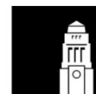

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GST Cash and Accrual Mismatches: Avoiding the Avoidance

Yige Zu* and Richard Krever**

Australia, like many jurisdictions, allows small businesses to use cash basis recognition of expenses and supplies when accounting for GST. The commonly offered rationale for the concession – a measure to simplify the tax and reduce compliance costs – is at best problematic. The more plausible explanation is to provide an optional subsidy for small businesses, perhaps to offset the regressivity of GST compliance costs. Tax authorities in a number of countries have discovered that the availability of both cash basis and accrual basis rules opens the door to avoidance arrangements not contemplated by the legislature when the dual accounting rules were adopted. Enterprises exploited the timing mismatches between cash basis vendors and accrual basis customers to create input tax entitlements and consequent refunds for buyers where there were no contemporaneous output tax obligations for sellers. Legislators in the UK and New Zealand concluded the optimal response to these schemes was the adoption of a specific anti-avoidance rule, which is supplemented by a general anti-avoidance rule in the case of New Zealand. To date, Australian authorities have relied on ad hoc application of a general anti-avoidance rule to address the problem. This article considers whether a systematic fix derived from, but improving on, overseas models is preferable to the ad hoc approach currently used in Australia.

THE PROBLEM

The Australian GST provides qualifying small enterprises with the option of reporting acquisitions and supplies on an accrual basis (the default rule)[1] or a cash basis (the optional rule).[2] Four types of enterprises may qualify for cash basis recognition: enterprises allowed to account on a cash basis for income tax purposes, enterprises that meet the income tax definition of a 'small business entity', enterprises that have obtained a determination from the Commissioner that allows them to use this basis, and enterprises with an annual turnover lower than the 'cash accounting turnover threshold', currently $2 million.

There are many opportunities for accounting mismatches in a GST regime co-hosting both cash basis and accrual basis enterprises, with one party recognising the tax consequence of a transaction at a different time from the other party. In a sense, the timing mismatches are a subset of a larger pool of mismatches in the GST. At one end of the spectrum are the absolute mismatches, where one party recognises a transaction for GST purposes and the other party never does. This mismatch is the basis for the infamous European 'missing trader' schemes where buyers claim input tax credits in respect of purchases from sellers who disappear without remitting tax on the sale.[3] A variation of the problem has been seen in

* School of Law, University of Leeds.
** School of Law, University of Western Australia.

[1] A New Tax System (Goods and Services Tax) Act 1999 (Cth) ss 29-5, 29-10.

[2] A New Tax System (Goods and Services Tax) Act 1999 s 29-40.

[3] See Ian Crawford, Michael Keen and Stephen Smith, 'Value Added Tax and Excises' in Stuart Adam et al (eds), Dimensions of Tax Design: The Mirrlees Review (Oxford University Press, 2010) 275, 312-313. BTS Specialised Equipment Ltd v Commissioners for HM Revenue & Customs [2017] UKUT 159 ([UK] Upper Tribunal) provides a graphic illustration of the complexity of some missing trader schemes.

Canada with buyers holding what turned out to be non-authentic tax invoices.[4] In both types of cases, tax authorities are unable to pursue the actual delinquent party and can only collect the missing tax from the registered customer by denying input tax credits on the basis that they knew the invoice was not genuine.[5]

Also in the mismatch pool are tax period mismatches involving enterprises on either side of a transaction subject to different tax periods. The mismatch in periods may allow a buyer to claim input tax credits some time before the seller is required to account for output tax on the supply. Mismatches of this sort appear to have troubled UK tax officials,[6] but have raised no concerns in Australia, which has three effective tax periods with monthly,[7] quarterly,[8] and annual filing[9] available to qualifying enterprises.

A third type of mismatch arises where a cash basis vendor sells to a registered accrual basis buyer on a deferred payment basis. In this case, the vendor will not recognise the transaction at the time of the supply or invoice but the buyer will be entitled to an immediate input tax credit. In the case of substantial acquisitions, input tax credits may exceed output tax liability on sales and the buyer will be entitled to a GST refund. The problem is identical to the mismatch over different tax periods, but potentially involving a much longer time scale. While tax period mismatches may allow deferral of output tax for a few months or a year at most, deferred payment schemes, if successful, can result in output tax remittance delays of years or even decades. The schemes also increase the risk of outright evasion if long delayed payment settlements never eventuate.[10]

Authorities in Australia and New Zealand have uncovered arrangements deliberately engineered to exploit the mismatch between cash basis and accrual basis recognition on opposite sides of a transaction and have aggressively pursued serious mismatches, characterising the transactions as avoidance motivated arrangements. Using general anti-avoidance rules (GAARs), they have reassessed the buyers in these cases to deny input tax credits where the contracts allow for deferred payment to cash basis sellers. In the UK, and now in New Zealand, specific anti-avoidance rules (SAARs) have been used in attempts at preventing the problem in the first place.

The current approach used by Australian authorities to address cash-accrual mismatch schemes is not the optimal response to the issue in the context of a self-assessment GST system. Replacement of stop-gap responses based on the GAAR with a targeted SAAR reinforced by the GAAR is a preferable approach for both policy and technical reasons. The remainder of this article explains why a cash basis accounting option is provided to small

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[4] Marie-Claude Marcil, 'The Recipient's Knowledge of Fraud and Its Impact on the Recovery of Refunds and Credits' (2013) 2(3) World Journal of VAT/GST Law 214.

[5] Tax authorities have attempted to argue the buyer should bear the consequences for dealing with what turned out to be a fraudulent supplier if the buyer knew or should have known the purported invoice was not a genuine tax invoice. Courts in Canada appear to have settled on the lower 'knew' onus. See further Salaison Lévesque Inc v. R [2014] GSTC 152 ([Canadian] Federal Court of Appeal). The UK court in BTS Specialised Equipment Ltd v Commissioners for HM Revenue & Customs [2017] UKUT 159 applied a similar level of knowledge threshold when denying the business in that case input tax credits.

