxable activity is one that is carried on “continuously or regularly” (section 6(1)(a)).

### **6 Meaning of term “taxable activity”**

- (1) 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 a 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:

“Supply” is defined in section 5 of the Act as including “all forms of supply”

The definition of consideration is found in section 2 of the Act:

## 2 Interpretation

(1) In this Act, other than in section 12, unless the context otherwise requires,—

**Consideration**, in relation to the supply of goods and services to any person, includes any payment made or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods and services, whether by that person or by any other person; but does not include any payment made by any person as an unconditional gift to any non-profit body:

Section 10(2) of the Act defines the “value of supply” and highlights a link between consideration and supply:

Subject to this section, the value of the supply of goods and services shall be such amount as, with the addition of tax charged, is equal to the aggregate of,—

- (a) To the extent that the consideration for the supply is consideration in money, the amount of the money:
- (b) To the extent that the consideration for the supply is not consideration in money, the open market value of the consideration.

Section 10(18) contemplates apportionment of a payment where it only partly relates to a taxable supply:

Where a taxable supply is not the only matter to which a consideration relates, the supply shall be deemed to be for such part of the consideration as is properly attributable to it.

Section 20A deals with GST incurred in determining liability to tax:

- (2) Subject to this section, any goods and services acquired by the registered person in connection with—
  - (a) The calculation of the taxable income of the registered person for any income year:
  - (b) The calculation or determination of the goods and services tax payable by the registered person for any taxable period:
  - (c) The preparation, institution, or presentation of an objection or challenge to or an appeal against or in consequence of any determination or assessment made, in respect of the registered person, by the Commissioner under the provisions of the Tax Administration Act 1994 or the Goods and Services Tax Act 1985:
  - (d) Any contribution by the registered person towards the expenditure incurred by any other taxpayer or registered person, as the case may be, where—
    - (i) if the expenditure were incurred by the first-mentioned registered person, it would be an allowable deduction in calculating the taxable income of that person or allowable in the calculation or determination of any goods and services tax payable by that person; and
    - (ii) the first-mentioned registered person has objected to or challenged or appealed against an assessment or determination made, in relation to the matter by, the Commissioner under the provisions of the Income Tax Act 1976 or the Tax Administration Act 1994 or the Goods and Services Tax Act 1985,—shall be deemed to be goods and services acquired by the registered person for the principle purpose of making taxable supplies; and the Commissioner shall allow that person to make a deduction under section 20(3) of this Act of the tax charged thereon.
- (4) Any amount received by the registered person at any time, whether by way of reimbursement, award of the Court, recovery, or otherwise howsoever in respect of goods and services deemed

under this section to be acquired by the registered person for the principal purpose of making taxable supplies, shall be deemed to be supplied by that registered person in the course of their taxable activity in the taxable period in which it is received.

Section 25 of the Act deals with credit and debit notes as they relate to adjustments to the nature or consideration for a supply:

(1) This section shall apply where, in relation to the supply of goods and services by any registered person,—

- (a) That supply of goods and services has been cancelled; or
- (aa) The nature of that supply of goods and services has been fundamentally varied or altered; or
- (b) The previously agreed consideration for that supply of goods and services has been altered, whether due to the offer of a discount or otherwise; or
- (c) The goods and services or part of those goods and services supplied have been returned to the supplier,—

and the supplier has—

- (d) Provided a tax invoice in relation to that supply and as a result of any one or more of the above events, the amount shown thereon as tax charged on that supply is incorrect; or
- (e) Furnished a return in relation to the taxable period for which output tax on that supply is attributable and, as a result of any one or more of the above events, has accounted for an incorrect amount of output tax on that supply.

## **ANALYSIS OF GST LEGISLATION AND PRINCIPLES**

### **When is a payment sufficiently connected to a supply**

Section 8 of the GSTA provides that a tax is to be charged on the supply of goods and services (but not including an exempt supply) in New Zealand. The supply must be made for a consideration by a registered person in the course or furtherance of a taxable activity.

*The need to identify the “supply”*

“Supply” in the GSTA is stated to include “all forms of supply”.

In order to determine whether a payment is “consideration” in the GST sense, there must be a supply of something for which the payment is consideration pursuant to section 2 of the Act. It follows that if there is no supply the payment can not be consideration. The need to identify the supply was noted by the Court of Appeal in *Chatham Islands Enterprise Trust v CIR* (1999) 19 NZTC 15,075. The *Chatham Islands* case involved a payment made by the Crown to a charitable trust that was established by the Crown to provide services and promote the wellbeing of Chatham Islands residents. Tipping J said:

While it is clear that the services do not have to be supplied to the person providing the consideration (as defined) for them, it is still necessary for there to be a supply of services within the proper meaning

of the phrase. **Although services are defined as meaning anything which is not goods, it is still necessary for there to have been a supply of something.** (p. 15,081) (emphasis added)

A similar comment was made in *NZ Refining Co v CIR* (1995) 17 NZTC 12,307 (HC), where it was considered whether a series of payments made by the Crown to the refinery pursuant to an agreement to release the Crown from an earlier undertaking were consideration for any supply by the refinery, either to the Crown or to third parties. In order to receive the payments the refinery had to be operational on the date of payment. If the refinery did not meet the condition of being operational the only recourse to the Crown was to withhold the payment.

Henry J said:

**The tax is chargeable against payments which go to make up the value of an identifiable supply which has been made.** Payments which are received in the course of a taxable activity are not chargeable unless they also have that additional quality or character, which these do not. GST is a consumer tax on goods and services supplied, not an activity tax on producing goods and providing the means of supplying services. (p. 12,314) (emphasis added)

#### *Supply to third parties*

Whilst it is necessary for there to have been a supply of something, the supply need not be made to the person who makes the payment. In *Turakina Maori Girls College Board of Trustees v CIR* (1993) 15 NZTC 10,032 (CA), the GST treatment of payments of school fees by parents of pupils to the proprietors of integrated state schools was analysed. McKay J, referring to the definition of supply, said:

It is clear from this definition that the supply of any service for consideration is part of a “taxable activity” under sec 6, even though it is to a person other than the person who provides the consideration. (p. 10,036)

#### *When is a payment consideration for a supply?*

GST is a tax on the supply of goods and services carried on in the course of a taxable activity. It is a transaction based tax: *CIR v Databank Systems Ltd* [1989] 1 NZLR 422. It is not a tax on receipts or turnover: *NZ Refining* (1997) 18 NZTC 13,187 at 13,193.

Accordingly, not all payments received by a registered person in the course of their taxable activity will be for supplies. As Blanchard J noted in *NZ Refining*:

**There is a practical necessity for a sufficient connection between the payment and the supply.** The mechanics of the legislation will otherwise make it impossible to collect the GST. (p. 13,193)

The Act requires there be consideration for a supply in order for GST to be imposed. Section 2 defines consideration as including any payment made, or any act or forbearance, whether voluntary or involuntary, and made “in respect of, in response to or for the inducement of a supply”.

A strict contractual analysis does not need to be undertaken in order to link a payment to a supply as noted by McKay J in *Turakina*. Referring to the definition of consideration in the act, the judge said:

It is clear from this definition that the supply of any service for consideration is part of a “taxable activity” under sec 6, even though it is to a person other than the person who provides the consideration. Likewise, the value of the supply is to be measured by the consideration, whether or not the consideration is provided by the person to whom the service is supplied. **It is not necessary that there should be a contract between the supplier and the person providing the consideration**, so long as the consideration is “in respect of, in response to or for the inducement of the supply” (emphasis added)

Further, the statutory definition of consideration has been interpreted in the High Court as wider than the common law meaning:

In the context of this matter I am not persuaded that it is helpful or appropriate to reflect upon the ordinary meaning of the word. The statutory definition extends the ordinary meaning and it is the scope of the extended statutory definition which needs to be determined.

