PARLIAMENT OF THE COOK ISLANDS

VALUE ADDED TAX AMENDMENT BILL

EXPLANATORY NOTE

The *Value Added Tax Amendment Bill 2014* (the **Bill**) provides for amendments to the *Value Added Tax Act 1997* (the **VAT Act**). The primary purpose of the Bill is to implement decisions made by Government in relation to value added Tax (**VAT**) resulting from the 2013 Cook Islands Tax Review. The Bill also modifies the taxation of cross-border services to better align with international practice and makes some technical amendments to the VAT Act.

This note does not form part of the Bill but is intended to indicate its effect, and to identify the more important aspects of the Bill.

Clause 1 This section provides that the short title of the Bill is the Value Added Tax Amendment Bill 2014.

Clause 2 This section provides that the Bill, when enacted, comes into force on 1 April 2014. Section 4 of the Bill provides for the application of the Bill and section 23 inserts generic transitional rules into the VAT Act that will apply for the purposes of the Bill. In addition, the Bill includes transitional rules specific to amendments in sections 14(3), 15(2) and 26 of the Bill.

Clause 3 This section provides that the Bill amends the VAT Act.

Clause 4 This section provides for the application of the Bill. When enacted, the Bill will apply to supplies and importations made on or after 1 April 2014. This is subject to the transitional rules in sections 23, 14(3), 15(2) and 26 of the Bill.

Clause 5 This section defines **application date** for the purposes of the Bill. The definition is relevant to the transitional rules in subsections 14(3) and 15(2) of the Bill. The application date is 1 April 2014, being the date specified in section 4.

Clause 6 This section amends section 3 of VAT Act, which provides for an extended meaning of "supply".

Paragraph (a) inserts new subsection (2A), which provides for a deemed supply rule relating to grants or subsidies provided by a foreign government, or an

international organisation or other non-government organisation. The deemed supply rule corresponds to the deemed supply rule in section 3(2) of the VAT Act applicable to grants or subsidies provided by the Cook Islands Government.

Subsection (2A) applies when the following conditions are satisfied:

(1) A foreign government, or an international organisation or other non-government organisation makes a payment in the nature of a grant or subsidy. "International organisation" is defined in new subsection (8) (inserted by the Bill - see below).

(2) The payment is made to a person in respect of the person's taxable activity.

If these conditions are satisfied, the person receiving the grant or subsidy is deemed to have made a supply of goods or services in return for the grant or subsidy. Thus, the grant or subsidy is treated as the consideration for the deemed supply. Further, the supply is treated as occurring in the Cook Islands in the course of the person's taxable activity. Section 24 of the Bill amends the First Schedule of the VAT Act by including a deemed supply under section 3(2A) of the VAT Act as an exempt supply.

Paragraph (b) inserts a new subsection (8), which defines "international organisation" for the purposes of the section. The term is used in new subsection (2A). An "international organisation" is an organisation the members of which are sovereign powers or the governments of sovereign powers. Examples of an international organisation are the Asian Development Bank, and the United Nations and its Specialised Agencies such as the World Bank.

Clause 7 This section inserts new section 4A, which defines the term "supply of imported services" for the purposes of the VAT Act. This is part of a series of amendments made in the Bill to modernise the VAT treatment of foreign-provided services used in the Cook Islands.

The definition is primarily relevant to section 10(2)(c) (inserted by the Bill), which imposes VAT on a supply of imported services with the VAT payable by the registered person receiving the supply (referred to as the 'reverse charge rule'). The definition is also relevant to section 6(9A) and (9B) (inserted by the Bill), which provide valuation rules for supplies of imported services, section 18(8) (inserted by the Bill), which specifies the VAT documentation required for supplies of imported services, and section 43 (amended by the Bill), which counters tax avoidance schemes including in relation to supplies of imported services.

The reverse charge rule applies to a supply of imported services only when the registered person does not use the services solely as an input to make taxable supplies. The reverse charge rule is stated in section 10(2)(c) (inserted by the Bill)

and, in effect, requires the registered person receiving the supply of imported services to charge itself VAT. Reverse charging does not apply when the registered person receiving the supply of imported services uses the services solely to make taxable supplies, as the VAT on the value added by the imported services will be captured when the registered person subsequently makes the taxable supply for which the imported services were an input. Further, the reverse charge rule does not apply to foreign-provided services made to unregistered persons (including end consumers). It is not administratively feasible for unregistered persons to report and pay VAT on any foreign-provided services they have acquired. VAT is payable on foreign-provided services to unregistered persons only when the supplier of the services is registered for VAT. The new place of supply rules in section 7(5), (6) and (7) (inserted by the Bill) expand the circumstances when foreign-provided services are supplied in the Cook Islands. If a supplier of foreign-provided services exceeds the registration threshold, the supplier must apply for registration under section 12 (amended by the Bill) and, if they do not have a fixed establishment in the Cook Islands, appoint a VAT representative under section 37(2) (inserted by the Bill).