[6] See, for example, The Queen on the Application of BMW AG & Another v Commissioners for HM Revenue & Customs [2009] EWCA Civ 77 ([UK] Court of Appeal).

[7] A New Tax System (Goods and Services Tax) Act 1999 ss 27-10, 27-15.

[8] A New Tax System (Goods and Services Tax) Act 1999 s 27-5.

[9] A New Tax System (Goods and Services Tax) Act 1999 s 151-5.

[10] The New Zealand Inland Revenue and The New Zealand Treasury, Options for Strengthening GST Neutrality in Business-to-Business Transactions (Wellington, 2008) 29.

businesses for GST purposes, how this rule can be abused in cash-accrual mismatch schemes, what solutions to the problem have been tried to date in the UK, New Zealand and Australia, and how shortcomings of those measures can be addressed in a new reform model for Australia.

WHY PROVIDE CASH BASIS ACCOUNTING?

Under a benchmark GST, the GST remittance obligation of sellers and the input tax credit entitlement of buyers arise when an invoice is issued and entitlement to receive and liability to make payment are established. Recognition rules are based solely on supplies and the time of payment rights and obligations. They ignore completely any separate explicit credit arrangement between the parties or any implicit credit arrangement by way of deferred payment terms.

As noted, Australia, following the precedent of a number of jurisdictions,[11] allows qualifying small businesses that sell on a deferred payment basis to recognise payments for supplies and outgoings for acquisitions on a cash basis for GST purposes. The explanation for the rule, to simplify the tax and reduce compliance costs, is universal.[12] It is also at best highly problematic.

An initial claim, which must be read with important caveats, is that cash accounting systems may significantly reduce compliance costs for small businesses.[13] However, for most very small businesses, cash basis and accrual basis recognition are largely synonymous. Sales are commonly made on a cash-on-delivery basis and tax invoices are issued at the time of sale and payment. The distinction between cash basis and accrual basis accounting can thus only have a significant impact on the smaller group of firms that routinely sell or buy on credit.[14]

There are, however, few obvious GST simplification benefits of a switch to cash basis recognition for small businesses that make supplies or acquisitions on a credit basis. If an invoice is issued, the business must record somewhere in its accounts the amount invoiced. Delayed recognition of this amount for GST purposes until payment is received or made actually involves an additional step, namely recording cash flows separately from the financial accounts used by the enterprise to record sales and purchase invoices. One key feature that has been cited as a simplification benefit of cash basis accounting, the elimination of any need for sellers to make an additional input tax claim when a bad debt adjustment event crystallises,[15] is likely to have limited practical impact on a business' compliance costs. Both cash basis and accrual basis businesses that extend credit to customers maintain comprehensive records of unpaid amounts as part of their debt management process and both undertake similar processes in the course of writing off bad debts for accounting purposes. The only difference for tax purposes is that the accrual basis enterprise adds the amount of the bad debt to the input tax credit claim in the period in which the debt is written off while the cash basis enterprise recognises the bad debt implicitly through a lower than expected output tax record in the later period.

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[11] See, OECD, Taxation of SMEs in OECD and G20 Countries (OECD, 2015) 110.
[12] The New Zealand Inland Revenue and The New Zealand Treasury, above n 10; OECD, above n 11.
[13] OECD, Taxation of SMEs: Key Issues and Policy Considerations (OECD, 2009) 123.
[14] Firms in this category will vary from jurisdiction to jurisdiction. The New Zealand Advisory Panel on Goods and Services Tax identified dairy farmers, builders and non-profit bodies as members of the group in New Zealand; see The New Zealand Inland Revenue and The New Zealand Treasury, above n 10, 31.
[15] OECD, above n 11.

Although the conventional simplification and compliance savings rationale for a cash basis accounting option for small businesses may be weak, there is a plausible alternative explanation for the option, namely that it is a subsidy to offset the regressive GST compliance costs faced by small businesses.[16] While GST compliance costs rise in absolute terms as businesses grow, they do not rise as rapidly as revenues, meaning the costs are relatively higher for small businesses if measured in proportion to the revenues they derive.[17] If cash accounting provides a fiscal benefit to small businesses,[18] the benefit could be seen as a subsidy to ease the relatively higher compliance costs these businesses face. The fiscal benefit for cash basis sellers is the deferral of a tax burden until the tax period in which payment on an earlier issued invoice is received.

Cash basis recognition of sales and acquisitions made on a deferred payment basis is a double edged sword, however. While one effect is to delay recognition of consideration where a business has sold on a credit basis, it also delays recognition of expenditures yielding input tax credits until payments are made where a business has bought on a credit basis. The concession is thus of no benefit to buyers that acquire inputs on credit terms. In terms of sellers, the fiscal benefit would only be enjoyed by a subset of small businesses, namely those that regularly make sales on a deferred payment basis. Cash basis accounting is also of no benefit to small businesses that operate on a cash-on-delivery basis as the time of payment coincides with the time of invoicing for these firms.

It can be seen, thus, that neither the simplification nor the cash flow subsidy rationales for a cash accounting option for small businesses is compelling. The best that could be said for them, perhaps, is that they obviate the need to concede a more plausible explanation for the option, namely its role in a package of concessions aimed at a politically sensitive and powerful sector of the community.[19] Given that political sensitivity, there is unlikely to be any move to withdraw the concession in the near future whatever its limitations in terms of simplifying GST for small businesses or providing an indirect subsidy to offset the impact of regressive compliance costs. The consequences of a GST that allows enterprises on either side of a supply to use inconsistent cash and accrual recognition may, however, be costly.