(per Chisholm J in *The Trustee, Executors and Agency Co NZ Ltd v CIR* (1997) 18 NZTC 13,076 at 13,085)

However, in *Taupo Ika Nui Body Corporate v CIR* (1997) 18 NZTC 13,147 (HC), Gallen J stated that whilst the statutory definition of consideration in the GSTA was wider than the contract law meaning, the definition did not remove the contract law requirement for an element of reciprocity to be present within a transaction in order for the payment to be “consideration” for a supply:

**The question arises therefore, whether the definition is so worded that there is no need for an element of reciprocity. With some hesitation I have come to the conclusion it does not.** The use of the term “consideration” imports the specialised meaning given to that term in a legal context, which would tell against a meaning involving a mere handling of the funds. (p. 13,150) (emphasis added)

The statutory focus is therefore on establishing a nexus between the supply and consideration. It is recognised that whilst the definition of consideration is broad, it does not dispense with the requirement that a linkage exist between the supply and consideration. As said by Blanchard J in *NZ Refining*:

“to constitute consideration for a supply the payment must be for that supply” (p. 13,193)

In evaluating the existence or nature of the requisite nexus for a payment to be consideration for a supply, the courts have consistently emphasised the need for reciprocity in the relationship. McGechan J stated in *CIR v Suzuki* (2000) 19 NZTC 15,819 at 15,831 that:

The breadth of the term “consideration” – inherent in the definitional phrasing “in respect of, in response to, or for the inducement of” – is to be acknowledged; but as those terms in themselves indicate it is necessary there be a genuine connection. The legislature is not to be taken as taxing on an unrealistic or tenuous connection basis.

The *Suzuki* approach is consistent with cases such as *NZ Refining*, which essentially held that conditions upon which payment depended did not amount to a state of

reciprocity between the parties. The payments could not be consideration for any supplies as the mechanics of the legislation require a “sufficient connection” between the payment and the supply. There were no obligations between the parties as if the refining company failed to meet the conditions for payment, the only recourse to the Crown was to withhold payment

The statement of Blanchard J above appears at first glance to be more restrictive than his statement in the same case that there needed to be a sufficient connection between the consideration and the supply. However, when the phrases are placed in their order in the judgement it can be seen that the reference to “sufficiently connected” should not be construed as broadening the requirements for the linkage of a payment a supply beyond those where the payment is made for the supply in question:

The definition of "consideration", though broad, cannot and does not dispense with that requirement. To constitute consideration for supply a payment must be made for that supply, though it need not be made to the supplier nor does the supply have to be made to the payer.

There is a practical necessity for a sufficient connection between the payment and the supply. The mechanics of the legislation will otherwise make it impossible to collect the GST. (p. 13,193)

To analyse the linkage between a payment and supply, it is necessary to have regard to the legal arrangements actually entered into:

In taxation disputes the court is concerned with the legal arrangements actually entered into, not with the economic or other consequences of the arrangements: per Blanchard J in *New Zealand Refining v CIR* (1997) 18 NZTC 13,187 at 13,192 (citing *Marac Life Assurance Ltd v CIR* [1986] 1 NZLR 694 at 706)

*“In respect of”*

When will a payment be made pursuant to sufficient reciprocal obligations such that the payment is consideration pursuant to its definition in section 2 GSTA? In the *New Zealand Refining* case, the Commissioner attempted to use a broad approach, as can be seen in the following extract from his argument:

“Consideration” is defined in relation to a supply of goods and services to a person. The supply in this case was by NZ Refining to the oil companies. It was submitted that the supply was either the making available of the refinery (even if it was not used) or the actual use of the refining facilities.

**“Consideration” is given an extremely wide definition in the Act, which “breathe[s] comprehensiveness”, as Richardson J said in *C of IR v Databank Systems Ltd* (1989) 11 NZTC 6,093 at p 6,102; [also reported as *Databank Systems Ltd v C of IR* [1989] 1 NZLR 422 at p 431]. It includes any payment made “in respect of, in response to or for the inducement of the supply of goods or services”. The payment did not have to be from the recipient of the supply (so it could be a payment by the Crown), nor did it have to be directly linked to a particular supply. It is said to be sufficient that there be a linkage “in the broadest way” between the supply and the payment. “In respect of” is a phrase of wide import, as this Court has previously recognised (*Shell New Zealand Ltd v C of IR* (1994) 16 NZTC 11,303 and *C of Ir v Fraser* (1996) 17 NZRC 12,607).....**

...In the absence of evidence to the contrary it is said to be a proper inference that the payments achieved their purpose but it was enough, in fact, if it was intended to achieve it, ie if they constituted an inducement. **This, it was submitted, provided a sufficient linkage for the purposes of the GST Act; linkage can be “broad based” and “pragmatic”.** (p. 13,191) (emphasis added)

It can be seen from the judgement of Blanchard J in *NZ Refining* (see previous page) that the broad definition of the terms “in respect of, in response to or for the inducement of” that was contended for the Commissioner was not accepted by the Court. The lack of any element of reciprocity between NZ Refining and either the Crown or third parties meant that the payments were received in the course of NZ Refining’s taxable activity but were not payments made in consideration for any supply by NZ Refining.

The meaning of “in respect of” was directly considered in the *Taupo Ika Nui* case where a body corporate collected an annual sum of money that paid for upkeep and maintenance for proprietors of a timeshare resort. The Crown alleged that the payments were “in respect of” the provision of the maintenance services. Gallen J concluded the payments were not consideration for any supply despite the term “in respect of” appearing to be broad, and stated:

Further, while the term “in respect of” is unrestricted and wide enough to encompass a meaning which would include what took place in this case, it must be construed in relation not only to the use of the term “consideration” but to the allied concepts of “response to” or “inducement of”, both of which involve an element of reciprocity.

“In respect of” has not been defined in the above cases by reference to what it includes, but what it does not. The cases both illustrate situations that are outside the scope of the phrase, yet both affirm the breadth of the phrase to be only to the extent that there are reciprocal obligations between the parties. The *NZ Refining* case further distinguishes between conditions upon which payment depends, and reciprocal obligations between the parties; meaning that conditions upon which payment depends will not, without more, be sufficient for the payment to be consideration for any supply.

*“For the inducement of”*

The words “for the inducement of” were considered in the *Chatham Islands* case. In this case the Crown made a payment to a charitable trust, allowing the trust to provide for its beneficiaries services that were previously the responsibility of the Crown. The Commissioner argued that the payments were consideration as they *induced* the trust to carry out its functions, and that this was a supply of services to the Crown. In the alternative, the Commissioner argued that the supplies were made by the trust to its beneficiaries.

Tipping J felt that duties that existed independently of any payments being made did not have the requisite reciprocal connotation required by the concept of a supply for consideration, whether the consideration was in respect of, in response to or for the inducement of the supply:

**When coupled with the definitions of taxable activity and consideration, to which I shall come, and in spite of the width of those definitions, the concept of supplying services has a reciprocal connotation. It is not apt to catch the fulfilment by the trustees of their duties as such, albeit that such fulfilment will necessarily, in a direct or indirect way, be of benefit to the beneficiaries and the settlor.** For these reasons, I do not consider that the trustees engaged in any supply of services in terms of s8.

There is a further and related difficulty in the Commissioner’s argument. Any supply of services by the trustees must have been made in the course or furtherance of a taxable activity carried on by them. To

constitute a taxable activity the supply of services must be for a consideration. Thus the definition of that term, which imports the concept of the supply of services already discussed (and which I am assuming for present purposes to have occurred) requires the payment or other qualifying conduct to have been made or done “in respect of, in response to, or for the inducement of the supply of the services”. As Blanchard J has put it, there must be a sufficient nexus between the payment or other conduct relied on as consideration and the relevant services.

If one assumes, contrary to my earlier conclusion, that what the trustees did amounted to the supply of services to the Crown as settlor and/or to the Islanders as beneficiaries, it must also be shown that the payments by the Crown had a sufficient connection with those services to fulfil at least one limb of the statutory definition.

