

GST – Deemed consideration for taxable supply

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TDS 22/03

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Subjects | Ngā kaupapa

GST: Deemed consideration for taxable supply

Abbreviations | Whakapotonga kupu

The abbreviations used in this document include:

CCS	Customer & Compliance Services of Inland Revenue
Commissioner	Commissioner of Inland Revenue
GST	Goods and services tax
GST Act	Goods and Services Tax Act 1985

Taxation laws | Ngā ture tāke

All legislative references are to the Goods and Services Tax Act 1985 (GST Act) unless otherwise stated.

Facts | Ngā meka

1. The Taxpayer is an incorporated company and is registered for GST. The Taxpayer has one director.
2. The Taxpayer and its director were involved in a negligence claim against their former solicitors.
3. The former solicitors held an indemnity policy with an insurance company. In accordance with that policy, the insurance company made a payment to the trust account of the Taxpayer's current solicitors. The payment reflected part payment of an order for damages made by the High Court. The Taxpayer was the ultimate recipient of the payment.
4. The premiums paid under the contract of insurance between the Taxpayer's former solicitors and the insurance company were charged with GST.
5. The insurance company claimed an input tax deduction in respect of the payment it made to the Taxpayer.

6. The Taxpayer claimed GST input tax deductions for the legal costs incurred in pursuing the negligence claim and damages from the Taxpayer's former solicitors.
7. The Taxpayer did not return any GST output tax in respect of the payment it ultimately received from the insurance company.
8. A time bar waiver was agreed between CCS and the Taxpayer for one year.

Issues | Ngā take

9. The issues considered in this dispute were:
 - whether the Taxpayer received the payment under a contract of insurance for the purposes of s 5(13);
 - if it is determined that s 5(13) does apply, whether the supply is standard rated or zero-rated under s 11(1)(mb);
 - if it is determined that s 5(13) does not apply, whether a consequential adjustment is required to disallow the input tax deductions claimed.
10. There was also a preliminary issue on the onus and standard of proof.

Decisions | Ngā whakatauranga

11. The Tax Counsel Office decided that:
 - The payment received by the Taxpayer is deemed to be consideration for a taxable supply under s 5(13). The Taxpayer is therefore liable for GST on the payment.
 - The supply is standard rated, and GST is payable at 15%.

Reasons for decisions | Ngā take mō ngā whakatau

Preliminary issue | Take tōmua: Onus and standard of proof

12. The onus of proof in civil proceedings¹ is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.² The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.³
13. The standard of proof in civil proceedings is the balance of probabilities.⁴ This standard is met if it is proved that a matter is more probable than not. Whether the Taxpayer has discharged the onus of proof is considered in the relevant issues.

Issue 1 | Take tuatahi: Does s 5(13) apply?

14. The issue is whether the Taxpayer received the payment under a contract of insurance for the purposes of s 5(13). Section 5(13) applies to deem a payment to be consideration for a taxable supply, and thus liable for GST, where the payment is received:
 - by a registered person;
 - under a contract of insurance (whether or not the person is party to the contract); and
 - in relation to a loss incurred in the course or furtherance of their taxable activity.
15. Where a registered person is deemed to have received consideration for a taxable supply under s 5(13), output tax will be payable on the consideration.
16. It is not in dispute that the Taxpayer is a registered person and was carrying on a taxable activity. This issue was not considered by the Tax Counsel Office.

¹ Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

² Section 149A(2) of the Tax Administration Act 1994.

³ *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

⁴ Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

The meaning of “receives”

17. The first question is what the word “receives” means in the context of s 5(13). The possible meanings put forward by the parties are:
 - a narrow interpretation, applying to the direct recipient of the payment (ie, the Taxpayer); or
 - a broader interpretation where an amount is not physically received by a person (ie, the former solicitors) but is paid to a third party claimant (ie, the Taxpayer) to discharge a liability. This could be considered “constructive receipt” by the person.
18. The word “receives” is not defined in the GST Act and so takes its ordinary meaning. The ordinary meanings of “receive” include to be given or paid or provided with, or to take, get or acquire something. In the context of the rest of the phrase “receives a payment”, this indicates that the person is given, paid or provided with a payment. This ordinary meaning does not appear to include “constructive receipt” where a third party is given, paid or provided with a payment by an insurer in order to discharge an obligation of the insured.
19. Analysis of the case law referred to by the parties indicates that in some contexts it is possible for the word “receives” to include both direct receipt and constructive receipt.⁵ It is important then to consider the legislative purpose of the provision to determine the most appropriate meaning of “receives” in the context of s 5(13).⁶
20. Prior to 10 October 2000, the wording of s 5(13) was different and did not include the phrase “whether or not the person is party to the contract”. There were concerns that this former wording was insufficient to impose GST in circumstances where an insurance payment was made directly to a GST registered third party claimant rather than to the insured person.
21. Several officials’ papers were produced as the Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill 2000 made its way through the legislative process.⁷ Of

⁵ See, for example, *Innovative Installation Inc v The Queen* 2009 TCC 5810 at [21]; *Pilcher v Logan* (1914) 15 SR(NSW) 24 at 27; *West v Miller* LR 6 Eq 59; *Re Hill, Hill v Caile* [1948] NZLR 356 at 363-364.

⁶ The meaning of an enactment must be ascertained from its text and in the light of its purpose - *Commerce Commission v Fonterra Co-operative Group Limited* [2007] NZSC 36 at [27].