CASH AND ACCRUAL MISMATCHES

While the GST law artificially divides an enterprise's ongoing activities into strict tax periods, commercial transactions in the real world carry on across continuous periods. Whether an enterprise recognises acquisitions and supplies on a cash basis or accrual basis, over a commercially reasonable period, output tax liability will ordinarily exceed input tax entitlements. In these cases, the net amount remitted to the Tax Office will be the GST levied on the taxpayer's value added to the supply. In some instances, however, input tax credits will exceed output tax liability within a particular tax period and the enterprise will be entitled to a refund of GST.

In a GST system, input taxes might exceed output taxes for a variety of reasons: a business may not be profitable and run at a genuine loss, a business may make GST-free supplies

[16] Cedric Sandford, 'The Administrative and Compliance Costs of the United Kingdom's Value Added Tax' (1990) 38 (1) Canadian Tax Journal 1; OECD, above n 11, 112.

[17] Cedric Sandford, Michael Godwin and Peter Hardwick, Administrative and Compliance Costs of Taxation (Fiscal Publications 1989); Sijbren Cnossen, 'Administrative and Compliance Costs of the VAT: A Review of the Evidence' (1994) 63 Tax Notes 1609, 1619-1623.

[18] See The New Zealand Inland Revenue and The New Zealand Treasury, above n 10, 31.

[19] Claire Crawford and Judith Freedman, 'Small Business Taxation' in Stuart Adam et al (eds), above n 3, 1086.

(supplies that provide an entitlement to input tax credits but which bear no output tax), or a business may have made significant acquisitions (usually large capital acquisitions) such as very long-life equipment or real property that will be used to make supplies over an extended period. In most cases, tax authorities have no difficulty making refunds to purchasers in these circumstances; in the ordinary course of events, the enterprise claiming input tax credits and receiving a refund has acquired goods or services from other enterprises that remitted tax on their outputs that can be used to pay the refund.

The refund request will raise alarm bells with tax authorities, however, if the acquisition that provides a refundable credit is made from cash basis vendor to a directly or indirectly related accrual basis purchaser and the contract provides for a significantly deferred payment. When payment is deferred until long after the supply is made, the amount to be paid may be many multiples of the value of goods or services at the time of supply, with the amount due in the future reflecting the time value of money. The input tax credit attached to the future payment will thus also be far larger than the credit that would be available had payment been made contemporaneously with the supply.

The quantum of the input tax credit alone is not a cause of concern. Nor does the concern turn on the fact that the accrual basis person claims an input tax credit at the time it receives an invoice and does not remit GST until the acquisition is resold in the future. The gap between credits on acquisitions and later remittances on subsequent sales is a basic and appropriate design feature of the GST. The input tax credit relates not to a later supply but rather to an acquisition; the input tax credit claimed by a buyer is matched by the output tax paid on the same transaction by the seller, not the buyer's future output tax. The concern, thus, is with the mismatch between a buyer's input tax credit and the seller's output tax. Each input tax claim by a customer should be matched by an output tax liability on the part of the vendor.[20]

That matching will not be found in the case of a sale from a cash basis seller to an accrual basis buyer where payment is deferred. While the mismatch is inconsistent with the output tax-input tax matching principle of a GST, in the case of an arm's length transaction, policy makers simply accept the outcome as an unavoidable consequence of the cash basis recognition concession provided to small businesses. They are not so tolerant, however, of mismatches between related persons that have been deliberately engineered to obtain a cash advance to be used as working capital, sometimes for decades and possibly forever, if the cash basis seller never remits output tax on the supply.[21]

The arrangement appears to arise most often in the property development industry, though it has been attempted in other sectors as well by enterprises seeking a cash infusion.[22] For example, a property developer seeking funds for a large project may establish a string of companies that enter into separate contracts with a landowner to acquire the property as

[20] Confused understanding of the tax in some judicial quarters initially equated the extended delay between acquisitions and later supplies incorporating those acquisitions as avoidance; see Robertson J for the Court of Appeal of New Zealand in *Ch'elle Proper*ties (NZ) Ltd v Commissioner of Inland Revenue [2007] NZCA 256 [2007] NZLR 342; (2007) 23 NZTC 21, 442, para 41. The view was effectively disregarded on appeal; see *Ch'elle Properties (NZ) Ltd v Commissioner of Inland* Revenue [2007] NZSC 73; (2007) 23 NZTC 21, 653.

[21] The Policy Advice Division of the Inland Revenue Department, GST: A Review (Wellington, 1999), 65.

[22] See, for example, Education Administration Ltd v Commissioner of Inland Revenue [2010] NZHC 663; (2010) 24 NZTC 24, 238 (private tuition business sought funding by way of input tax credit refunds to develop software program).

separate lots. Each company registers as a cash basis taxpayer which then commits to build a premises on the property and sell the land and building to the related property developer which accounts on an accrual basis, with settlement scheduled for 10 or 20 years in the future. Because settlement is delayed for such a long time, the price may be up to 10 times the actual market value of the land at the time of sale. The accrual basis buyer then claims input tax credits and passes the funds to the intermediary cash basis companies as deposits for the eventual sales. The cash basis companies can then use the funds to complete purchase of the land.

