Draft Operational Statement - ED0164
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
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By email to: public.consultation@ird.govt.nz

CC: Struan Little, Deputy Commissioner, Policy and Strategy

Dear Sir/Madam

Submission on "GST and the costs of sale associated with mortgagee sales"

The Financial Services Federation ("FSF") is grateful for the opportunity to submit on the Draft Operational Statement, "GST and the costs of sale associated with mortgagee sales" (the Draft Statement) released by your office in February 2015. By way of background, the FSF is the industry body representing the responsible and ethical finance and leasing providers in New Zealand. The FSF has nearly fifty members and affiliates providing first-class financing, leasing, investment, banking and insurance products and services to over 1 million New Zealand consumers and businesses. The FSF's affiliate members include internationally recognised legal and consulting partners.

Whilst the Draft Statement seems to only refer to mortgagee sales, the FSF is concerned that a similar approach could be adopted for all secured assets. On that basis, whilst the FSF's following comments relate to the treatment of GST input tax deductions in relation to the costs incurred in mortgagee sales, the FSF would have similar concerns if it was ever proposed that the repossessing of all secured assets were to be treated in the same way. The FSF therefore asks that while the following submission refers to "mortgagee sales" it should be considered that the FSF holds the same views on the treatment of GST input tax deductions in relation to the costs incurred in the repossession of any secured assets.

The FSF has also consulted with the New Zealand Bankers Association ("NZBA") in the preparation of this submission. The two organisations are very much in agreement in terms of the appropriate response on behalf of the members of both organisations to the Draft Statement and therefore it will be noticed that much of what follows repeats what the NZBA is saying in their submission to you.

With that in mind, in regard to the Draft Statement the FSF particularly wishes to comment on the view expressed that "no input tax deduction is available to a mortgagee for costs associated with a mortgagee sale made under the business to business financial services rules[1]."

[1] ED0164: paragraph 27, page 4

The FSF is concerned that this view is inconsistent with the practical reality of mortgagee sales: specifically, mortgagee sale costs are incurred solely to enforce a debt owing. Where the underlying transaction with the customer is eligible for zero-rating under the Business to Business financial service rules (B2B rules), the mortgagee sale costs are incurred in the course or furtherance of the mortgagee's taxable activity, so input GST deductions should be available.

Denying these input GST claims increases the costs of transacting for financial institutions, resulting in the very tax cascades and distortions that the B2B rules were introduced to prevent.

All legislative references are to the Goods and Services Tax Act 1985.

Commercially, mortgagee sale costs are only incurred where the mortgagor has defaulted and the mortgagee must enforce the security of the underlying lending transaction to recover the debt owing. The mortgagee may subsequently recover the costs of these actions through the fees charged to the mortgagor for financial services provided when a lending transaction is terminated due to default. Where the mortgagor is GST registered and making greater than 75% taxable supplies, it follows that all such activities are clearly undertaken in the course or furtherance of the mortgagee's zero-rated supply of finance to the mortgagor.

The Commissioner acknowledges a direct link between the expenditure and the recovery of amounts owing under the lending transaction in paragraph 28 of the Draft Statement, which states:

> *"the recipient of the supply of these services is the mortgagee and* ***the purpose of the sale is for the mortgagee to receive the amount or part of the amount owing on the mortgage****." (emphasis added).*

However, in paragraph 26 of the Draft Statement, the Commissioner appears to instead link the mortgagee sale costs to the supply that is deemed to occur under section 5(2). This essentially treats the mortgagor as incurring the costs in the course or furtherance of the mortgagee sale. By implication, the Commissioner divorces the supply received by the mortgagee from its business activities; this fails to recognise the mortgagee's business purpose for acquiring the services required for the mortgagee sale.

