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GST policy issues

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ICNZ submission on GST policy issues

Thank you for the opportunity to submit on the officials' Issues Paper titled 'GST policy issues' ('Issues Paper'), which was released by Inland Revenue (IRD) in February 2020.

ICNZ represents general insurers that insure about 95 percent of the New Zealand general insurance market, including about a trillion dollars' worth of New Zealand property and liabilities. ICNZ members provide insurance products ranging from those usually purchased by individuals (such as home and contents insurance, travel insurance, motor vehicle insurance) to those purchased by small businesses and larger organisations (such as product and public liability insurance, professional indemnity insurance, commercial property, and directors and officers insurance).

In this submission we comment on Chapter 2 (Tax invoice requirements) and Chapter 8 (Insurance pay-outs to third parties) of the Issues Paper.

Chapter 2 (Tax invoice requirements)

ICNZ welcomes IRD's willingness to consider pragmatic solutions to the issues addressed in Chapter 2. We have the following comments on the proposed options for simplification of tax invoice requirements proposed in the Issues Paper:

- Paragraph 2.16 – We agree with removing the requirement that a 'copied' invoice be marked as 'copy only'.
- Paragraph 2.17 – We agree with the principle of modifying the Tax Invoice requirements such that only the information that is required to be kept on a Tax Invoice is retained. We further suggest that this concept be extended to issuers of Tax Invoices. The GST Act currently requires an issuer to be able to recreate the Tax Invoice in its original format. The compliance

burden would be eased if issuers also only needed to retain the information that is required to be kept on a Tax Invoice.

- Paragraph 2.19 – We agree it is unnecessary that IRD approves the use of buyer-created Tax Invoices and that instead, buyer-created Tax Invoices should be based on what is most appropriate for the businesses in question.
- Paragraph 2.21 – We agree that Shared Invoices should be able to be used in a wider range of circumstances such as described.
- Paragraph 2.23 – We agree that the penalty for issuing more than one Tax Invoice in relation to the same supply is removed and replaced with a penalty placed on the Purchaser for multiple claims for the same supply.

Chapter 8 (Insurance pay-outs to third parties)

Chapter 8 raises a potential issue associated with insurance pay-outs to third parties and outlines three options for addressing it:

1. Making the insurer responsible for the GST obligations (two possible mechanisms proposed);
2. Requiring disclosure by the general insurer that the payment is covered by insurance; or
3. No law change but provide education and guidance.

In this section of the submission, we provide comments on the potential issue and the three options proposed. We support option 3.

Nature and scale of the problem

The potential problem is framed in the Issues Paper as being of high fiscal risk on the basis of the commercial incentives to general insurers to negotiate lower settlement amounts, based on anecdotal evidence from several tax and legal advisers about the existence of the issue and an increasing number of disputes in respect of section 5(13). The Issues Paper however notes in paragraph 8.16 that officials “...do not have enough information to quantify the magnitude of these issues.” In this regard, and in the absence of such reliable information, it is our view that costly interventions shifting the compliance obligations and risk onto insurers should not be pursued.

We are unable to provide specific information on the scale of the perceived problem as our members do not typically track pay-outs to third parties separately to pay-outs directly to insured's, and do not have any visibility as to the tax positions taken by those receiving insurance pay-outs. However, we can make some generic comments as set out in the following paragraphs.

Insurers do make efforts to ensure that parties to a settlement are aware that there may be a GST aspect to consider. Before starting a negotiation, insurers would normally flag the basis of the negotiation, often conducted on an “inclusive of GST, if any” basis. In that way, the recipients are on notice that there is a potential GST aspect to consider. Insurers would encourage the claimant to seek appropriate advice before finalising a settlement reflected in the settlement agreement. Settlement agreements typically include explicit wording dealing with GST, such as that the settlement amount “includes GST, if any”. On this basis, we disagree that recipients would not generally be aware that they may have a GST obligation, and the reference to GST within the settlement agreement should serve to put them on notice to this possibility.