The money was not paid for any particular purpose, albeit that in terms of ordinary trustee law it had to be used within the terms of the Trust. **I therefore have difficulty in seeing how it can be said that the payments made by the Crown were in respect of or for the inducement of any services. Clearly the payments were not in response to the supply of services. With the use of the money not in any way related to any particular purpose mandated, except by the conventional requirement that the trustees should keep within broad and general powers vested in them by the Trust deed, I do not consider the relationship between the payment and the (assumed) services fulfils the definition of consideration.** As a consequence, the trustees did not make their (assumed) supply of services in the course or furtherance of a taxable activity. There is nothing I wish to add to what Blanchard J has said about s 5(6D). These are my reasons for agreeing that the appeal should be allowed with the consequences as to costs proposed in the judgment prepared by Blanchard J. (p 15,081) (emphasis added)

Also in the *Chatham Islands* case, Blanchard J stated:

The Trust is not making a supply of anything to the settlor in exchange for, or induced by, the payments; it is the recipient of an endowment to be held upon the terms of the deed. Nor can it, consistently with well established principles, be said that the Trust is performing services for its beneficiaries in return for a consideration provided by the settlor. It acts on their behalf and in their interests. They are benefited by its activities. **In the broadest sense, therefore, it may be said that because it serves their interests it is performing services for them. But there is no consideration passing to the Trust since the payments are not properly seen as an inducement. Without them, it is true, it would not have even come into existence. But in law they cannot be properly characterised as inducing its functions nor can it be said that what the Trust did with the money was a response to the payment. There is an absence of reciprocity in the relationship.** (p. 15,079) (emphasis added)

Again, as with the phrase “in respect of” the scope of the phrase “for the inducement of” has been defined by what it is not in the *Chathams* case. The payments made by the Crown were not for the inducement of any supplies as there was an absence of reciprocity between the parties.

*“In response to”*

Finally, the meaning of the term “in response to” is illustrated by the *Suzuki* case, where the Court of Appeal upheld the findings of McGechan J in the High Court. A series of documents were read as having the contractual intention of placing on one of the parties the obligation to perform repairs to vehicles under warranty, in return for an obligation by the other party to pay. The Court of Appeal stated:

The Judge was of the view that the payment made was in discharge of the SMC warranty, in the sense that SMC would not be paying it but for that warranty, “but it also is made in respect of the SNZ repair services rendered.” The SNZ repair service was thus an integral component of the situation and activity which brought about the SMC payment. That brought the supply within the GST Acts

definition of “consideration” for such a payment. **“There is a clear nexus. The payment, if not “in respect of” certainly was “in response to” those repair services.”** (p. 17,100) (emphasis added)

In the *Suzuki* case the payment in question was by the above statement impliedly within the scope of the definition of “in response to”, and as for the above cases, this was determined by reference to the existence of reciprocal obligations between the parties. The Court of Appeal upheld the High Court in all respects, and characterised the payments as consideration for the supply of a repair service by SNZ to SMC (and simultaneously via another warranty from SNZ to its customers) rather than consideration for the supply of repair services to customers. There was a contractual intention of the parties that SNZ would carry out the repairs under the SMC warranty, and that SMC would pay SNZ after these had been completed (p. 17,102).

The underlying obligation upon SMC to pay for the repairs represented the requisite reciprocal obligation (for the payment to be consideration), and this obligation to pay arose upon the occurrence of a contingent event (being the repair under warranty). The payments were “in response to” the repair of the cars, yet the service for which they were consideration was the supply of repair services from SNZ to SMC rather than the service of the actual repairs of the cars.

In addition, the *Suzuki* case is obliquely further support for the narrow view of the definition of the phrase “in respect of” (as requiring underlying reciprocal obligations between the parties in order for a payment to be consideration), adopted above. As the requisite reciprocal obligations were present between the parties, the Court of Appeal did not in detail consider the wording of the definition of consideration, nor the exact scope of each phrase within. They did however adopt the characterisation that the supplies were from SNZ to SMC, which is the adoption of a more narrow nexus between the payment and the supply. A broad definition of the term “in respect of” in this case would have been likely to characterise the payments as consideration in respect of the actual repair services.

### *Reciprocal obligations*

As GST is a tax on transactions, ultimately the commercial reality of a transaction will aid in determination of what is actually being supplied. Once the existence of a supply is established, the relationship between the parties needs to be evaluated. If the supply cannot be connected to the payment by enforceable reciprocal obligations it can not be said the payment is consideration for the supply. The payer and the supplier must have the ability to enforce the bargain for the transaction to have the reciprocity required to impose GST. *It is not necessary for there to be a contract between the parties, but reciprocity does require some type of enforceable reciprocal or two-sided relationship that links the payment to the supply.*

Other types of legal and enforceable obligations that are not contractual include: obligations enforceable in equity, such as an award of quantum meruit; and obligations that exist via operation of statute (eg under the Fair Trading Act 1986 – see examples below). Despite statements in cases such as *Shell New Zealand v CIR* (1994) 16 NZTC 11,303 that the term “in respect of” was a phrase of the widest import, the courts in recent years have consistently rejected tenuous linkages between payments and supplies, and have reinforced the requirement there must be enforceable reciprocity between the parties in regards to the degree of linkage required.

Examples where reciprocity was clearly held to be absent are the cases of *NZ Refining* and *Chatham Islands*.

In *NZ Refining*, the Crown could only cease payments if the conditions upon which to receive the payments were not fulfilled. Similarly, in the *Chatham Islands* case the Crown had no means of recourse if the Trust did not make any supplies, other than an action in equity against the trustees *based on their duties as trustees rather than on any equitable duties in relation to the payment from the Crown* (p. 15,079).

The Commissioner considers that the relatively recent rejection of broad linkages in the cases mentioned above and the consistent emphasis upon reciprocity, suggests the inclusion of the words “in respect of”, “in response to” or for the “inducement of” in the definition of consideration have a meaning by reference to the *time* at which the consideration passes. “In respect of” can be characterised as a contemporaneous situation where payment is given for a supply at the time of payment. “In response to” would include cases where a supply is received and later paid for, and “for the inducement of” would include cases where an enforceable supply or agreement for supply was tendered following an offer of payment for that supply.

The payments by the Crown in *NZ Refining* were not “in respect of” any supply by the refinery as there were no enforceable reciprocal obligations in return for payment. Similarly, in the *Chatham Islands* case the payments were not an inducement for any supply despite the fact that but for the payments the Chatham Islands Trust would not exist for the benefit of the Chatham Islanders. Finally, in the *Suzuki* case, the contractual obligations between the parties were the basis upon which the supply relationship was analysed, with the result that the supply was not of the end product of repair services, but was to Suzuki Japan (SMC) via the enforceable and reciprocal obligation for SMC to make payment *in response to* the contingent event of an actual repair under the SMC warranty.

Underpinning all transactions where a payment is within the definition of consideration for a supply is the requirement there are enforceable reciprocal obligations between the parties. Earlier cases such as *Databank* emphasised the broad nature of the definition yet more recently attempts to use a broad linkage have been rejected by the courts. All transactions where a payment is consideration for a supply must be based upon a platform of reciprocal obligations as noted in the cases above.

In order to determine when a payment is “sufficiently connected” to a supply to be consideration for that supply, the following principles can be drawn from the cases:

- It is the legal nature of the transaction that will define the nexus between the payment and any supply: *Chatham Islands Enterprise Trust*.
- For a payment to be consideration for a supply there must first be an identifiable supply: *NZ Refining* and *Chatham Islands Enterprise Trust*.
- The concept of supply is active; to supply is to furnish or provide: *Databank*.

- For a payment to be consideration there must be a sufficient connection between the payment and a supply of goods or services: *NZ Refining*.
- Tenuous or unrealistic connections between the payment and supply will not be sufficient: *Suzuki (HC)*.
- A sufficient connection involves legally enforceable reciprocal obligations between the payer and payee: *Chatham Islands Enterprise Trust, New Zealand Refining* and *Suzuki*.
- Conditions that must be fulfilled to receive payment do not, without more, evidence a supply: *NZ Refining*.
- An expectation that the recipient of the payment would carry out a certain activity is not enough for a payment to be in respect of or for the inducement of a supply. It is not sufficient that the person who receives the payment carries out some activity that has the effect of benefiting either the person making the payment or some other person. See *Chatham Islands Enterprise Trust*.
- A supply will only be liable to tax if it is made in the course or furtherance of a taxable activity: *Chatham Islands Enterprise Trust*.

### **Adjustments to consideration**

It is possible, where a payment is made as a result of a court award or an out of court settlement, that it will not be consideration for a supply but will be an adjustment to the previous consideration provided for a supply, such as a partial refund of the consideration for a supply.

Section 25 of the GSTA deals with situations where a supplier has either issued a tax invoice or furnished a return with the incorrect amount of output tax shown (section 25(1)(d) or section 25(1)(e)) due to subsequent changes to a taxable supply transaction. After specified adjustment events (section 25(1)(a) to 25(1)(c) inclusive) the supplier must issue a credit or debit note to the recipient of the supply and both parties (if registered) must adjust their output and input tax amounts where required.