Subsection (1) provides that there is a supply of imported services if the following conditions are satisfied:

(1) There must be a supply of services. Supplies of goods are not subject to the reverse charge rule because goods are tangible and, in order to be consumed in the Cook Islands, they must either be located there when supplied (in which case the supply will generally be taxable and reverse charging is not necessary), or they must be brought into the Cook Islands (in which case they will be taxed at the border under section 10(2)(b)) of the VAT Act. “Supply” is defined in sections 2 and 3 of the VAT Act, and “services” is defined in section 2 of the VAT Act.

(2) An unregistered person must make the supply of services. Thus, a person who is not actually registered nor required to apply for registration under section 12 of the VAT Act (amended by the Bill) must make the supply.

(3) A registered person must be the recipient of the supply of services.

(4) The supply is not a taxable supply because the supply is made outside the Cook Islands. A requirement for a supply to be a taxable supply is that the supply must be made in the Cook Islands (see section 2 of the VAT Act for the definition of “taxable supply”). The basic rules in sections 7(4) and 8 of the VAT Act specify that a supply of services is located in the Cook Islands if any of the following applies: (i) the only fixed establishment of the supplier is in the Cook Islands; (ii) the supplier has a fixed establishment both in and outside the Cook Islands and the supply is made in carrying on activities through that part of the fixed establishment in the Cook Islands; or (iii) the supplier has no fixed establishment anywhere but is resident of the Cook

Islands. Thus, a supply will satisfy this condition if the supplier is a non-resident who does not have a fixed establishment in the Cook Islands. While section 7(5) (inserted by the Bill) lists a number of cases when services are supplied in the Cook Islands because the recipient uses the benefit of the services in the Cook Islands, section 7(5) (inserted by the Bill) applies only to a supply of services to an unregistered person (not a registered person).

(5) If the supply had been made in the Cook Islands it would have been a taxable supply. In other words, the only reason why the supply is not a taxable supply is because it is made outside the Cook Islands. This means that the supply must be made in the course of carrying on taxable activities and the supply must not be an exempt supply. Thus, the reverse charge rule does not apply to a supply of services that, if made locally, would be an exempt supply, such as when a registered person "imports" financial services, which are exempt supplies in the Cook Islands under the First Schedule of the VAT Act. Similarly, the reverse charge rule does not apply to supplies that would not otherwise have been taxable, e.g. because they are made by the foreign supplier other than in the course of carrying on a taxable activity.

(6) The registered person receiving the supply would not have been entitled to a deduction for the full amount of VAT payable if the person had acquired the services in a taxable supply. This means that the services have been acquired by a registered person wholly or partly for the purpose of making supplies that are not taxable supplies. For example, the registered person is a financial institution that has acquired the services for the purpose of making exempt supplies of financial services in the Cook Islands.

Subsection (1) applies only when there is a supply of services between two separate persons. The reverse charge rule can be avoided through the acquisition of services from another part of the same entity located abroad (such as the entity's headquarters or a foreign branch). Subsection (2) provides deeming rules that have the effect of treating an internal transfer of services as a supply of imported services. Subsection (2) applies when a registered person carries on a taxable activity both in and outside the Cook Islands. In this situation, the following deeming rules apply:

(1) The part of the taxable activity carried on outside the Cook Islands is treated as if it were a taxable activity carried on by a person (referred to as the "overseas person") separate from the registered person. In other words, the overseas part of the enterprise is "carved out" of the registered person and is treated as a separate enterprise carried on by another person. This facilitates the treatment of the internal provision of services as a supply of services by the overseas person to the registered person in the Cook Islands. As the deemed supply is treated as being made to the registered person, subsection (1)(a) is satisfied. It is also provided that the overseas person and registered

person are related. This facilitates the application of the value of supply rule in section 6(9A) (inserted by the Bill).

(2) The overseas person is treated as an unregistered person. This ensures that the internal provision of services satisfies subsection (1)(b).

(3) The internal provision of services from the overseas person to the registered person is treated as a supply of services made in carrying on a taxable activity outside the Cook Islands. Thus, the internal provision of services is treated: (i) as a supply of services; (ii) the supply is made outside the Cook Islands (which ensures that the internal provision of services satisfies subsection (1)(c)); and (iii) the supply of services is made in the course or furtherance of an enterprise of the overseas person.