To illustrate, assume 100 companies accounting on a cash basis buy the land for $70,000 each and on-sell the property for $770,000 (including a constructed premises) with settlement scheduled for 10 or 20 years in the future. The accrual basis buyer could claim an immediate refundable input tax credit of 1/11 x $770,000 = $70,000 for each purchase. The input tax credit refund would be applied as a down payment to the cash basis sellers and these enterprises would in turn use the funds received to pay the purchase price to the original land owner. The cash basis intermediaries would recognise the $70,000 each received as consideration for GST purposes and acknowledge a GST obligation but claim an offsetting input tax credit for the land they purchased from the original land owner. As the purchases are divided between 100 companies, each remains under the accrual basis threshold when it recognises $70,000 consideration for its sale to the accrual basis buyer.[23]

Importantly, in the scenario outlined above, the parties do not contemplate a transaction that gives rise to any evasion of tax or even avoidance in the sense of rearranging a transaction to reduce a tax liability. The input tax credit claimed by the accrual basis buyer will eventually give rise to an output tax liability by the cash basis vendor companies. Because the sellers retain property interests in the land until the final sale, the debt is fully secured, ensuring the tax will be paid eventually. What the parties are doing, in effect, is obtaining an interest-free loan from the government – the accrual basis side of the transaction receives an immediate refund for excess input tax credits and the cash basis side does not remit for a decade or more.

JUDICIAL RESPONSES TO CASH AND ACCRUAL MISMATCHES

Cash-accrual basis mismatch schemes have been addressed through two means: purposive judicial characterisation of the underlying commercial transaction and legislated anti-avoidance rules. An illustration of purposive interpretation of the underlying transaction is found in the decision of the New Zealand Tax Review Authority in the *Ch'elle Properties* (NZ) Ltd chain of appeals.[24] The scheme involved the sale and acquisition of properties in circumstances similar to those described in the illustration above. When the Commissioner initially denied the accrual basis enterprise the input tax credits it sought, it was unable to pay the deposits due to the cash basis sellers and the sellers were thus unable to complete their acquisitions of the properties they intended to sell. The Taxation Review Authority concluded that even if there may have once been an entitlement to input tax credits, once the contracts fell through, the entitlement evaporated as there were no supplies.[25] This view was

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[23] This fact situation is adapted from Case W22 (2003) 21 NZTC 11,212 (Taxation Review Authority); upheld *Ch'elle Properties (NZ) Ltd v Commissioner o*f Inland Revenue [2004] 3 NZLR 274l; (2004) 21 NZTC 18,618 (New Zealand High Court); [2007] NZCA 256 (New Zealand Court of Appeal), [2007] NZSC 73; (2007) 23 NZTC 21,653 (New Zealand Supreme Court).

[24] See above n 23.

[25] Case W22 (2003) 21 NZTC 11, 212. While the Taxation Review Authority ultimately relied on the GAAR to dispose of the taxpayer's appeal, it first found that the input tax credit claim failed on the basis of the incomplete

endorsed by the first court above the Tribunal[26] in what would prove to be a lengthy appeal chain that ended in a decision in the New Zealand Supreme Court in favour of the Commissioner on the basis of the New Zealand GST GAAR.[27]

Opportunities for judicial responses of this sort are limited. If the facts allow, it may be possible to deny input tax credits on the basis of contract law interpretation. But since the approach is fact based, it offers no general solution. Not surprisingly, therefore, authorities have relied on statutory measures to counter cash and accrual mismatch schemes.

Legislative responses to cash and accrual mismatches

Both specific and general anti-avoidance rules have been used to combat cash and accrual mismatches. New Zealand, the UK and Australia provide useful case studies for statutory responses to the mismatches as all adopted different approaches. New Zealand has used both a SAAR and a GAAR to combat cash and accrual mismatches. The UK used only a SAAR and Australia used only a GAAR. These SAAR and GAAR approaches are considered in turn below.

The UK SAAR approach – require cash basis suppliers to use accrual basis recognition for extended credit period sales: The UK targeted response to cash-accrual mismatch schemes, adopted in 1995, required cash basis suppliers to use accrual basis recognition whenever an invoice provided by a cash basis vendor deferred the buyer's payment liability for more than 12 months from the date of invoice.[28] The rule was simultaneously generous and severe. On the one hand, the one year threshold had the effect of legitimating mismatch schemes deliberately engineered to last for less than 12 months. The opportunity for abuse was seen as too generous and two years after the rule was first adopted, the 12 month threshold was reduced to six months.[29]

On the other hand, the sudden-death feature rule was and remains particularly harsh and inequitable for small businesses entering into arm's length contracts that provided longer-term credit arrangements for legitimate commercial reasons. An enterprise providing 182 days of credit can defer recognition of consideration for the entire period; the enterprise providing 183 days of credit is allowed no deferral. Legitimate businesses that must provide slightly longer payment terms are denied any relief while enterprises abusing the concession to obtain short-term interest-free loans from the tax authority can exploit the half year deferral allowed. The arbitrary all or nothing cut-off seriously compromises the policy goals behind the concession.

The rule might also be susceptible to abuse. The risk arises because the threshold is based on the time at which payment is due under the invoice rather than the time payment is actually made. As the schemes involve two parties not operating truly at arm's length, the parties could agree to an invoice that states payment is due within six months but the cash basis

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supply. The case and somewhat convoluted principle it expressed that entitlement to input tax credits will never have existed if a supply is not completed is discussed further in Rebecca Millar, 'Time is of the Essence: Supplies, Grouping Schemes and Cancelled Transactions' (2004) 7(2) Journal of Australian Taxation 132.

[26] *Ch'elle Properties (NZ) Ltd v Commissioner of Inland Revenue* [2004] 3 NZLR 274l; (2004) 21 NZTC 18, 618 (New Zealand High Court).

[27] *Ch'elle Properties (NZ) Ltd v* Commissioner of Inland Revenue [2007] NZSC 73; (2007) 23 NZTC 21,653 (New Zealand Supreme Court).

[28] Value Added Tax Regulations 1995 (UK), reg 58(2), as it then stood.