Following the issuance of the recent Commissioner’s Statement¹ (“Commissioner’s Statement”) directed at third-party recipients emphasising their potential GST obligations, third-parties and their advisers should be very clear on their GST obligations in this area. We have noted a recent increase in interest in this topic following this Commissioner’s Statement, demonstrating the effectiveness of measures to educate and raise awareness.

While there are sound commercial reasons when insurers may prefer that their involvement in settlement negotiations with third parties not be highlighted, our members report that this is not for reasons related to the potential GST treatment of the pay-out. However, in the case of larger settlements where legal or other advisers are involved, our members consider it much less likely that the involvement of insurers will not be known to all parties.

Insurers will often make insurance pay-outs directly to the third party and we do not consider that it is usual practice for payments to be made to solicitors’ trust accounts, so third parties should have visibility that the payment has come from an insurer.

Proposed options

Making the insurer responsible for the GST obligations (Options 1a and 1b)

We do not support the option of making the insurer responsible for the GST obligations (arising under either Option 1a or Option 1b) because it will impose substantial costs and compliance risk on insurers in the place of those who currently rightly have the obligations.

Option 1 suggests two possible mechanisms to solve the perceived issue:

- a) Reverse charge on insurer (insurer effectively returns the output tax that the third party would have to otherwise return as output tax)
- b) No input credit for insurer (insurer unable to claim GST input tax on these claims as they can under the current rules)

As noted in the Issues Paper, the compliance costs to implement either Option 1a or Option 1b will be significant and would result in the imposition of additional compliance risk on general insurers on a go forward basis, as both options require the general insurer to know if the recipient is a GST-registered person and whether the pay-out relates to a loss incurred in the furtherance of that recipient’s taxable activity (as opposed to a private or exempt activity).

In addition, the proposals for ‘partial’ use, appear to maintain a degree of compliance for the GST-registered recipient, which would defeat the purpose of any amendments, calling into question their effectiveness. If the onus to navigate “partial” use was passed onto the general insurer this will introduce further cost and complexities for the general insurer.

Instead of addressing the potential issue with the third parties bearing the obligations, options 1a and 1b essentially pass on the costs and risks of compliance to general insurers, despite insurers having less information about the third-party taxpayer’s GST status, than either the third-party taxpayer themselves or IRD. The Issues Paper does not note any compensation element for the expected costs to the general insurers to ensure compliance and in fact refers to potential penalties applying if errors were to arise, further adding to the insurer’s (albeit potential) costs.

¹ Commissioner’s Statement CS 20/01 GST liability for insurance and settlement payments to third party claimants – Section 5(13) of the Goods and Services Tax Act 1985.

We agree in principle that making the general insurer responsible for GST would reduce compliance costs on GST-registered businesses receiving insurance pay-outs, but question the fairness of transferring this onus on to general insurers, which is already an over-burdened industry with the costs of collecting various levies, such as Earthquake Commission (EQC) and Fire and Emergency New Zealand (FENZ) levies, as well as other existing and planned regulatory obligations and compliance costs. All these compliance obligations add to the cost of providing insurance to New Zealanders and any additional GST compliance burden could add further to this cost.

Paragraph 8.31 of the Issues Paper seeks submitters' views on the Australian approach and the extent of any associated compliance costs. Based on feedback from members who are part of Australasian corporate groups, we understand that Australian general insurers view their compliance regime as being difficult to comply with, subject to human error, and onerous. This is strong evidence of why New Zealand should not adopt any more complicated regimes which require insurers to obtain information regarding the GST status of those to whom claims are paid.

Officials are correct to be concerned that Options 1a and 1b would impose high compliance costs and system changes on insurers, in some cases across multiple legacy systems. It is difficult to estimate the extent of any costs without knowing the specifics of any legislative changes. However, by way of illustration, relatively simple changes to the EQC cover and levy resulted in system costs on the impacted part of the industry (i.e. not all insurers) of around \$3.5 million and further planned FENZ levy changes (now deferred) have been estimated to require system development costs in the tens of millions across the industry.