Subsection (1)(d) is satisfied if the internal provision of services would, apart from the fact that it is made outside the Cook Islands, be a taxable supply. This is the case if the internal provision of services is: (i) a supply of services made by the overseas person in carrying on a taxable activity by the overseas person (subsection (2)(c) deems the internal provision of services to be made in carrying on a taxable activity); and (ii) not an exempt supply (the internal transfer or services deemed to be a supply of services will be an exempt supply if it comes within the First Schedule of the VAT Act).

Subsection (1)(e) is satisfied if the registered person receiving the internal provision of services uses the services other than to wholly make taxable supplies.

Clause 8 This section amends section 5 of the VAT Act, which provides rules for determining the time of a supply.

Subsection 5(1) of the VAT Act is amended so that it applies also to a supply of imported services. Thus, the time of a supply of imported services is the earlier of: (i) the time that the recipient of the supply prepares a recipient-created tax invoice for the supply (subsection (1)(a) of the VAT Act); (ii) the time that payment is received by the supplier (subsection (1)(b) of the VAT Act); or (iii) the time of delivery of the services (subsection (1)(c) of the VAT Act). In the ordinary case, the time of a supply of imported services will be the earlier of the time of payment or delivery.

Clause 9 This section amends section 6 of the VAT Act, which provides rules for determining the value of a supply. The purpose of the amendment is to include new subsections (9A) and (9B), which provide rules for determining the value of a supply of imported services.

A supply of imported services is subject to VAT under section 10(2)(c) (inserted by the Bill). In broad terms, a supply of imported services is a supply of services made by an unregistered person outside the Cook Islands to a registered person when the registered person does not use the services wholly to make taxable supplies (section 4A(1))(inserted by the Bill). For example, the registered person may be a financial institution in the Cook Islands that uses the imported services wholly or partly to make exempt supplies of financial services. Further, section 4A(2) (inserted by the Bill) provides deeming rules to treat an internal transfer of services by a part of a taxable activity of a person located outside the Cook Islands to a part of a taxable activity located within the Cook Islands as a supply of imported services (such as a supply of services by the head office of a bank outside the Cook Islands to a branch of the bank in the Cook Islands). The effect of section 10(2)(c) (inserted by the Bill) is that the registered person receiving the supply must charge itself VAT on the supply (i.e. the charge for VAT is reversed with the recipient of the supply (not the supplier) liable for VAT).

Subsection (9A) provides for the determination of the value of a supply of imported services. Two situations are identified. Subsection (9A)(a) applies if the overseas supplier and the registered person receiving the supply are related persons (by blood, marriage or ownership). It is noted that the "overseas person" and registered person in the case of an internal transfer of services are treated as related under section 5A(2)(a) (inserted by the Bill). In this case, the value of the supply is the open market value of the supply at the time of supply. The open market value of the supply is determined under section 2 of the VAT Act and the time of supply under section 5 of the VAT Act. Subsection (9A)(b) applies when the overseas supplier and the registered person are not related persons. In this case, the value of the supply is the consideration for the supply as determined under subsection (6)(1) of the VAT Act, namely the consideration in money plus the open market of any consideration in kind. The consideration for a supply under subsection (6)(1) of the VAT Act is a VAT-exclusive amount, so the consideration does not include the amount of VAT that the recipient of the supply is required to charge itself for the supply.

Subsection (9A) is expressed to be subject to subsection (9B), which provides for proration of the value of the supply if the registered person receiving the supply will use the services partly to make taxable supplies and partly for other purposes (such as making exempt supplies). Subsection (9B) provides that if the registered person receiving a supply of imported services would have been entitled to a deduction for part of the VAT payable if the person had acquired the services in a taxable supply, the value of the supply under subsection (9A) is reduced by an amount equal to the proportion of the VAT that would have been deductible. So, for example, if a financial institution acquires imported services for a consideration of $10,000 to be used 50% for the purposes of making taxable supplies and 50% for the purposes of making exempt supplies, the registered person would have been entitled to a deduction for 50% of the VAT paid. In this case, subsection (9B) has the effect of reducing the value of the supply by 50%,

(i.e. the value of the supply is $5,000). This means that the supply of imported services is taxed only to the extent that the imported services are used other than to make taxable supplies. That part of the imported services used to make a taxable supply forms part of the value added for that supply and is effectively taxed when the subsequent taxable supply is made.

Clause 10 This section amends section 7 of the VAT Act, which provides rules for determining the place of a supply.