[29] Value Added Tax (Amendment) (No 3) Regulations 1997/1614, reg 3.

vendor makes no effort to collect within this time and fails to bring the unpaid amount to account as a bad debt. The risk is limited, however, by a separate adjustment event rule that requires enterprises to reverse input tax credit claims if consideration has not been paid six months after the date on which it was due to have been paid,[30] effectively limiting the timing mismatch to one year.

The New Zealand SAAR approach – require cash basis suppliers to use accrual basis recognition for high value sales: Five years after the UK adopted a SAAR to address cash-accrual mismatch arrangements, New Zealand tax auditors became aware of a deliberate mismatch arrangement that ultimately led to what became the most important New Zealand case on the issue.[31] Unlike the UK, which had no GAAR in its VAT law,[32] New Zealand had a GAAR in its GST legislation that in theory could be used to void the arrangements but uncertainty about the application of the GAAR to mismatch schemes prompted New Zealand authorities to adopt a SAAR in 2000. The rule requires cash basis suppliers to recognise consideration on an accrual basis – that is, when the invoice is issued –where the payment due exceeds NZD $225,000.[33] However, the SAAR provides an exception for "short-term" agreements in which the settlement takes place or services are performed within a year of the agreement being entered into, in effect viewing these arrangements as legitimate extensions of credit by cash-basis vendors.[34]

Three aspects of the New Zealand rule are problematic. The first is the high dollar trigger for application of the rule applying to mismatches, which in effect invites scheme planners to split transactions into several parts to avoid crossing the trigger threshold.[35] The provision allows the Commissioner to consolidate separate supplies where the total sum of consideration exceeds the threshold but this can only be done where the Commissioner believes more than one supply was made to avoid crossing the mandatory accrual basis recognition threshold.[36] The subjective test needed to invoke the consolidation rule is prima facie incompatible with a full self-assessment regime. It may also be of limited utility; well-advised enterprises are likely to have a plausible business case apparently unrelated to tax considerations for multiple supplies that fall below the threshold. In the leading splitting case, an accrual basis enterprise claimed an input tax refund of more than NZD $1.5 million from seven acquisitions, each of which was for a value slightly under the SAAR threshold, with consideration not payable for 36 years.[37] Unable to apply the SAAR to the business, the Commissioner relied (ultimately successfully) on the GAAR to deny an input tax credit refund.

[30] Value Added Tax Act 1994 (UK), s 26A.
[31] Case X25 (2006) 22 NZTC 12,303; [2006] NZTRA 9, para 39 explained that the SAAR was enacted in response to the assessment dispute that was ultimately heard by the New Zealand Supreme Court in *Ch'elle* Properties (NZ) Ltd v Commissioner of Inland Revenue [2007] NZSC 73; (2007) 23 NZTC 21,653.
[32] The UK General Anti-Abuse Rule was enacted in Finance Act 2013. The VAT is not a tax to which it applies (see s 206(3)).
[33] Goods and Services Tax Act 1985 (NZ), s 19D(1).
[34] Goods and Services Tax Act 1985 (NZ), s 19D(2). The provision relies on the definition of a short-term agreement in s YA 1 of the Income Tax Act 1994 (NZ).
[35] See, for example, Case X25 (2006) 22 NZTC 12,303; [2006] NZTRA 9. While it successfully bypassed the SAAR, the scheme in Case X25 was ultimately defeated by the Commissioner of Inland Revenue using the New Zealand GAAR.
[36] Goods and Services Tax Act 1985 (NZ), s 19D(3).
[37] Case X25 (2006) 22 NZTC 12,303; [2006] NZTRA 9.

The second, and equally problematic, aspect of the New Zealand rule is its sudden death feature. With the aim of curbing cash-accrual mismatch abuse, subject to the short-term contract exception the threshold rule removes entirely the cash accounting subsidy from businesses that cross the threshold. Both legitimate and abusive businesses selling on a credit basis for $224,999 enjoy the full subsidy intended for the former only while legitimate firms selling for $225,001 have no concession at all.

The third troubling feature of the New Zealand SAAR is its time-based safe harbour exception for contracts providing for settlement or the performance of services within a year of the agreement being entered into. The exception was presumably adopted to prevent hardship for enterprises that make supplies for consideration exceeding the SAAR threshold if the likelihood of a prolonged mismatch is small because delivery of contracted supplies is completed within a relatively short period. It may well be the case that neither party to short duration contracts, where the provider does not require an infusion of capital to complete the supply, is likely to seek substantial deferral of payment. The assumption might not hold, however, if the parties are looking for funding for other projects.

Authorities considered two possible alternative responses to the timing mismatches problem.[38] The first was to retain the existing form of rule but lower the application threshold at which cash basis sellers must recognise GST on sales on an invoice basis to NZD $90,000. The second was to shift the effect of the rule from the seller to the buyer, establishing a quasi-amortisation rule that would have required accrual basis buyers to recognise input tax credits over a nine-year period where the cost of an acquisition exceeded the anti-avoidance rule threshold. The spread-out recognition requirement would terminate if the invoice were paid during the extended recognition period. To date, neither alternative has progressed beyond the original suggestion.

It is unlikely either proposal would successfully overcome the shortcomings of the rule. Reducing the trigger threshold may simply shift the point at which enterprises will split transactions without addressing the underlying mismatch problem. Adoption of an input tax amortisation-like recognition rule might reduce the mismatch but would still allow almost a decade of undeserved benefit to scheme participants while generating considerable compliance complexity and possibly cash-flow problems for legitimate accrual basis businesses. An amortisation rule is also likely to prompt further transaction splitting.