Based on the options as they are described in the Issues Paper, we can envisage at a minimum the following issues arising:

- Both options would require new system functionality to clearly distinguish between claim settlement payments to GST registered persons and non-GST registered persons, regardless of whether that person is the insured or a third party, and to hold information regarding GST status and GST number, and potentially the extent to which the claim related to the undertaking of a taxable activity. This would also result in changes to processes and documentation in order to gather the necessary information.
- Option 1a would require new system functionality to calculate and recognise the GST reverse charge, in addition to the GST claim on the amount paid. There would likely be decisioning required by staff to identify the situations when this functionality needed to be applied.
- There are currently a few existing situations where GST cannot be claimed in respect of claim payments. These are generally dealt with by specialised teams with the requisite experience. However, if a generally applicable exception, which would require a GST/no GST decision on potentially all claims payments were to be introduced, the additional complexity is likely to result in a high incidence of error. Current exemptions which result in no GST claim arising are well understood by relevant business units (e.g. a marine cargo claim to a non-resident).
- It appears that Option 1b has not been fully considered as to what impacts the measure has on other areas with the proposed removal of section 5(13). For example, there would be flow on impacts to GST registered reinsurers and general insurers receiving recoveries from these reinsurers, to name one.

Whilst it may seem that "turning off" any GST claim is a simpler solution than Option 1a (the reverse charge option), claims resulting in no GST claim or the reverse charge are going to require a claims staff member to determine the appropriate treatment. This may lead to errors occurring by general

insurers with potential penalties, which we consider unreasonable given that it is not inherently the insurer's tax obligation that these proposed changes are in respect of.

As each insurer's systems maybe better suited to adapting to either Option 1(a) or 1(b) we cannot comment on the preferred approach out of these two options.

To summarise, we are strongly opposed to either Option 1a or 1b, for the following reasons:

- We question the fairness of transferring the onus onto general insurers. It is not the insurer's responsibility to ensure a third-party's GST position is correct.
- Substantial system development across multiple claims payment systems would be required.
- Insurance contract wording across a large number of products would need to be revised. This is a time consuming and costly exercise. Long lead times would be required before any legislative change could be implemented.
- Both alternatives require the insurer to accommodate a mixture of GST outcomes in its claims payment systems. A function that may not currently be provided for across all systems.
- Each alternative relies on a degree of human decision by claims processors to ensure the correct treatment with potential penalties if this decision is ultimately incorrect. It is not equitable for these penalties to fall on the general insurer.
- The proposals in relation to "partial" use appear to maintain a degree of compliance by the third-party, which calls into question the effectiveness of the proposals, in any case.

Requiring disclosure that the payment is covered by insurance (Option 2)

Option 2 is less problematic than Options 1a and 1b, but would still require significant system, documentation and process changes and impose additional compliance costs on insurers in order to deal with an issue of third parties not meeting their existing obligations. It is also unequitable to make the general insurer liable for any GST because of any failure to disclose.

We agree with the comments in the Issues Paper that the imposition of this requirement could cause confusion by claim payment recipients if the disclosure is made on a widespread basis, as many claimants will have no obligations to deal with. Therefore, a targeted disclosure requirement for specific products most likely to give rise to the issues noted would be preferred if this option is pursued.

As noted in the Issues Paper, the timing of the disclosure would also need to be addressed and could have the outcomes of increasing claims costs, and therefore ultimately the cost of insurance for New Zealanders as noted in the paper.

No law change, but provide education and guidance (Option 3)

We consider this to be the best of the available options noting the Commissioner's Statement has already raised awareness in this regard. Target communications to relevant professional bodies will significantly increase compliance. For example, the Law Society, the Australasian Institute of Chartered Loss Adjusters, the Arbitrators' & Mediators' Institute of New Zealand Inc, Chartered Accountants New Zealand and Australia.

We disagree with the view outlined in paragraph 8.44 that Option 3 would be ineffective as it "...relies on their tax and legal advisors...being both aware and sufficiently concerned about the GST risk...". We submit that it is exactly the job of the third-party's tax and legal advisors to be aware and sufficiently concerned about the GST risk.