The basic rules in sections 7(4) and 8 of the VAT Act specify that a supply of services is located in the Cook Islands: (i) if the only fixed establishment of the supplier is in the Cook Islands; (ii) if the supplier has a fixed establishment both in and outside the Cook Islands, the supplies are made in carrying on activities through the part of the fixed establishment in the Cook Islands; or (iii) if the supplier has no fixed establishment anywhere but is resident of the Cook Islands. Thus, a supply of services by a non-resident without a fixed establishment in the Cook Islands does not take place in the Cook Islands under section 7(4) of the VAT Act.

Subsection (5) is inserted providing for additional place of supply rules, which treat certain services provided to an unregistered person as supplied in the Cook Islands if the services are utilised in the Cook Islands. Subsection 7(5) is expressed to apply despite subsection (4) of the VAT Act and, therefore, can apply even if a non-resident supplies the services from a fixed establishment outside the Cook Islands. Further, subsection 7(5) applies only when the services are utilised in the Cook Islands by an unregistered person.

Subsection (5)(a) provides that services provided to an unregistered person that are physically performed in the Cook Islands by a person who is in the Cook Islands at the time of supply is a supply of services occurring in the Cook Islands. The key requirement is that the services are physically performed in the Cook Islands. The services may be performed by an individual as an independent contractor, by an employee or by an agent. The person physically performing the services must be in the Cook Islands at the time of supply as determined under section 5 of the VAT Act.

Subsection (5)(b) provides that a supply of services provided to an unregistered person that are directly related to immovable property located in the Cook Islands occurs in the Cook Islands. This covers, for example, legal services relating to the conveyance of property in the Cook Islands. Thus, if a lawyer in New Zealand provides legal advice to an unregistered person in relation to the conveyance of immovable property in the Cook Islands, the supply of the services occurs in the Cook Islands.

Subsection (5)(c) provides that a supply of radio or television broadcasting services to an unregistered person that are received at an address in the Cook Islands is a supply occurring in the Cook Islands.

Subsection (5)(d) provides that a supply of consulting, engineering, legal, architectural, accounting, or similar services to an unregistered person who is in the Cook Islands at the time of supply occurs in the Cook Islands. The person receiving the services must be in the Cook Islands at the time of supply as determined under section 5 of the VAT Act.

Subsection (5)(e) provides that a supply of electronic services delivered to an unregistered person in the Cook Islands at the time of supply is a supply occurring in the Cook Islands. "Electronic services" is defined broadly in subsection 7(7) and the time of the supply is determined under section 5 of the VAT Act.

Subsection (5)(f) provides that the transfer or assignment of, or the grant of a right to use, a copyright, patent, trademark or similar right in the Cook Islands is a supply of services in the Cook Islands if the transfer, assignment, grant or right is made to an unregistered person. The reference to "similar right" is intended to cover any intellectual or industrial property right, such as the grant of a licence to use a patent (see section 2 of the VAT Act for definitions of "services"). Thus, the grant of the right to an unregistered person to use a patent in the Cook Islands is a supply of services occurring in the Cook Islands.

Subsection (5)(g) provides that a supply of telecommunications services (as defined in subsection 7(7)) to an unregistered person occurs in the Cook Islands if the person who initiated the supply (i.e. the call) is physically in the Cook Islands at the time the supply is initiated. Subsection 7(6) provides rules for determining who initiates a supply of telecommunications services. Paragraph (a) provides that the person who initiates the supply is the person who controls the commencement of the supply, who pays for the supply, or who contracts for the supply. These factors must be considered in the order listed in the paragraph. In most cases, the person who initiates a phone call will be the person who controls the commencement of the call (i.e. subsection 7(6)(a)(i) applies). If a person cannot be identified under subsection 7(6)(a), the person who initiates the supply is the person to whom the invoice or the supply is sent (subsection 7(6)(b)).

There are two exceptions to the location rule in subsection (5)(g). First, it does not apply to an inter-carrier transaction. Thus, a supply of telecommunication services between telecommunication service providers is a supply in the Cook Islands only under subsection 7(4) of the VAT Act (i.e. if the supply is made by a resident or from a fixed establishment in the Cook Islands). Secondly, it does not apply if the person who initiated the supply is global roaming while temporarily in the Cook Islands (this is a *de minimis* exception based on administrative ease). In broad terms, global roaming means the extension of the telecommunications connection

service to a location different from where the person is registered with the telecommunications service provider.