The Australian-New Zealand GAAR approach – deny the buyer input tax credits in significant mismatch cases: In Australia, and originally in New Zealand, tax officials relied on GAARs to combat schemes after the fact. Following adoption of a SAAR, the New Zealand Inland Revenue Department continued to rely on the GAAR in cases in which enterprises structured transactions to avoid the application of the SAAR.[39] Unlike SAARs that limit the ability of cash basis vendors to recognise sale on a cash basis, GAARs are applied to accrual basis buyers, denying them input tax credits for acquisitions from cash basis suppliers made in the course of a tax avoidance scheme.

Not surprisingly, given New Zealand's 16 year jump on Australia in adopting a GST, New Zealand courts were asked to consider whether the GST GAAR could be used to combat cash-accrual mismatch schemes long before their Australian counterparts. On its face, the

[38] The New Zealand Inland Revenue and The New Zealand Treasury, above n12, 34.
[39] See Case X25 (2006) 22 NZTC 12,303 (enterprises avoided the SAAR by splitting supplies so consideration for each sale was below the SAAR threshold).

application of the New Zealand GAAR to cash-accrual mismatch schemes was challenging as the provision stood when authorities first became aware of the issue. The original provision allowed the Commissioner to void the tax outcome of an arrangement and substitute a tax outcome the Commissioner thought appropriate to counteract the effect of the voided arrangement if the arrangement had been entered into to defeat the intent and application of the GST Act.[40] The essence of a cash-accrual scheme is not to defeat the application of any provision of the Act; rather, it works by explicitly using the provisions of the Act.[41] There is no obvious intent of the Act in respect of mismatch transactions between cash and accrual basis enterprises. A revised GAAR adopted in 2000 uses a structure not dissimilar to the Australian provision, applying where a taxpayer enters into a tax avoidance 'arrangement' (similar to a 'scheme' in the Australian law), with the purpose or effect of 'tax avoidance' (similar to obtaining a 'tax benefit' in Australian law).[42] The trigger bar is set lower in the New Zealand law where the Commissioner has to show that a tax avoidance objective or effect was more than merely incidental as opposed to the Australian 'sole or dominant' purpose or 'principal' effect threshold.[43]

The first assessment raised by Inland Revenue in a cash-accrual mismatch case was appealed to the Taxation Review Authority and three appellate courts by the registered business claiming input tax credits.[44] All four bodies found in favour of the Commissioner but each offered different reasons why the GAAR should apply. Along the path to the final disposal of the appeal, the New Zealand High Court acknowledged the mismatch between deferral of GST liability by a cash basis vendor and acceleration of input tax recognition by an accrual basis buyer is both 'contemplated and tolerated' by the Act, but concluded that the scheme in that case had escalated the mismatch 'to a level which could never have been intended'.[45] Central to the final decision in the chain was recognition that the arrangements lacked any commercial viability without the advance of funds that the scheme was intended to trigger.

Not long after the initial New Zealand cases, writing extra-judicially, Justice Graham Hill concluded that mismatch schemes would also be considered avoidance in Australia and would fall afoul of the Australian GST anti-avoidance rule.[46] The GAAR in the Australian GST legislation applies where an entity enjoys a GST benefit from a scheme and it can be shown that the entity entered into the scheme with the sole or dominant purpose of obtaining a GST benefit or that the principal effect of the scheme was to bestow a GST benefit on the entity.[47] The GAAR identifies four types of GST benefits that may trigger application of the rule:

- an amount payable by an entity is smaller than it would have been but for a scheme;
- an amount payable to an entity is larger than it would have been but for a scheme;

[40] Goods and Services Tax Act 1985 (NZ), s 76(1), as it stood prior to 2000.
[41] Graham Hill, 'Scheme New Zealand or an Example of the Operation of Div 165' (2003) 1(2) e-Journal of Tax Research 147, 150; see also Rebecca Millar, 'Thoughts on the Contribution of the Late Justice JG Hill to Australia's GST' (2013) 28 Australian Tax Forum 137; and *Ch'elle Properties (NZ) Ltd v Commissioner of* Inland Revenue [2004] 3 NZLR 274l; (2004) 21 NZTC 18,618, para 49.
[42] Goods and Services Tax Act 1985 (NZ), s 76 (8), definition of "arrangement" and"tax avoidance".
[43] Goods and Services Tax Act 1985 (NZ), s 76 (2); A New Tax System (Goods and Services Tax) Act 1999, s 165-5.
[44] Case W22 (2003) 21 NZTC 11, 212, above n 23. The facts in the decision were used as the basis for the example set out in the text at above n 23.
[45] *Ch'elle Properties (NZ) Ltd v Commissioner of Inland* Revenue [2004] 3 NZLR 2741; (2004) 21 NZTC 18,618, para 49.
[46] Hill, above n 41.
[47] A New Tax System (Goods and Services Tax) Act 1999 Div. 165.

- an amount is payable by an entity later than it would have been but for a scheme; or
- an amount is payable by an entity earlier than it would have been but for a scheme.[48]

The range of GST benefits that may trigger operation of the GAAR appears to limit its application to timing mismatches, with the definition of a GST benefit focusing on the amount or time of consideration payable rather than the accounting mismatch between two persons on either side of a transaction.[49] Hill J nevertheless suggested the GAAR would apply to similar arrangements and the saving rule, which states that the GAAR will not apply if the tax benefit arises as a result of an election by a registered person, would not rescue the scheme. He acknowledged a crucial element of the scheme was the election by the seller to account on a cash basis but concluded the benefit of the scheme did not arise from the election but rather from the mismatch that arose after the election was made. Separately, he suggested the scheme gives rise to a tax benefit (input tax credits that would not be available but for the scheme as the transaction would not have proceeded but for the scheme) and facts (an arrangement between associated persons and transactions that had no independent commercial rationale) that pointed towards a dominant purpose of the scheme being to obtain that benefit.