In relation to the discussion in paragraphs 8.42 and 8.43 we note the following. General insurers are unlikely to be prepared to provide any form of GST indemnity as it will have an RBNZ regulatory capital compliance impact (to name one) that will be too onerous to comply with. General insurers are unlikely to be prepared to adopt wording “plus GST, if any” in settlement agreements, because general insurers and their reinsurers, need certainty and closure when settling a claim. We cannot accept a situation where there is a latent possibility that a claimant will come back later asking for incremental amounts to be paid.

Application date

2021 would seem to be an ambitious target date and may not allow sufficient time for the Generic Tax Policy Process to be undertaken.

It is difficult to estimate how much lead time post enactment would be required, without detailed system, documentation and process change requirements being known. By way of illustration, it was expected to take a lead time of at least 12 months to implement the recent planned, (but later deferred), changes to the FENZ levy. We would estimate that at least the same lead time could be required for changes under these options.

The proposed GST changes may also require insurers to revisit policy and documentation wording across a wide range of insurance products. The costs and time required to review and potentially update large numbers of policies as well as broker wordings is significant. Having to change policy and document wordings is a major and costly exercise.

Officials should also note that insurers do not carry significant capacity to make continual compliance changes to their systems. In recent years considerable system development resources have been diverted away from value-add, customer focused needs towards compliance work such as EQC and FENZ changes. General insurers do not want to have to divert resources from important business needs to implement the proposed Options 1a, 1b or 2.

Specific questions for submitters

When a damaged third-party receives an insurance or compensation payment is it difficult for them to determine whether or not the payment comes from an insurer?

It is our view that it should generally not be difficult for a third-party to determine whether or not the payment came from an insurer.

In what situations does the problem occur and what information is available to assess the potential scale of the problem?

We are unable to provide specific information on the scale of the perceived problem as our members do not typically track pay-outs to third parties separately to pay-outs directly to insured's, and do not have any visibility as to the tax positions taken by those receiving insurance pay-outs.

What are the costs, benefits and practical issues associated with the policy options? How much lead time would insurers or other affected parties need to implement these options?

Option 3 is our preferred option as this has benefits with few costs and leaves the compliance obligations and risk where we consider that they rightly should sit. There are numerous practical challenges as described in our detailed responses above in relation to the other options.

The lead time and cost of implementing any of the other options will vary for individual insurers and are difficult to estimate until the specific requirements are fully understood, and their system,

documentation and process implications thoroughly investigated. Based on experience of other recent compliance changes such as those related to the Earthquake Commission and Fire and Emergency levies, such time and costs are likely to be considerable. If any of these options were to be implemented, we would expect at least twelve months lead time to be required from when the changes were legislated to when they became operative.

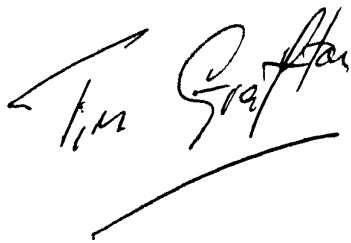
Possible other related issue for reform

A related issue is that in the case where an NZ resident general insurer has paid out a claim in NZ and then seeks recovery from the at fault party, then if the at-fault party and/or their insurer is a non-resident, members have reported that the other party are often refusing to gross-up for GST their payments to the NZ general insurer. This is despite the fact that the NZ general insurer must account to IRD for GST on receipt of any claim recovery, pursuant to section 5(13). This is leaving NZ general insurers with a claim recovery shortfall. We suggest that a remedial measure is introduced into any GST legislative amendment to deem such recoveries from non-resident parties to be zero-rated for GST purposes. Alternatively, we consider that IRD should issue specific guidance on this scenario making it clear that GST applies to the amount paid by the reinsurer to the NZ general insurer.

Conclusion

Thank you again for the opportunity to submit on the Issues Paper. If you have any questions please contact our Operations Manager by emailing terry@icnz.org.nz.

Yours sincerely,



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