Output tax is required to be charged upon the supply of goods or services in the course or furtherance of a taxable activity pursuant to section 8 GSTA. An invoice or tax return will only have been furnished where a taxable supply has already occurred or been agreed to, as for a supply to be taxable it must also be made for a consideration, or no tax is payable (section 10(19) GSTA).

In order to make an adjustment under section 25, one of the following must be satisfied:

- The supply has been cancelled, or
- The supply has been fundamentally varied or altered, or
- The previously agreed consideration has been altered, or

- The goods or part of those goods have been returned.

In order for section 25 to apply there must have been either a taxable supply, or an agreement for a taxable supply between the parties to the transaction, and the output tax must be either incorrectly provided for on the invoice, or incorrectly returned.

*(a) cancelled*

The meanings of “cancelled”, “fundamentally varied” and “altered” are not defined in the Act. The *Concise Oxford Dictionary* (9<sup>th</sup> ed, Clarendon Press, Oxford 1995) defines cancel as:

**cancel**.v 1 tr. **a** withdraw or revoke (*a previous arrangement*). **b** discontinue (*an arrangement in progress*).

The Commissioner considers the above definition of “cancel” (including discontinuance as well as withdrawal or revocation) can be appropriately applied to section 25(1)(a) as in the GST context the cancellation is of a supply, not a contract. Situations where a supply could no longer be performed would be within the above definition, even if the parties had not agreed to a formal contractual cancellation.

*(b) alteration of consideration*

Section 25(1)(b) applies where the previously agreed consideration is altered.

Consideration must already have passed or been agreed to for output tax on a taxable supply to require adjustment pursuant to section 25. As the courts have emphasised the need for reciprocity between the parties in order for a payment to be consideration for a supply, reciprocity must be established in order for the supply to be taxable. Once a supply is taxable, if the consideration has not passed, it will be due as a debt (being payment owing for a supply).

Looking at section 25 and the GSTA as a whole, the Commissioner considers that in order for the previously agreed consideration to be altered the parties or a court must actually alter the consideration; rather than an event having the economic effect of altering the price for a supply being included within the meaning of the subsection. Aside from the constant citation of the *Marac* case that the court must look into the legal arrangements actually entered into in determining liability to tax, this approach is consistent with the context of consideration in the GSTA which requires reciprocity in order for a payment to be linked to a supply. A payment that passes between parties (although nominally because of a supply) will not alter the consideration unless it involves reciprocity between the parties in regards to altering the consideration for the supply. Commonly this would occur by agreement of the parties, but it could also for example be imposed by Court order, or by a Commission of Inquiry (pursuant to section 15 Taxation Review Authorities Act 1994).

Support for the statement above is found in the judgment of the Court of Appeal in *Montgomerie v CIR* (2000) 19 NZTC 15,569. This case considered whether payments received by a liquidator of a company for transactions made void by the operation of section 292 of the Companies Act 1993 were alterations to consideration previously provided by the company for supplies it received. The High Court held that partial

recoveries were alterations to the consideration as part of the value provided by the company was returned. The Court of Appeal did not favour this analysis, and stated:

We are not attracted to the concept that a recovery in part only amounts in itself to alteration of consideration provided for in the underlying agreement in terms of s25(1)(b). **The contract price is not reduced merely because pursuant to Court order or agreement reached between liquidator and creditor the latter restores to the company all or part of the value received from the company during the “specified period” in s 292.** (p. 15,369) (emphasis added)

In *Montgomerie* the payments made by the creditor appear to have been viewed by the High Court as an alteration to the consideration. Yet whilst the transactions appear to have had the economic effect of reducing the contract price, the Court of Appeal pointed out that the payments were made owing to the provisions of the Companies Act, and this in itself did not mean there was an alteration of consideration for the previous supplies. The reasoning of the Court of Appeal is founded upon the principles behind consideration, including the requirement that there is reciprocity present within a transaction in order to link a payment to a supply. If as in the above case, a payment is made that is in some way connected to an original supply and has the appearance of reducing the consideration previously provided for that supply, it will not alter the consideration unless the parties to the transaction agree to do so. The payment made in the above case was as a result of a one-sided transaction as distinguished from one that is reciprocal; as the liquidator had a statutory right to void previous transactions and require payment from the creditors. Although the statute provided a link between the payment and the previous supply, the link was by reference to issues that were different to those that would reduce the contract price for the supply, and the Court of Appeal held accordingly.

*(aa) fundamentally varied or altered*

Section 25(1)(aa) was included in the Act by amendment in 1986 and states that an adjustment of output tax might be made if the nature of a supply has been fundamentally varied or altered.

There is a mention in the Public Information Bulletin #150, July 1986 regarding the introduction of the subsection:

Where goods are hired with an option to purchase within a set period the arrangement normally falls within the terms of the Hire Purchase Act 1971. The GST is therefore payable at the commencement of the hire. However, a potential anomaly existed where the option to buy was not taken up. *The agreement then would have become a mere agreement to hire and the wrong amount of output tax accounted for.* Section 25 as previously drafted did not provide scope for this. This amendment ensures that in the above situation and any similar circumstances an adjustment can be made. (emphasis added) The necessity for the amendment is illustrated by the hire purchase example given above. Changing the hire purchase agreement into a mere agreement to hire would not necessarily have the effect of altering the overall consideration. If the consideration was not altered, the (then) existing section 25(1)(b) could not be applied.

When a hire purchase agreement is entered into, GST on the whole supply amount is calculated at the beginning of the agreement (section 9(3)(b) GSTA as the supply is

deemed to take place at this time. Where the option to purchase is subsequently not exercised the nature of the supply is no longer that of a purchase, it is merely a hire with the GST payable in instalments (section 9(3)(a)), and the successive supplies are deemed to take place each time a payment becomes due or is received, whichever is the earlier. In a situation where a hire purchase agreement changes to become a mere agreement to hire, a supplier would be disadvantaged by having initially returned the full amount of tax on the transaction, instead of progressive returns of smaller tax amounts.

“Fundamental”, “vary” and “alter” are defined in the *Concise Oxford Dictionary* (10<sup>th</sup> ed, Oxford University Press, Oxford 1999) as:

**fundamental** *adj.* of or serving as a foundation or core; of central importance. *n.* **1** a central or primary rule or principle.

**vary** *v.* **1** differ in size, degree, or nature from something else of the same general class. **2** change from one form or state to another. Modify or change (something) to make it less uniform.

**alter** *v.* **1** change in character, appearance, direction, etc.

In order for GST consequences to arise in section 25, the amount of tax due and payable must alter in order for the invoice or return to be incorrect. (section 25(1)(d) and 25(1)(e)). The critical aspect of section 25(1)(aa) is that the alteration to the nature of the supply affects the tax amount payable in the period to which the invoice or return relates. Where an alteration to the nature of a supply had output tax implications it would often also involve an alteration to the consideration and thus be within subsection 25(1)(b), this would be the usual section applied where the nature of the supply changes. However, where timing or other issues arise as a result of a variation or alteration to the nature of a supply, and they are not within the scope of section 25(1)(b), subsection 25(1)(aa) can be applied.

### **Apportionment of a sum only partly consideration for a taxable supply.**

Section 10(18) of the GSTA states that where a taxable supply is not the only matter to which a payment relates, the supply shall be deemed to be for the part that is properly attributable to it.

*When can section 10(18) be applied?*

The term “properly attributable” is not defined in the Act.

“Properly” is defined in the *Concise Oxford Dictionary* (10<sup>th</sup> ed, Clarendon Press, Oxford 1995) as “correctly, suitably or completely”.

Section 10(1) of the GSTA states:

For the purposes of this Act the following provisions of this section shall apply for determining the value of any supply of goods and services.

Section 10(18) only applies where a *taxable* supply is not the only matter to which a consideration relates, so establishing that there is a taxable supply as well as something else for the consideration is a prerequisite to its application.

There have been no cases decided specifically pursuant to this section, however two cases have commented upon its application and scope: *CIR v Smiths City Group Limited* (1992) 14 NZTC 9,140 (HC) and *CIR v Coveney* (1994) 16 NZTC 11,328 (CA).

In the *Smiths City* case the taxpayer had purchased a commercial property which included an area of bare land. The purchase price was inclusive of GST, and the taxpayer accordingly sought a credit for input tax. The claim was disallowed by the Commissioner on the basis that the supply was one of a going concern and was accordingly zero-rated. The Taxation Review Authority held that two-thirds of the land represented the sale of a going concern and should be zero-rated, and the taxpayer was entitled to an input tax credit based on the amount of the purchase price that related to the bare land. The Commissioner appealed to the High Court where the appeal was dismissed.