The Administrative Appeals Tribunal adopted a similar logic in its judgment in favour of the Commissioner when it heard the first Australian appeal of a cash-accrual mismatch assessment, VCE and FCT.[50] In that case, the Commissioner had relied on the GST GAAR to deny an accrual basis company an input tax credit in respect of an acquisition of property from its cash basis shareholder and controller. The Tribunal noted that if it were not for the scheme, the accrual basis buyer would not be in a fiscal position to make the acquisition as it was structured and thus there would be no amount payable and no entitlement to an input tax credit by the buyer or, in the alternative, a much smaller sale price and consequently a much smaller input tax credit.[51] If the counterfactual were no entitlement or a reduced entitlement to an input tax credit but for the scheme, the Commissioner could easily establish a GST benefit from the scheme.

APPLYING THE LESSONS

The most direct way of addressing cash-accrual mismatch schemes would be to remove the cash basis concession that makes the schemes possible. Given the sensitivity of governments to any disaffection from the small business sector benefiting from the concession, it is highly unlikely that any would contemplate removing the cash basis option.[52] For the foreseeable future, both cash and accrual basis accounting in the GST will continue and the immediate task is to reduce opportunities for abuse of any mismatches between the two. As there are only limited opportunities in which effective judicial responses based on judicial characterisations of the underlying commercial arrangements can be used, the only practical response is a legislated anti-avoidance rule. The models tried to date – a GAAR denying accrual basis buyers entitlement to input tax credits and two variations of a SAAR requiring

[48] Paraphrased from A New Tax System (Goods and Services Tax) Act 1999 s 165-10.

[49] As Hill J commented, "What is perhaps unusual with the deferred payment scheme is that it depended upon both the taxpayer being entitled immediately to the input tax credit and the vendor to the taxpayer not being required to pay GST until a later time." See Hill, above n 41, 152.

[50] VCE and FCT [2006] AATA 821 (AAT).

[51] VCE and FCT [2006] AATA 821, paras 62-63.

[52] In New Zealand, in the vicinity of 96% of enterprises qualify for the cash basis concession and almost 80% of all GST-registered persons use the concession; see New Zealand Inland Revenue and New Zealand Treasury, above n 10, 33 and 36.

cash basis sellers to recognise consideration on an accrual basis when transactions cross designated avoidance triggers – are less than ideal.

The GAAR has been shown to be an effective response to known cash-accrual mismatch schemes uncovered in the course of assessment or audit after enterprises have effectively navigated an avoidance path through operative provisions. However, its inherent uncertainty and the potential for unfairness resulting from selective application make the GAAR a poor choice for an effective initial safeguard measure.[53]

The uncertainty of a GAAR derives from its dependence on a finding that the primary purpose behind a transaction or its primary effect is to obtain a tax benefit. This determination must be made on a case-by-case basis considering the distinct facts of each case. The process of reaching that determination is uncertain and case law precedents provide little in the way of firm guidance. Different appeal bodies considering the same case are quite likely to have adopted very different lines of reasoning and to have used different interpretation approaches when analysing a single set of facts.[54] The measure offers neither assurances to businesses nor clear guidelines to tax authorities apart from the comfort that they can ultimately prevail in assessments based on the provision.

Taxpayer uncertainty, a substantial problem on its own, also exacerbates unfairness in two ways. The first results from the impossible onus imposed on enterprises responsible for determining whether the GAAR applies to their transactions. As Justice Graham Hill pointed out, authorities will only be able to use the GAAR if the arrangements satisfy all the substantive rules in the legislation.[55] The law allows taxpayers to establish separate cash basis and accrual basis enterprises, allows related parties to transact with one another using arm's length prices, and allows cash basis and accrual basis entities to recognise supplies and acquisitions at separate times. Parties to these schemes are doing no more than taking advantage of concessions explicitly allowed in the legislation. Complying businesses run the risk of crossing the imaginary line that separates acceptable tax planning and unacceptable tax avoidance arrangements[56] without ever learning what constitutes avoidance.[57]

Unfairness also results from the necessarily selective application of a GAAR. There is no doubt that the overwhelming majority of sales by cash basis suppliers are to unrelated parties and no mismatch is intended. There is, however, no easy way for tax authorities to segregate the small number that are part of a mismatch scheme. Despite the most sophisticated auditing techniques based on amount, time, history and other factors, some schemes will escape notice and others will be noticed but accepted. Inevitably only a minority of scheme participants will be caught and stopped through the application of the GAAR. In an environment in which fairness is equated with similar tax treatment for all businesses participating in similar transactions, the unfairness of selective GAAR assessments is obvious to all, undermining community support for the tax to which it is applied.

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[53] A summary of international views on these problems is set out in Richard Krever, 'General Report: GAARs' in Michael Lang et al (eds), GAARs – A Key Element of Tax Systems in the Post-BEPS World (IBFD, 2016) 1.
[54] The *Ch'elle Properties* dispute, above n 23, illustrates the phenomenon well – the Taxation Review Authority, New Zealand High Court, New Zealand Court of Appeal and New Zealand Supreme Court all found in favour of the Commissioner for different reasons.
[55] See Millar, above n 41, 150.
[56] Eugen Trombitas, 'Role of a General Anti-Avoidance Rule in GST' (2007) 13(3) New Zealand Journal of Taxation Law and Policy 396, 436.
[57] Mark Keating, 'GST Tax Avoidance: A New Zealand Perspective on the Application of Div 165' (2009) 8(1) eJournal of Tax Research 64, 66.