⁷ See, for example, *Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill: Commentary on the Bill* (Inland Revenue, May 2000); *Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill 2000* (Officials’ Report to the Finance and Expenditure Committee on Submissions on the Bill, Inland Revenue and Treasury, 21 August 2000).

particular relevance to this dispute is a report produced by the Finance and Expenditure Committee which states:⁸

General insurance

In order to address concerns raised by the Insurance Council, we recommend the following changes to the proposed legislation affecting the treatment of general insurance:

- **The clause that would impose a GST liability on an insured person in relation to an insurance payment to a third party (if registered for GST) should be amended to place the liability instead on the third party where the third party receives the payment. This change is recommended after the Insurance Council indicated that the existing proposal would impose significant compliance costs on the industry.**
- ... [Emphasis added]

22. The changes as outlined in the report of the Finance and Expenditure Committee were reflected in the revised Bill which became law during 2000.
23. Having regard to the amendment to the Bill made by the Finance and Expenditure Committee, it was clearly intended by the legislator that "receives" would only take the narrow interpretation in the amended provision. If that were not so and constructive receipt by the insured was also included, then the identified "significant compliance cost concerns" would not have been avoided.⁹ Given that was the only identified reason for the change to the amendment proposal included in the Bill, the inclusion of constructive receipt by the insured cannot have been within the intended meaning of "receives" following the amendment.
24. Accordingly, the Tax Counsel Office concluded that:
 - The meaning of the word "receives" must be limited to direct receipt by the person actually paid, at the exclusion of constructive receipt by the insured due to the discharge of their liability to the claimant.
 - Therefore, for the purposes of s 5(13), the insured party (the former solicitors) did not "receive" the payment. The recipient of the payment was the Taxpayer.

⁸ *Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill 2000*, Commentary, as reported from the Finance and Expenditure Committee.

⁹ The Insurance Council was concerned that an insurer would have to issue two payments – one (exclusive of GST) to the third party claimant, and a second one for the GST amount to the insured to be used to discharge their output tax liability.

Under a contract of insurance

25. The second question is what the phrase “under a contract of insurance” means in the context of s 5(13). The Tax Counsel Office concluded that the starting position for the meaning of the word “under”, given that it is followed by the words “whether or not the person is a party to the contract”, is that “under” should be interpreted widely. This would favour an interpretation along the lines of “by virtue of” or “because or as a result of”. This interpretation is also consistent with the legislative intent.
26. In this case, it was considered that the payment was made “under” a contract of insurance because the payment was made to the Taxpayer because of or as a result of an indemnity policy between the insurance company and the Taxpayer’s former solicitors.

Whether or not the person is a party to the contract

27. The final wording in s 5(13) that is discussed in any detail is the phrase “whether or not the person is a party to the contract”. The “person” in question being the person who receives the payment under a contract of insurance.¹⁰
28. The Tax Counsel Office concluded that the reference in s 5(13) to “whether or not the person is a party to the contract” is intended to have a broad meaning to reinforce the GST liability of a registered person third party claimant who receives a payment from an insurer – even when they are not a party to that contract of insurance.

Conclusion

29. Overall, the Tax Counsel Office concluded that s 5(13) applies to deem the payment to be consideration for a taxable supply made by the Taxpayer. It is noted that this conclusion is consistent with the decision of Dunningham J in *Southland Indoor Leisure Centre*.¹¹

¹⁰ Where a third party enforces the obligation and is paid by the insurer, such a payment is paid under a contract of insurance – *Pegasus Group Limited v QBE Insurance (International) Limited and another* (unreported, High Court, CIV 2006-404- 6941, Auckland Registry, 24 September 2010) at [12].

¹¹ *Southland Indoor Leisure Centre Charitable Trust v Invercargill City Council and others* [2015] NZHC 1983.

Issue 2 | Take tuarua: If it is determined that s 5(13) does apply, is the supply standard rated or zero-rated under s 11(1)(mb)?

30. A supply will be zero-rated under s 11(1)(mb) where it includes the supply of land. The taxable supply in this dispute was deemed to have taken place by s 5(13). Although it is difficult to identify the true nature of a supply that would not have occurred if not for this deeming provision of the legislation, it is still necessary to have regard to the legal form of the contracts and transactions underlying the payment received as consideration for a supply. The payment in this case was received as a result of a court award for damages for negligence and an indemnity insurance contract held by the negligent party. The supply is a supply of services relating to the insurance contract and the Taxpayer's former solicitors' negligence; it does not include a supply of land for the purposes of s 11(1)(mb). Accordingly, the Tax Counsel Office concluded that the supply should be standard rated, and not zero-rated under s 11(1)(mb).

Issue 3 | Take tuatoru: If it is determined that s 5(13) does not apply, is a consequential adjustment of input claims for expenditure incurred required?

31. As explained above, it is concluded that s 5(13) applies to deem the payment received by the Taxpayer to be consideration for a taxable supply, and thus liable for GST at the standard rate. Notwithstanding this conclusion, consideration was also given to the consequential issue: Whether the input tax claimed was allowed as a deduction under s 20(3). Section 20(3C) states that the deductions are allowed to the extent the services have been used for or available for use in making taxable supplies. The Tax Counsel Office concluded that if s 5(13) did not apply to deem a taxable supply, then there are no supplies that the services acquired could relate to, and therefore the legal services were not acquired for use or available for use in making taxable supplies. Accordingly, the claimed input tax deductions would be disallowed in the alternative.
32. The Tax Counsel Office further concluded that the time bar waiver would not limit the ability of CCS to make an adjustment to the input tax claims. There is no provision in the law for parties to agree to limit the scope of a time bar waiver to specific issues. The only exception to a time bar waiver is in regard to issues that a Taxpayer has not been made aware of. This consequential issue had previously been raised with the Taxpayer before the signing of the time bar waiver, and therefore the exception does not apply.