In the High Court, Tipping J found a case for apportionment was made out under a different section of the Act. In regard to section 10(18) and apportionment of consideration he stated:

The framers of the Act have not incorporated any statutory definition of the expression “going concern”. Nor is there any statutory guidance, so far as I am aware, for when and how the apportionment exercise should take place.

The only assistance, on the material to which I was referred, seems to derive from section 10(18) which, as earlier noted, provides that where a taxable supply is not the only matter to which a consideration relates the supply shall be deemed to be for such part of the consideration as is properly attributable to it. That of course relates to the distinction between a supply which is taxable and one which is not. It would seem logical however to apply the same approach to a supply which is in part liable for tax and is in part zero-rated. (p. 9,144)

The comments above might be taken to suggest that a single consideration must relate to a taxable supply and a non taxable supply, however it was recognised in *Coveney* that part of a consideration could relate to some other matter without being restricted only to non taxable *supplies*. In *Coveney* the application to allow apportionment of items that comprised part of one supply was rejected. This case concerned the Commissioner’s attempt to disallow part of an input deduction for the purchase of a farm property, on the basis that the transaction involved two supplies – one of the farm and one of the domestic dwelling on the farm.

In the High Court, Fraser J concluded there was only a single supply, and that section 10(18) can only apply where a single consideration relates to more than a single taxable supply. This ruling was upheld by the Court of Appeal, where Richardson J stated in regard to section 10(18):

The provision applies where, and only where, “the supply is not the only matter to which the consideration relates”. To come within the proviso it is necessary to identify a matter, other than the supply in question, to which the consideration relates. Thus on the supply of land with late settlement,

the consideration may contain an interest equivalent component which may fairly be described as a second matter to which the consideration relates.

Section 10(18) applies in order to apportion the part of the consideration that is for the taxable supply. As section 10 GSTA as a whole deals with valuation of supplies, the inclusion of the words “properly attributable” in section 10(18) suggest the valuation of the supply is the amount of consideration that would suitably or correctly be provided for the supply in isolation, taking into account the overall consideration provided and if necessary, pro-rating the various amounts.

### **Application of section 20A of the GSTA**

Section 20A(2) of the GSTA allows a taxpayer to claim an input tax deduction for GST incurred on goods and services acquired for determining liability to tax, by operating as a deeming provision and deeming these goods and services as being acquired for the “principle purpose of making taxable supplies”.

Where a taxpayer receives any recovery or reimbursement of costs incurred in determining liability to tax (such as an award of costs in a successful appeal to the TRA), section 20A(4) operates to *deem* the receipt of the award to be in return for taxable supplies, and requires the taxpayer receiving the award to account for output tax. Such awards or payments are not within the scope of this statement, as the focus of this provision is upon the recovery or award of costs incurred in determining liability to tax rather than awards in settlement of disputes.

### **TAX TREATMENT OF COURT AWARDS AND OUT OF COURT SETTLEMENT**

When a court award is made it is likely that a wrongful act will be involved at some stage of the dispute. However owing to the emphasis placed in the *NZ Refining* and *Chathams* cases upon reciprocity and the requirement that a payment must be for a supply, the Commissioner considers that the appropriate focus is whether the award is payment for any supply that has been made, and not the action that gave rise to the award. In order to identify potential GST consequences, every transaction must always be analysed upon its individual facts and will involve the application of GST principles relating to supply and consideration.

As the degree of linkage identified above is narrower than in the previous statement for a payment to be consideration for a supply, a broad classification of classes of transactions in the awards and settlement context will be attempted below, rather than stating only that GST principles must be applied to the facts of each transaction. Whilst every transaction must always be analysed upon its individual facts the exercise will involve the application of *principles* relating to supply and consideration, which have become increasingly conceptual in regards to reciprocity and the required link between supply and consideration. When a payment is made under a court award or out of court settlement and it is consideration for a taxable supply (or an adjustment to a consideration for a taxable supply) this will be taxable. If the payment is made for compensation or damages it is not taxable.

## **Court awards, remedies and GST liability**

For the purposes of this statement, the term “court awards” refers to all awards made by a binding decision of a third party, including awards of the courts, awards made by tribunals and settlements reached in binding arbitration, that are *not* within the scope of section 20A(4) GSTA. Where the parties themselves agree on the nature of a settlement, including via mediation or at the invitation of a court, and these are not within the scope of section 20A(4) GSTA, they are referred to in this report as “out of court settlements”. The same GST principles will apply in an analysis of any settlement transaction, whether it is the result of a court award or an out of court settlement.

Courts have powers to grant relief pursuant to statute as well as common law. A dispute might result in a number of potential claims and different remedies being available for a party to pursue. The nature of any court awarded payment will be influenced by the claim that is made by the recipient, and determined by the type of remedial award the court makes if the claim is made out.

Statutory provisions can provide specific remedies, in addition to preserving the right of a party to receive a common law measure of damages. For example, where a trader has received goods of a lesser quality than they contracted for, they can either claim at common law for damages to be awarded in compensation for the loss they have suffered (relative to the value of the supply), or claim the goods had a “lack of merchantable quality” pursuant to section 43(2) of the Fair Trading Act 1986 (“FTA”). Under the statutory provision, the court can make a specific order to vary or adjust the consideration or order the supplier to refund the purchase price. It is the legal nature of the court award, rather than the economic effect that is the basis for an analysis of reciprocal relations between the parties in regards to the payment and therefore liability to GST.

### Example

An Italian chef purchases an expensive pot for \$500, which the retailer claims is of commercial quality and therefore suitable for high use situations such as commercial catering operations.

The large pot is used on three occasions. On the occasion of its fourth use one of the handles breaks.

The chef is unsuccessful in his attempts to persuade the retailer to replace the pot, as there are no longer any available. Additionally, the retailer refuses to refund the purchase price, owing to its policy only to offer refunds on unused goods.

### *Scenario #1*

The chef brings the case to court, claiming general damages, as he has suffered a loss in receiving goods of lesser quality than he paid for. The judge agrees, and orders the retailer to pay the chef \$300.

- The \$300 is compensation for the chef's loss in receiving goods of poor quality. As the payment is for a loss, the GST consequences are nil.

### *Scenario #2*

The chef brings the case to court, claiming that pursuant to section 43(2) of the FTA, the pot had a "lack of merchantable quality" as the handles were not secured by rivets. The judge agrees, and pursuant to section 43(2) of the FTA orders the retailer to refund \$300 to the Chef.

- The \$300 is a refund of the purchase price owing to the *specific order* of the court. The retailer will need to make a GST adjustment pursuant to section 25 of the GSTA if output tax was paid prior to the time the refund is ordered by the court. The chef (if a registered person) is also required to make an adjustment to their GST return.

Whilst damages for loss appear to have the same economic effect as a variation of the purchase price, the two awards above give rise to different treatment for GST purposes. Where damages are awarded for a loss, the nexus of the payment for GST purposes is with the loss, rather than the supply that gave rise to the damages claim. Where a refund of the purchase price is ordered this will give rise to an adjustment for GST purposes regardless of whether the goods are returned to the supplier.

### *Debts and adjustments to consideration*

If a judgment debt is received that is payment for a previous supply, that payment is consideration for that supply and not a new supply. Even in situations where liability is unclear, where a judgement debt is ordered paid by the court the court is recognising the existence of reciprocal obligations between the parties. By virtue of judgment being ordered the payment is linked to the supply and the requisite element of reciprocity is present. Therefore, the payment will be consideration for the earlier supply. If the supplier accounts for GST on an invoice basis, receipt of the payment will not trigger any GST implications as the GST will have been returned following the issue of the invoice. If the supplier accounts for GST on a payments (cash) basis, receipt of the judgment sum will trigger liability for GST on the original supply.

### Example

B responds to an advertisement offering a 30 day free trial of a new stereo costing \$500, and places an order with A. (A, a mail order retailer, accounts for GST on a payments basis.) B understands that if she retains the stereo after 30 days then she has accepted A's offer to sell it, and B must then make payment of \$500 to A.

As A is overly trusting, he does not require any credit card details or cash bonds before sending any goods to potential purchasers.

