Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKAWĀ

GST – Output tax deductions, shortfall penalties

Decision date | Rā o te Whakatau: 11 October 2024

Issue date | Rā Tuku: 28 February 2025

TDS 25/03

Subjects | Kaupapa

Output tax deductions for indemnity payment under a deed, shortfall penalties

Taxation laws | Ture tāke

All legislative references are to the Goods and Services Tax Act 1985 (GSTA), except for Issue 2 in which references are to the Tax Administration Act 1994 (TAA).

Summary of facts | Whakarāpopoto o Meka

1. The Taxpayer was a company that owned property with both residential and commercial leases.
2. The Taxpayer was registered for GST from its date of incorporation on a payments basis.
3. The Taxpayer entered into both a lease and a separate deed with a tenant.
4. The deed required action to be taken by the Taxpayer in the form of alterations to the building, by a date specified in the deed (the date of default).
5. The deed contained a contractual obligation to indemnify the tenant for certain obligations incurred under the lease for a period of time. The obligation was triggered when the alterations to the building were not made by the date of default.
6. Failure to fulfil this obligation resulted in a payment to the tenant.
7. The Taxpayer made a payment the amount of which equalled the rent and outgoings of the tenant under the lease for a specified period and claimed a deduction from output tax for GST on this payment.

Issues | Take

8. The main issues considered in this dispute were:
    - Whether the Taxpayer was entitled to a deduction from output tax for GST on the payment under s 20(3)(b)(iv).
    - Whether the Taxpayer was liable for a shortfall penalty for not taking reasonable care, reduced by 50% for previous behaviour, under ss 141A and 141FB of the TTA.

Decisions | Whakatau

9. The Tax Counsel Office (TCO) decided:

   - The Taxpayer was not entitled to claim a deduction from output tax under s 20(3)(b)(iv) for GST on the payment made to the tenant under the deed.
   - The Taxpayer was not liable for a shortfall penalty for not taking reasonable care.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Was the Taxpayer entitled to a deduction from output tax under s 20(3)(b)(iv)?

10. Customer and Compliance Services (CCS) argued the Taxpayer was not entitled to a deduction from output tax for the GST on the payment because the deed did not alter the amount of rent and outgoings payable by the tenant under the lease.

11. CCS argued the payment compensated the tenant for the loss associated with the Taxpayer's failure to make the alterations to the building by the specified date and accordingly, there was no underlying supply of a good or service on which GST was charged.

12. The Taxpayer argued the payment was a refund of rent and outgoings paid by the tenant under the lease and in respect of which it had accounted for GST output tax to the Commissioner.

13. The Taxpayer argued it accounted for an incorrect amount of output tax on its supply of services to the tenant and was entitled to an adjustment for the excess output tax paid.

14. The Taxpayer described the issue as being whether the payment was consideration for an earlier supply of services made by it to the tenant for which it could claim an input tax deduction under s 25(1).

15. It was not disputed that there was taxable supply of the property by the Taxpayer to the tenant on which the Taxpayer had accounted for output tax. Further, neither CCS or the Taxpayer considered the payment was consideration for a supply of goods or services acquired by the Taxpayer from the tenant. The issue was whether the payment made by the Taxpayer to the tenant under the deed was an alteration of the previously agreed consideration for that supply or supplies under s 25(1)(b), and whether the deed altered the previously agreed consideration for the supply of services by the

Taxpayer to the tenant under the lease such that a deduction from output tax for the GST on the payment could be claimed under s 20(3)(b)(iv).

16. TCO noted:

- Section 20(3)(b)(iv) provides that a taxpayer who accounts for GST on a payments basis can deduct from its output tax an amount calculated in accordance with s 25(2)(b), to the extent that a payment has been made in respect of that amount.
- The effect of s 25(2)(b) is that where a supplier has accounted for an incorrect amount of output tax because the previously agreed consideration for the supply has been altered, whether due to the offer of a discount or otherwise, the supplier must make an adjustment to correct the amount of tax (s 25(1)(b) and (e)).
- Section 25(1)(b) refers to a situation where the previously agreed consideration for a supply of goods and services has been "altered".

17. TCO concluded the previously agreed consideration for a supply could not be altered without an element of reciprocity to link the payment to a supply.[1]

18. TCO concluded the parties did not, under the deed, agree to alter the previously agreed consideration for the supply of services by the Taxpayer to the tenant under the lease. In particular:

- The use of the word "indemnify" in the deed was not determinative of the legal nature of the payment.[2]
- What was important was the legal arrangements actually entered into, not the economic or other consequences of the arrangement and/or an arrangement that could have been entered into but was not.[3]
- In accordance with the deed, the legal nature of the payment made by the Taxpayer was a payment for a breach of contract.
- The payment was for the Taxpayer's failure to meet the terms of the deed on or before the specified date, rather than an alteration of the previously agreed consideration for the Taxpayer's supply of services to the tenant under the lease.

