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Dear Sir or Madam

ED0164: GST and the costs of sale associated with mortgagee sales

Thank you for the opportunity to comment on the draft operational statement (“the ED”).

We have two general areas of comment. The first is a general suggestion that the scope of the ED be expanded to make it clear that it applies to all sales in satisfaction of a debt and not just to mortgagee sales. The second sets out the reasons why we disagree with the conclusion reached in the ED that costs incurred in recovering a debt that has been zero-rated cannot be claimed by the lender.

Mortgagee sales and coverage of Operational Statement

The ED refers consistently to “mortgagee sales”. We think it would be useful if the ED expanded its scope to include all sales of goods owned by one person where the goods are sold under a power exercisable by another person in satisfaction of a debt owed.

This would make it clear that the operational statement would apply to all sales in satisfaction of a debt including hire purchase debt, loans with a security taken over personal property, or sales of land by a mortgagee.

Costs incurred by a lender in selling an asset to recover a debt that has been zero-rated under the business-to-business zero-rating rules

The ED concludes in paragraphs 26 and 27 that no input tax is available to a mortgagee for costs associated with a mortgagee sale even if the provision of the loan was zero-rated under the business-to-business zero-rating rules.

The rationale for this conclusion is not entirely clear or fully explained. It appears to be based on the reasoning that the costs incurred by the mortgagee can only be attributed to the mortgagor’s taxable activity because section 5(2) deems the mortgaged goods to be sold in the course or furtherance of a taxable activity carried on by the mortgagor. This seems to mean that the mortgagee makes no supply to which the costs attach. Further, this means that the costs cannot be attributed directly or indirectly to any taxable activity carried on by the mortgagee.

(This summary is based on paragraph 26 which considers the costs are connected only with the section 5(2) supply by the mortgagor.)

We consider that this is incorrect.

Section 5(2) does not prevent a connection with the mortgagee's activity

Section 5(2) deems the relevant goods to be sold in the course or furtherance of a taxable activity carried on by the borrower and section 17 requires the lender to account for the output tax. However, section 5(2) does not deem the lender to be carrying on the taxable activity of the borrower and nor does it deem any costs incurred by the lender to have been incurred by or on behalf of the borrower. (The ED recognizes the latter point in its conclusion and analysis of the mortgagor's ability to claim the input tax associated with the costs of sale. It states that the mortgagor does not acquire the goods or services.)

The key questions are therefore on what basis does the mortgagee incur the costs and for what purpose and the nature of those costs as between the mortgagee and the mortgagor.

The mortgagee incurs the cost in carrying on its financial service activity

A lender can only exercise a power of sale because they have made a loan. Any goods and services acquired by the lender are wholly used to recover (and maximize) the recovery of the debt owed by the borrower. The costs are incurred in carrying on that activity by the mortgagee.

This is the commercially realistic interpretation of what is occurring. The mortgagee does not incur the costs to dispose of the property. It incurs the costs so that it is able to recover its advance. The costs are connected to its own activity and not to the mortgagor's actual activity or to the section 5(2) supply. This is consistent with the analysis and commentary at paragraphs 20 to 24.

The mortgagee makes further advances

Any costs incurred by the lender are an additional loan advance made by the lender to the borrower. In accordance with section 185(1)(a) of the Property Law Act 2007, the lender is entitled to recover the costs as a first charge on the sale proceeds. As a result, there is a further supply made by the lender (being the further loan advance).

Direct connection to zero-rated taxable activity

Where the original loan is zero-rated, any goods and services acquired by the lender in recovering that debt which are then treated as a further loan to the borrower would be:

- directly used in making that further zero-rated taxable supply. There is a direct nexus between the costs incurred and taxable supplies made by the lender; and, in any case
- directly used in carrying on its taxable activity of making zero-rated supplies

Indirect connection and incidental

The discussion at paragraphs 20 to 24 are not reconsidered when the zero-rated activity is considered. Those paragraphs suggest that an indirect connection is sufficient to justify an input tax deduction. (It does not justify an input tax deduction in those paragraphs as the mortgagee is assumed to be making exempt financial services supplies).

Although we consider that there is a direct connection with the mortgagee's taxable activity, following the analysis at paragraphs 20 to 24, the mortgagee's cost are incidental to the carrying on of the zero-rated activity.

Y2 does not apply

For completeness, we note that the decision in *Case Y2* (quoted at paragraph 17 of the ED) is not authority to the contrary. *Case Y2* concerned the mortgagee's ability to deduct input tax in the section 17 special return and not the mortgagee's ability to deduct input tax itself. Further, the case did not concern a mortgagee which was applying the business to business zero-rating rules.

Conclusion

In conclusion, we consider that a mortgagee is entitled to claim an input tax deduction in full for any costs incurred in collecting a loan that has been zero-rated. The costs are clearly connected to that activity and are not connected to the section 5(2) supply.

We also submit that, given the importance of this issue, that the reasoning and analysis in the ED should be fully set out before the ED is finalized.

Please feel free to contact me if you have any queries.

Yours sincerely



Peter Scott
Partner