The FSF considers this is inconsistent with the practical reality of the mortgagee sale transaction:

- The mortgagee only incurs the mortgagee sale costs to recover the amount owing under the lending transaction. Consistent with other costs incurred to issue, service or terminate the lending transaction, the mortgagee can recover these costs from the mortgagor via its charges for banking services. It follows that the GST treatment of such costs should also be consistent.
- The mortgagor neither acquires nor receives any supply for the mortgagee sale. Thus, even though the mortgagor is deemed to have supplied the asset and may

ultimately incur these costs, practically the mortgagor does not sell the mortgaged asset. Rather, the mortgagor receives the supply of the banking services required to terminate the mortgage account.

It is the FSF's view that section 5(2) has the sole purpose of giving effect to the appropriate GST outcome for sales transactions where the sale occurs through the exercise of some form of security interest such as a mortgagee sale transaction: i.e. the mortgagor is deemed to dispose of the asset to access the funds required to repay the mortgagee. It follows that the GST treatment of that mortgagee sale transaction should be aligned to the GST status of the mortgagor.

The FSF agrees with the Commissioner's view that it is the mortgagee, not the mortgagor, that is the recipient of the services supplied in consideration for the mortgagee sale costs. However, the NZBA does not agree that section 5(2) attributes those costs to the deemed sale by the mortgagor. Rather, the intention of the mortgagee in acquiring those services must be considered. The FSF submits tha the costs associated with the mortgagee sale are incurred by the mortgagee for the sole purpose of recovering the debt owing. Thus they are clearly in connection with the zero-rated supply of finance. Any recharge of such costs occurs under the specific terms of the agreement with the customer, which outline the banking services provided when a mortgage agreement is terminated due to default.

The FSF submits that the Draft Statement is internally inconsistent, offering differing views on who is acting and in what capacity depending on the GST treatment that results: if financial services are exempt, then the mortgagee is acting on its own behalf and engaging in an exempt activity; if financial services are zero-rated then the mortgagee is acting on behalf of the mortgagor.

In the FSF's view, either:

- As the sale of the mortgaged asset is deemed to be in furtherance of a taxable activity conducted by the mortgagor, the mortgagee should be seen to be acting as agent for the mortgagor. The mortgagee should therefore be able to claim input GST as agent for the mortgagor; or
- If the mortgagee is seen to be acting on its own behalf, this should be seen as in furtherance of its business of financial services in all cases. The mortgagee should therefore be able to claim input GST when providing zero-rated services.

The FSF believes there is strong policy support for allowing the mortgagee to claim input GST on the costs of mortgagee sales.

The B2B rules were introduced to alleviate the distortions that arise when a financier is unable to recover the GST costs incurred to provide the financial services. It was widely understood that this had the potential to overtax the supply of financial services to businesses.

Equally, where a mortgagee incurs costs for which it cannot recover the GST, as a practical consequence, the full GST inclusive costs must be recovered from the mortgagee sale. This

reduces the credit available to fund the customer's repayment obligation or, alternatively, increases the bad debt cost for the mortgagee.

The FSF submits that this outcome is absurd. Practically, this treatment pushes the GST cost to an entity that is already in financial difficulty, thus negatively impacting that entity's prospect of servicing its financial commitments. This is particularly inappropriate where the mortgagor would, itself, have been able to recover the GST incurred on the mortgagee sale costs.

Additionally, where the outstanding debt is not recovered from the mortgagor, the irrecoverable GST increases the costs borne by the mortgagee. In such circumstances, standard commercial practice dictates that suppliers must recover these costs through the pricing of their supplies: this potentially cascades the GST cost incurred to all business customers through the pricing of business financial service transactions. This is exactly the cascading issue that the B2B rules were originally introduced to address.

Conclusion

The view expressed in the Draft Statement is inconsistent with both the practical reality and commercial purpose of a mortgagee sale. It produces absurd and inefficient tax outcomes that have the potential to increase the cost of financial services not only to mortgagors, but New Zealand businesses in general.

Therefore, the FSF requests that Inland Revenue accept our submission that mortgagees should be entitled to claim input GST incurred on the costs of mortgagee sales when the B2B rules apply.

We trust that the above is helpful in outlining our concerns on this matter and we welcome your consideration of our concerns.

Yours faithfully

Lyn McMorran
EXECUTIVE DIRECTOR