A sends the goods to B, and the 30 day period passes (indicating that the offer to sell is accepted). A receives no payment from B, and is unsuccessful in his attempts to contact her or collect the money owing.

A brings the case to court, seeking judgment for the \$500 owing. The court duly enters judgment for the sum requested. B pays on the day the judgment is entered.

- The \$500 is consideration for the supply of the stereo. As A accounts for GST on a payments basis, he has not returned GST on the supply of the stereo prior to the award of the judgment sum by the Court. Once B pays A, GST liability is triggered, and A must return the GST on the \$500.
- If instead, A accounted for GST on an invoice basis, and issued an invoice to B at the time the purchase became finalised (ie, after the 30 day period elapsed), the GST would have been returned under the normal time of supply rules. The subsequent judgment and payment of the \$500 would not have any new GST consequences.

#### *Awards in restitution*

Where restitution is received by a party that made a supply (and the supply was made in the course or furtherance of a taxable activity) the payment will be consideration for a supply. The legal nature of the transaction will be that the court is recognising obligations exist between the parties. For example, an award for quantum meruit can be made where the recipient has provided something for the payer's benefit, but where there is no contractual remedy for them to pursue in order to receive payment.

“Quantum meruit is the generic term used to identify a right to a reasonable remuneration for goods supplied or services rendered; the same expression is used irrespective of whether the right to remuneration is an incident attached by implication to a contractual relationship or whether it arises independently of contract in one of the assortment of situations which are classified, for lack of a better term, as quasi-contractual”. (per Prichard J, *Seton Contracting Ltd v Attorney-General* [1982] 2 NZLR 368,376.

Often an award of this nature is made where a contract is silent as to the price of goods or services, where there has been a supply of something upon the assumption that a contract would eventuate.

The above analysis might seem inconsistent with one of the principles drawn from the *Chatham Islands* case noted above, which states that:

An expectation that the recipient of the payment would carry out a certain activity is not enough. It is not sufficient that the person who receives the payment carries out some activity that has the effect of benefiting either the person making the payment or some other person.

This statement however refers to a situation where a payment is made, but in return the existence of any potential supply is unclear and uncertain. Where a payment is made but any supply is uncertain there are problems in identifying liability to GST and therefore collecting GST. Therefore the statutory focus is on supplies and not payments, as was identified in *Databank*. Awards of quantum meruit are made where something of value has been provided by one party, and there is an inability to enforce payment for this owing to a lack of formal contractual relations. Where an award is made for quantum meruit the payment awarded will be consideration for a supply made by the other party.

### Example

A Ltd hears B Ltd is looking for new office accommodation, and puts together a proposal whereby A Ltd will purchase a site, and design and build office space to B Ltd's requirements. B Ltd chooses the site, and informs A Ltd that its directors have approved A Ltd's proposal. B Ltd requests A Ltd proceed rapidly as the timing of the completion of the building is important.

A Ltd purchases an option to buy the site chosen by B Ltd, and starts work immediately. Ten days later B Ltd informs A Ltd they wish to proceed with an alternative site. Meanwhile the option to purchase the site expires.

Despite not having a contract with B Ltd, A Ltd claims in court for the cost of the work performed for B Ltd up to the time of B Ltd's advice regarding the alternative site. The court holds that despite the absence of a concluded contract, A Ltd proceeded upon the representation of B Ltd, and is entitled to judgment for its normal charge out rates.

- The judgment sum is consideration for the supply of services by A Ltd to B Ltd.

If a supply is made for consideration then GST is payable. In the above example the recipient of the award had made a supply for which the payer was liable. Rather than in the *Chatham Islands* case, where any supply was uncertain following payment, in this example the supply is certain and has occurred in order for the supplier to receive a court awarded payment, as the award can only be made retrospectively. The concept of consideration in the GSTA does not require the existence of a contract (see principles above). The court's action links the (eventual) payment of the award to the supply and the requisite element of reciprocity for a payment to be consideration is present. The payment is thus consideration for a supply, which will be taxable if made in the course or furtherance of a taxable activity.

Using the fact situation in the above example, if A Ltd had merely heard B Ltd required the office space, and proceeded having had no communication with B Ltd regarding its proposed requirements, a court would be unlikely to order an award based on quantum meruit as the work could not fairly be said to be at B Ltd's request. In this situation there is no supply from A Ltd to B Ltd, as there is an absence of reciprocity.

### *Payment awarded for continuing wrong*

Under section 16A of the Judicature Act 1908, a court can award prospective damages for a continuing wrong, instead of granting an injunction or specific performance.

### Example

A council constructs a sewer pipe on private property without permission of the owners. The owners take the case to court and request the removal of the pipe.

The court refuses to order removal of the pipe but exercises its power under section 16A of the Judicature Act 1908, and awards the owners a sum based on the amount they could reasonably expect if the council had agreed to pay for the use of the land.

- The payment by the council to the owners is a payment of damages and is not consideration for any supply.

It might be argued that the award in the above example is consideration for a supply, as it is for the use of the land. However, the damages are in lieu of the court's refusal to enforce the plaintiff's rights via an injunction. On the basis of the *Databank* characterisation of a supply as being something that is "furnish[ed] or provid[ed]" there cannot have been a supply in the above case. The court did not require the plaintiffs to make any supply to the defendant, only that they accepted payment in return for non-enforcement of their property rights. Neither the plaintiffs (nor the court on their behalf) have furnished or provided anything to the defendant. What has occurred is that the court has declined to enforce the plaintiffs' property rights, and the payment merely has a nexus with the continuing trespass.

#### *Awards in respect of loss (compensatory damages)*

The basic principle that governs compensatory damages was stated by Cooke P in *Gardiner v Metcalfe* [1994] 2 NZLR 8 (CA):

In general terms there can be no doubt that, as was said in the High Court of Australia in *Haines v Bendall* (1991) 172 CLR 60,63:

"The settled principle governing the assessment of compensatory damages, whether in actions of tort or contract, is that the injured party should receive compensation in a sum which, so far as money can do, will put that party in the same position as he or she would have been in if the contract had been performed or the tort had not been committed..."

Compensatory damages are awarded for loss, however the label attached to a payment is not determinative of its nature in terms of liability to GST, as the Act imposes a tax upon goods and services supplied rather than payments received.

Where compensatory damages are awarded for a loss, reciprocity will be absent from the transaction. Unlike situations where the payer has gained something at the expense of the recipient, where loss is the basis for an award the recipient can not be said to have supplied anything to the payer in return for the payment. The payer's causation of the loss gives rise to liability to make payment, but the basis for the other party's receipt of payment is the fact they have suffered loss rather than made any supply. It is the legal nature of a transaction not its economic effect that determines liability to tax (*Marac Life Assurance Ltd v CIR* [1986] 1 NZLR 694 at 706). The payment cannot be consideration for a supply if it is not reciprocal to the supply of *something* by the other party.

An award for a loss arising from an earlier supply may appear to be an adjustment to consideration. However whilst the calculation of a compensatory award might induce this appearance it will not affect the legal nature of the award. In *Coxhead v Newmans Tours Ltd* (1993) 6 TCLR 1 (CA) it was said that:

...at common law the purchaser could not recover the purchase price except on a total failure of consideration as money had and received. **The ordinary remedy at common law is not the return of a proportion of the purchase price, but damages to compensate the innocent party for the wrong which he has suffered.** Where that wrong is the breach of a contract, his loss is measured by the amount which would put him as far as practicable in the position he would have been in if the contract had been performed. If the breach is the failure to complete the sale of a business, then the purchaser has lost the value of the business, which may be greater or less than the agreed purchase price. (p. 12) (emphasis added)

In the *Montgomerie* case the distinction between the effect of an award or settlement and its legal nature (upon which liability to tax rests) was emphasised. The court stated:

We are not attracted to the concept that a recovery in part only amounts in itself to alteration of consideration provided for in the underlying agreement in terms of s 25(1)(b). **The contract price is not reduced merely because pursuant to Court order or agreement reached between liquidator and creditor the latter restores to the company all or part of the value received from the company during the “specified period” in s 292.** (p. 15,369) (emphasis added)

*Case S77* (1996) 17 NZTC 7,483 specifically considered the issue whether an amount received for damages could be consideration for any supply subject to GST. The taxpayers were a farming couple registered for GST. A fire they lit on their farm spread to the neighbouring farm and caused substantial damage, leading to allegations of negligence which resulted in an out of court settlement. The taxpayers sought an input tax credit on the amount they paid and this was disallowed by the Commissioner on the basis that the recipient of the payment had made no taxable supplies in return. Barber DJ held that the transaction did not involve the supply of any goods and services to the taxpayers, as the payment was made on account of a loss:

While I find that the L partners issued the court proceedings in the course of their taxable activity as agricultural contractors, they have merely received payment of a liability of and from the objectors. The L partners made no supply in return for the payment. They merely received a debt due to them in recompense for the loss they suffered from the fire for which the objectors were responsible.