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[1] *Montgomerie v CIR* (2000) 19 NZTC 15,569.

[2] *CIR v New Zealand Refining Co Ltd* (1997)18 NZTC 13,187.

[3] *CIR v New Zealand Refining Co Ltd* (1997) 18 NZTC 13,187 at p 13,192 citing *Marac Life Assurance Ltd v CIR* [1986] 1 NZLR 694 at p 706 [also reported as *Marac Life Assurance Ltd v CIR; CIR v Marac Life Assurance Ltd* (1986) 8 NZTC 5,086 at pp 5,097, 5,098].

- In economic terms, the effect of the payment was that the tenant was reimbursed for the rent and outgoings for a specified period to the end of the first term of the lease. However, it was not appropriate to conflate contractual or legal effect with economic outcomes or equivalents.[4]

19. TCO agreed with CCS that the Taxpayer was not entitled to claim a deduction from output tax under s 20(3)(b)(iv) for GST on the payment made to the tenant under the deed.

Issue 2 | Take tuarua: Did the shortfall penalty apply?

20. In this part of the summary, all legislative references are to the TAA unless stated otherwise.

21. Section 141A imposed a shortfall penalty of 20% of the tax shortfall if a taxpayer does not take reasonable care in taking a taxpayer's tax position.

22. The shortfall penalty for not taking reasonable care was considered in the Interpretation statement *Shortfall penalty for not taking reasonable care* published in *Tax Information Bulletin* Vol 17, No 9 (November 2005): 3. Despite later case law, TCO considered that the Interpretation statement correctly stated the law in relation to the penalty.

23. The Taxpayer was liable for a shortfall penalty under s 141A if the following requirements were satisfied:

- The Taxpayer had taken a taxpayer's tax position as defined in s 3(1).
- The Taxpayer's tax position led to a tax shortfall as defined in s 3(1).
- The Taxpayer had not taken reasonable care in taking the taxpayer's tax position.

24. In *Case W4*, Judge Barber said that the test of "reasonable care" was whether a person of ordinary skill and prudence would have foreseen as a reasonable probability or likelihood that an act or failure to act would cause a tax shortfall.[5] This was having regard to all of the circumstances.

[4] *Marac Life Assurance* supra.

[5] *Case W4* (2003) 21 NZTC 11,034. See also *Hong v CIR* [2018] NZHC 2539, (2018) 28 NZTC 23-073 at [22].

25. The Taxpayer would have taken reasonable care in taking a tax position if any of the following tests were satisfied:

    - They relied on the action or advice of a tax advisor (and none of the exceptions listed in s 141A(2B)(b)-(e)), applied).
    - The tax position taken was an acceptable tax position.[6]
    - They did what a reasonable person in their circumstances would have done.[7]

26. TCO concluded that the Taxpayer was not liable for a shortfall penalty for not taking reasonable care.

27. TCO noted that notwithstanding the incorrectness of the tax position taken, the issue was significant and complex, and while a reasonable person might have foreseen the possibility of a shortfall, the Taxpayer sought advice in taking the tax position.

28. The Taxpayer consulted an accountant who was a member of an approved advisor group and therefore a "tax advisor" under s 141A(2B).

29. The accountant had business and tax credentials that had not been (explicitly or validly) disputed by CCS. The accountant also thought that the tax position taken in relation to the payment was the correct one.

30. The Taxpayer did what a reasonable person would have done in the circumstances by involving the accountant.

31. TCO considered the Taxpayer, in relying on the advice of the accountant, had taken reasonable care for the following reasons:

    - The accountant was external to the Taxpayer.
    - The evidence provided supported the conclusion that the accountant had adequate information and instructions relating to the tax position taken.
    - There was nothing indicating that the Taxpayer had reason to believe that the accountant's advice was incorrect or that it previously had a tax shortfall for GST in a period ending less than 4 years before the beginning of the period to which the tax position relates.

32. TCO agreed with the Taxpayer that it was not liable for a shortfall penalty for not taking reasonable care under s 141A.

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[6] See s 141A(3).

[7] See *Case W4* at [61].

Conclusion

33. TCO concluded that the Taxpayer was not entitled to claim a deduction from output tax under s 20(3)(b)(iv) for GST for the payment made to the tenant under the deed.

34. TCO concluded that the Taxpayer was not liable for a shortfall penalty for not taking reasonable care under s 141A.