In the context of a full self-assessment GST system, businesses seek and deserve unambiguous guidance and certainty. With clear and unambiguous rules, a SAAR can avoid the uncertainty and selective application unfairness of a GAAR. Certainty and universal application come at a cost, however. Inherent in every bright line test is a compromise – any limitation on deferred GST recognition by sellers of supplies that will be recognised immediately by buyers involves a trade-off. Wherever the line is set, some legitimate traders will find themselves on the immediate recognition side of the line and some abusive traders will be able to position themselves on the deferred recognition side. Universal deferral for all legitimate traders and complete denial of deferral to abusive traders is not possible; the goal is thus to design a SAAR that has minimal impact on legitimate enterprises and maximum impact on abusive traders.

Both the UK and New Zealand SAARs fall short of a model solution in part because of their sudden death design. One apparent aim of the cash accounting option is to subsidise small businesses offering credit terms. However, subject to a safe harbour rule in New Zealand, both the UK and New Zealand SAARs strip the deferral subsidy completely from small businesses where commercial imperatives require them to agree to terms for a payment that is greater than the amount threshold (in the case of the New Zealand SAAR) or that is due at a date beyond the time threshold (in the case of the UK SAAR). The sharp sudden death approach creates obvious inequities between similar enterprises that find themselves on either side of the boundary between full deferral and no deferral. A more sensible approach is to treat the threshold as a cap and subsidise credit arrangements up to the cap. If a New Zealand-style dollar cap is used, consideration up to the cap can be recognised on a cash basis and the part of the consideration which exceeds the cap will then be recognised on an accrual basis. If a UK-style time limit is used, the subsidy can be provided for the period up to the threshold and accrual basis recognition can apply when the subsidy period ends.

Modified in this way, the UK and New Zealand models establish a sensible compromise. They do not prevent truly abusive taxpayers from securing unwarranted interest-free loans by structuring transactions immediately below the SAAR trigger point – in the UK arranging for payments immediately before the time threshold and in New Zealand selling for consideration immediately below the dollar threshold. Nor do they offer unlimited subsidies to small businesses extending longer term or higher value credit in wholly legitimate transactions with third parties. If the threshold is set properly, however, it can allow for a suitable level of subsidy while greatly limiting opportunities for abuse.

The UK time-based threshold limit appears less vulnerable to exploitation than the New Zealand dollar-based threshold. While there is no limit to the size of the loan that UK abusers can seek apart from the risk of setting off audit alarms, the duration of the subsidy is limited to six months. In contrast, a scheme inserting a cash basis small business between the underlying vendor and the accrual basis buyer in New Zealand for consideration just below the SAAR threshold can give rise to a de facto interest-free loan of indefinite duration from Inland Revenue of just under NZD $29,348.[58] It might be concluded, therefore, that a better SAAR would use a time threshold to cap the subsidy provided to small businesses selling on a credit basis while avoiding the weakness of the UK rule. This could be done by replacing the sudden death time limit with a bifurcated measure that provides a subsidy up to a time

[58] The New Zealand GST rate is 15%. A tax-inclusive sale price of $225,000 will be broken down to a tax-exclusive price of $195,652 and a GST component of $29,348 (15% of $195,652).

limit and then withdraws it only for any deferral after that time. There is a risk, however, that a time-based threshold, even if it has no sudden death feature, could prejudice those types of small business that commonly agree to longer credit terms in legitimate arm's length transactions with no deliberate mismatch element.[59]

Importantly, a time-based SAAR must avoid the risk of time of payment collusion created by the UK current rule that looks at notional payment date stipulated in an invoice[60] or the New Zealand safe harbour rule that looks at the time of settlement or performance. The focus of a SAAR aimed at recognition timing mismatches should be the actual time of payment, the trigger for cash basis recognition.

In the context of the Australian legislation, the provision might appear as a further subsection to the principal cash accounting provision (s 29-40), indicating that a registered person that accounts on a cash basis will be treated as receiving payment for a supply at the earlier of time of payment and a threshold date some time after a supply is made or an invoice is issued for a supply.[61] Policy makers can then be expected to set that time threshold by reference to the cost of the cash basis accounting concession, balancing their interest in extending a subsidy to legitimate small business traders against the risk of exploitation of the subsidy up to the limit set in the SAAR by cash-accrual mismatch schemers.

AVOIDING THE AVOIDANCE

The cash basis accounting option for small businesses provides a subsidy to a subset of this group that make supplies on a credit basis. Misused, however, cash basis accounting can be incorporated into arrangements with the aim of obtaining interest-free financing from the Tax Office, an outcome at odds with the legislative intent behind the concession. The UK, New Zealand and Australia have responded to the issue with various GAAR and SAAR measures but none is ideal. The optimal solution is a rule that provides the certainty of a SAAR while avoiding known and potential shortcomings of existing rules elsewhere. A significant flaw with the UK and New Zealand SAARs is their sudden death design, removing the cash basis subsidy entirely from small businesses that agree to payment terms exceeding the SAAR thresholds in legitimate commercial arrangements. The UK approach that limits access to the concession by reference to time is more effective at limiting opportunities for abuse than the New Zealand rule that references application of the SAAR to the value of a supply.

A preferable SAAR would thus allow cash basis accounting only up to a specific time limit and require accrual basis recognition at that point if payment has not been made prior to the date at which the time limit is reached. It would use actual pay dates to set a time limit rather than notional payment due dates or the contracted date of settlement or performance. The GAAR could then remain a useful backstop measure. A solution building on lessons from New Zealand and UK experience may be the best way to avoid the avoidance.

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[59] See note 14, above.

[60] As noted, the UK VAT legislation limits the collusion risk by providing for automatic recognition of a VAT liability six months after the due date for payment (see above n 30). There is no counterpart in the Australian law.

[61] The provision could be framed along the following lines: 29-40(2): If you *account on a cash basis, you will be treated as receiving payment for a supply at the earlier of actual time of payment and [the threshold period] after the supply is made or the time an invoice is issued for the supply.