*Case S77* emphasised the importance of the distinction between payments and receipts made in the course of a taxable activity and the requirement these are linked to supplies in order for GST liability to arise. Loss may be suffered in connection with a supply. Where payments are compensatory, and relate to loss, the nexus is with the loss, rather than the supply that caused the loss.

### Example

A Ltd sells trucks with freezer units on board. B Ltd, an expanding icecream company purchases a truck for \$100,000 so it can deliver its own outgoing orders of icecream, and pays \$75,000, with the remaining \$25,000 due in one month.

The truck is delivered and functions well for two weeks as B Ltd transports icecream from its factory in Invercargill to retailers in Christchurch. One day however, the truck driver arrives in Christchurch to find the entire consignment melted. Upon investigation, the freezer unit on the truck is found to be faulty.

B Ltd takes A Ltd to court claiming \$20,000 for the loss of the icecream, and a further \$10,000 for inconvenience and loss of trade associated with the breakdown. The judge awards the full amount claimed as well as ordering A Ltd to remedy the freezer fault at its own cost.

As B Ltd had a payment arrangement with A Ltd for the purchase price of the truck, B Ltd still owes A Ltd \$25,000. A Ltd proposes to set off the \$30,000 award of the court against the balance owed by B Ltd on the truck. B Ltd agrees, and receives the difference of \$5,000 in cash.

- The entire award is for the loss B Ltd has suffered, and is not consideration for any supplies it has made.
- The set off of \$25,000 against the amount owing for the truck does not affect the amount of consideration provided for the truck. The set off has the same effect as if A Ltd paid B Ltd \$30,000, and B Ltd then in return paid A Ltd the \$25,000 owing on the truck, and thus the consideration for the supply of the truck is \$100,000.

Applying GST principles, awards made for a loss must be contrasted from reciprocal awards where the payer (or a third party) has gained something as a result of the recipient's actions and is making the payment in return. Reciprocity is absent where a payment is for loss even if the loss is directly attributable to an earlier supply, as the nature of the payment is that it is for the loss rather than the supply. If a payment is received for a loss the payment will be compensatory and outside the scope of GST.

### **GST treatment of out of court settlements**

As for court awards, where a payment is for loss or damage it will not be consideration for a supply and there will be no element of reciprocity between the parties in regards to the payment; rather the payment is to compensate one party for the loss caused by the wrongful act of the other. The following section provides examples of out of court settlements that may or may not give rise to GST consequences, rather than providing a conclusive guide to categories of settlement giving rise to GST liability.

#### *Where earlier supplies have been made*

If a debt is recovered that is payment for a previous taxable supply, that payment is consideration for the supply.

#### Example

A shop sells groceries to a customer and accepts a cheque for \$100 in payment. The shop returns GST on an invoice basis. Five days later it is informed that the cheque has been dishonoured.

The shop engages the services of a debt collection company, which some weeks later collects the sum of \$110 (including a debt collection fee) in cash from the customer. \$100 is passed on to the supermarket, and the agency keeps \$10 as its fee.

- As the shop has already returned GST after receiving the cheque, there are no additional GST consequences in regards to the \$100. The shop is merely collecting the consideration for the original supply.
- The debt collection company must return GST on the \$10 it has charged for the supply of services it has made to the supermarket, for which the defaulting customer has paid. The supply by the debt collection company to the shop is not an exempt supply of a “financial service” as debt collection services are expressly excluded from the definition of “financial service” pursuant to section 3(4)(b) GSTA.

### *Adjustments to GST*

If an earlier taxable supply has been made, and the nature of that supply has been fundamentally altered or cancelled, or the consideration for that supply has been adjusted, section 25 will apply.

### Example

A purchases a kilo of roasted coffee beans from B for \$50. The coffee was advertised as being “premium quality”, however when A opens the bag one week later he can see the beans are clearly of a cheap and inferior quality. Outraged, A returns to B’s roastery, and demands that B refund the difference in price between what he paid for and what he actually received.

B apologises profusely, explaining that a mistake in labelling the coffee must have occurred. B agrees to refund \$25, which is the difference in price between the two grades of beans.

- The original consideration for the coffee (\$50) has been varied as a result of the partial refund B has given to A. The variation is because the parties agreed to a partial refund, not because the amount B paid to A represented the difference in price between the goods. (It is the legal nature of the transaction that will determine liability to tax, not its economic consequences.)

If GST has already been returned on the \$50, B will need to make a GST adjustment and issue a credit note to correct the original tax invoice issued. The result of the above refund means the consideration for the original supply of the coffee has been *varied*, and is in fact \$25, meaning that B will have returned too much output tax. B will be able to claim a credit for the amount of tax already returned that corresponds to the refund given to A. If B did not issue a tax invoice at the time of the original supply (and has not returned GST on the value of the original consideration) he will not need to make a GST adjustment. B will return output tax on the \$25 sale that is the ultimate result of the above transaction.

### Example

A purchases B's truck for \$10,000 plus GST. Only B is GST registered. B provides A with a tax invoice, and A takes possession of the truck. B returns GST on the supply of the truck.

A does not register the change of ownership papers immediately. Two weeks later A finds the truck has disappeared from its usual parking spot, and after making inquiries finds out that it has been repossessed. A discovers that 5 days after she purchased the truck B's bank had served B with papers to exercise its rights as holder of a registered security interest in the truck to repossess it for B's non payment of its business loan.

Rather than waste time arguing in court over ownership of the truck, A accepts a refund from B of the \$10,000 plus GST paid for the truck (which is now in the possession and ownership of the bank).

- The original supply of the truck has been cancelled and section 25(1)(a) GSTA will apply. As B has already furnished a return for \$1,250 (being the GST portion of the \$10,000), a tax adjustment is necessary. B must issue a credit note to correct the tax invoice originally issued. Pursuant to section 25(2)(b) (and under section 20(3) of the GSTA), B can make a corresponding deduction of input tax to the value of \$1,250.

*Payment connected to a unilateral action – eg termination of a contract where there is no “right” to terminate*

Where one party terminates an ongoing supply contract without a right to terminate or the agreement of the other party, any settlement sum in respect of this action will be outside the scope of GST. This is because the party receiving payment is being compensated for the wrongful or unilateral act of the other party, and has made no supply in return. An example of such a payment was in *NZ Refining*, where the Crown removed various concessions enjoyed by *NZ Refining* unilaterally, without needing the agreement of *NZ Refining*. As no supply was made in return the payment from the Crown to *NZ Refining* was compensatory and no GST liability attached. GST liability for supplies made for consideration up to the point of termination will not be affected, owing to the timing of supply for GST purposes being set at the time payment is received or an invoice provided (section 9).

### Example

A has a 5 year, five million dollar contract with B, to make regular supplies of a fixed number of items. The contract runs smoothly for 3 years, when all of a sudden B informs A it is no longer willing to accept the contracted supply.

As the contract is extremely valuable to the ongoing viability of A's business, A informs B it will pursue its contractual rights to the fullest extent of the law.

B still refuses to perform its side of the contract in accepting the items, and A files a claim in court for two million dollars.

B decides that it would be sensible to offer a compromise sum as an out of court settlement, offering A \$1,500,000 to avoid the court case. A accepts.

- The payment is not made for any supplies and is therefore not consideration. The payment is made to compensate A for the wrongful act of B in refusing to be bound by the contract.

#### *Termination or modification of contract by agreement*

Where there is no provision in the contract to alter or terminate, and the parties reach agreement to do so, this will be a supply for consideration if payment is made. The passage of rights and obligations in this situation will constitute a supply of services for GST purposes. The requirements from *NZ Refining* and *Chatham Islands* that there are reciprocal obligations and a nexus between the payment and supply are met in this case; as the payment is given in return for the agreement to alter or release from the contract.

#### Example

A has a 5 year, five million dollar contract with B to make regular supplies of items. After 3 years, B no longer wishes to receive these supplies, and contacts A in order to negotiate an early termination to the contract.

A informs B that it will terminate the contract in return for a one-off payment of \$1,000,000. B agrees, and makes payment.

- The payment is consideration for A's supply of a service to B – being the early release from a fixed term contract – and is subject to GST.

#### *Where there has been no supply*

For a supply to take place, something of value must be “furnish[ed] or provide[d]” (*Databank*). The supply must additionally involve enforceable reciprocal obligations (*Chatham Islands*). If something has been used, but there was no agreement for its supply between the relevant parties, any payment subsequently received by the aggrieved party is not consideration for the supply. The receipt of payment does not involve any reciprocal obligations between the parties, and cannot be retrospectively linked to there having been a “supply” for GST purposes. Any payment received relating to a previous use of an item where there has been no agreement to supply will be by nature compensatory, and thus outside the scope of GST. (eg, of theft and wrongful use of trade name)

#### *Agreement to allow an act in the future*

Where agreement is reached that payment will be given in return for one party's forbearance in relation to the future conduct of another party, the payment will be consideration for the supply of a right or obligation provided the agreement is binding and enforceable, rather than a mere understanding or assumption. (*NZ Refining, Chatham Islands*)

## Example

A is a manufacturer and has a patent for a lucrative product. For three years business is booming, with global exports increasing every year. However, in the subsequent two years business suddenly drops, and export volumes are only 20% of the earlier totals.

A finds out from a local contact that for the past two years another company B has been using the technology patented by A to create and sell an almost identical product. A is provided with ample evidence of the unauthorised use of the patent, and approaches B, informing B that a court case is imminent.

B accepts that it has made wrongful use of the patent, and offers \$100,000 as compensation to A. A accepts the compensation offered and makes an offer to B to sell it the patent rights in return for an additional \$50,000. B accepts and makes payment.

- The \$100,000 is not consideration for any supply – rather it is to compensate A for B’s wrongful use of the patent. The \$50,000 however, is consideration for the supply of the patent rights by A to B and A must return output tax, with B entitled to claim a corresponding input tax deduction.

### *Forbearance to sue as part of an out of court settlement*

A settlement including payment for loss caused by an earlier supply might include a clause where the recipient of the payment accepts “full and final payment”, and forbears to sue in future. Forbearances are explicitly mentioned as satisfying the definition of “consideration” in section 2 GSTA.

The principles identified above that relate to supply and consideration illustrate that a nexus in the form of reciprocal obligations is required in order for a payment to be consideration for GST purposes. The *Databank* case stated that to supply is to “furnish or provide”, and the definition of services in section 2 GSTA is “anything that is not goods or money”. Forbearance to sue would thus appear to be *capable* of being a supply of a service within the GST definition, regardless of whether it is seen as the giving up of a “right” or the provision of something of value to the other party (being a service). If supply of forbearance to sue is the supply of a service, it will only be taxable if it is made in the course or furtherance of a taxable activity, and is given in return for consideration.

Where a forbearance to sue is undertaken there will usually be an underlying dispute in settlement of which the payment is made, and any GST inquiry will commence with a determination of what the payment is for. The usual result will be that the payment is for something other than the forbearance, and the forbearance is merely a mechanism to ensure finality in the dispute. Whilst the forbearance is *capable* of being a supply for GST purposes, in such cases it might fairly be said it is given for no *consideration*. Accordingly, in the majority of cases there will not be a separate and ascribable value attached to a forbearance to sue, and it will not be given in return for any consideration as the payment will not be linked to the forbearance, but some other issue such as a loss or damage. If however, one party to the dispute is making

an identifiable payment that is reciprocal and directly linked to the obligation of forbearing to sue, the payment will be consideration for the supply of forbearance and will be taxable (provided the supply is made in the course or furtherance of a taxable activity (section 8 GSTA)).

### Example

A and B are both GST registered. A causes B to lose thousands of dollars as a direct result of B relying upon A's negligent business advice. B believes he has a solid case to take to court, but is persuaded by A to settle out of court as A wishes to avoid adverse publicity.

### *Scenario #1*

The parties settle the claim for loss for \$10,000, and the settlement agreement includes a clause whereby B accepts the sum in "full and final settlement" of his claim against A.

- The GST consequences of the payment for loss are nil. The agreement not to sue is merely a mechanism in order for A to ensure finality in the dispute, and does not have a separately attributable sum ascribed to it.

### *Scenario #2*

The parties settle the claim for loss for \$10,000, with an additional payment of \$5,000 by A to B in order for B undertaking to refrain from pursuing his claim by bringing the matter before the courts, as A believes his reputation would be seriously damaged by the resulting publicity.

- The GST consequences of the payment for loss are nil. The payment of \$10,000 is not payment for any supply.
- GST consequences do arise as a result of the \$5,000 payment as the payment is clearly made by A in return for the enforceable obligation undertaken by B in his agreement not to sue A. The payment is consideration for a taxable supply by B as B is accepting payment in the course of his taxable business activity. B must accordingly return output tax of \$650, and A will be able to claim an input tax deduction pursuant to section 20(3).

### *Overseas treatment - Australia*

The ATO have recently issued a ruling on the GST treatment of court orders and out of court settlements. The ruling does not distinguish between court awards and out of court settlements for the purpose of liability to GST. Payments made pursuant to either a court order or out of court settlement are characterised in the ruling as relating to either "Earlier supplies", "Current supplies" or "Discontinuance supplies". These categories recognise that an award or settlement might relate to an earlier supply, be for a supply made as a result of the award or settlement, or be a payment made in return for refraining from doing something. As is the case in New Zealand, where a

payment is compensatory (eg. for a loss suffered) it will not be for any supply and will not attract GST in Australia.

The Australian ruling however, differs from this Interpretation Statement in regard to the degree of linkage required for a payment to be consideration for a supply. The recent introduction of GST in Australia means there is little judicial guidance in regards to the degree of connection required for a payment to be consideration for a supply. Whilst the Australian statutory scheme is similar to the NZ Act there is a degree of difference between the two interpretations of the relevant statutory definition of “consideration”. The Australian Act uses the phrase “in connection with” (in regard to the link between a payment and a supply), which differs from the New Zealand wording “in respect of”.

The words “in connection with” have been interpreted in the Australian ruling as having the same meaning as in *Berry v FCT* (1953) 89 CLR 653. This case considered the meaning of “in connection with” in the context of a provision in the Income Tax Act 1936, which considered consideration “for or in connection with goodwill in a lease premium”. Kitto J held that consideration will be “in connection with” property where “*the receipt of the payment has a substantial relation, in a practical business sense, to that property*” (at p. 659).

Recent judicial direction in New Zealand diverges somewhat from the Australian interpretive position in this regard, due to an emphasis upon the concept of reciprocal obligations between parties being evidence of a sufficient connection between a payment and a supply. In particular, the *NZ Refining* and *Chatham Islands* cases suggest that this approach should be followed in New Zealand.

### *Conclusions*

A court award in relation to a claim that relates to an earlier supply or alleged supply will give rise to GST consequences where it is payment *for* that supply and therefore “consideration”. It has also been concluded that in most cases forbearance to sue will not be given for any consideration. However it has been concluded that forbearance to sue is capable of being a supply if it is given pursuant to a binding obligation, and that a payment will be capable of being consideration for this supply if it has the requisite linkage and a clear value ascribed to it.

Examples where a payment will be consideration include an award at common law in quantum meruit, and orders made pursuant to statutory authority for a variation, adjustment or refund of consideration. Awards of the court that have a nexus to something other than a taxable supply, such as loss caused by a taxable supply or negligence, will not attract GST liability as they will not be consideration for any supplies.

In an out of court settlement the legal nature of the settlement and what the parties have agreed will provide the basis on which to identify any reciprocal obligations and determine liability to GST. Where a decision is made by the court the relevant reciprocal obligations will be those that arise as a result of the judgment of the court. The remedy itself will be determinative of the nature of the transaction rather than the

cause of action upon which it is awarded, as a court may have a number of potential remedies at their disposal for one cause of action.

Finally, where a number of disputes between the parties give rise to the set off of monies owing between the parties, there is no change to consideration. Set off can only occur after any liability between the parties has been quantified, meaning the value of any consideration and the GST portion will not change, rather the actual amount of money that is received will differ.