In each case listed in subsection (5), if the services are utilised in the Cook Islands, the supply takes place in the Cook Islands. Consequently, if the other conditions in the section 2 VAT Act definition of "taxable supply" are satisfied, the supply of the services will be a taxable supply. It will be subject to VAT if the supplier is a registered person (section 10(2)(a) of the VAT Act). This will depend on whether the supplier is registered or liable to be registered for VAT in the Cook Islands (see the section 2 VAT Act definition of "registered person"). If the supplier is liable to be registered and is a non-resident person without a fixed establishment in the Cook Islands, the supplier is required to appoint a VAT representative in the Cook Islands under section 37(2) (inserted by the Bill) with responsibility to ensure compliance with the VAT Act on behalf of the non-resident person (including the payment of VAT).

As stated above, subsection (5) does not apply to a supply of services to a registered person. The VAT treatment of foreign services provided by an unregistered person to a registered person depends whether or not the registered person uses the services solely to make taxable supplies. If they are used solely to make taxable supplies, then no VAT is imposed on the supply of the services, as the value added by the services will be captured in the consideration for taxable supplies made by the registered person for whom the foreign services are an input. If the foreign services are used wholly or partly by the registered person to make exempt supplies, then the reverse charge rule in section 10(2)(c) (inserted by the Bill) applies and the registered person must charge itself VAT in relation to the foreign services to the extent that they are used to make exempt supplies.

Clause 11 This section amends section 10 of the VAT Act, which imposes VAT.

Subsection (1) amends section 10(2) of the VAT Act by inserting new section 10(2)(c), which provides that VAT is payable by a registered person in respect of a supply of imported services made to the person by reference to the value of the supply as determined under section 6(9A) and (9B) (inserted by the Bill). "Supply of imported services" is defined in section 5A (inserted by the Bill). In broad terms, a supply of services from outside the Cook Islands by an unregistered person to a registered person is a supply of imported services if the registered person acquires the services other than to wholly make taxable supplies. The main example of a supply of imported services is foreign-provided services acquired by a registered person (such as a financial institution) wholly or partly to make exempt supplies.

Subsection (2) amends section 10(4) of the VAT Act in three respects. First, the cross-reference to "section 19(2)(b)" is changed to "subsection (2)(b)". Secondly, the words "subject to subsection (5)" are deleted. This is consequent upon the repeal of subsection (5) of the VAT Act (see below). Thirdly, the word "assessed"

is inserted before "collected". This ensures that section 10(4) of the VAT Act is properly aligned with the Customs legislation under which duty may be assessed.

Subsection (3) amends section 10 of the VAT Act by repealing subsection (5), which relates to the operation of subsection (4). In broad terms, subsection (4) of the VAT Act provides that the Customs legislation applies to the assessment and collection of VAT on imports. However, subsection (4) of the VAT Act is expressed to be subject to subsection (5), which limits the scope of subsection (4) in two important respects. First, subsection (5)(a) of the VAT Act provides that subsection (4) applies only in respect of goods imported by the same person who exported the goods and only if the export was not zero-rated. Secondly, subsection (5)(b) of the VAT Act provides that certain provisions of the Customs legislation apply only for the purposes of the VAT on imports by unregistered persons. While there may have been policy reasons for these limitations at the time the VAT Act was enacted, these limitations should no longer apply. The Customs legislation should apply for the purposes of collecting VAT on all imports. The amendments to subsection (4) of the VAT Act and the repeal of subsection (5) ensure that this is the case.

Clause 12 This section amends section 11 of the VAT Act, which specifies the rate of VAT.

Subsection (1) amends section 11(1) of the VAT Act by increasing the rate of VAT from 12.5% to 15%. Sections 48 and 49 of the VAT Act (inserted by the Bill) provide for transitional rules applicable when there is, *inter alia*, an increase in the VAT rate. Section 26 of the Bill provides for a special transitional rule applicable to the tourism sector for the purposes of the increase in VAT rate from 12.5% to 15%.

Subsection (2) inserts new section 11(3), which provides that the rate of VAT applicable to a supply or importation is the rate applicable at the time of the supply or importation. This is particularly relevant to a registered person reporting VAT on a payments basis. It means that, if the VAT rate changes in the period between the time of the supply and the time of receipt of the VAT, it is the rate applicable at the time of the supply that applies. Thus, in the case of the rate change implemented by subsection (1), if the time of supply is before 1 April 2014, VAT is payable at the 12.5% rate even if the VAT is received by the registered person making the supply on or after 1 April 2014.

Clause 13 This section amends section 12 of the VAT Act, which provides for VAT registration.

Subsection (1) amends section 12(1) of the VAT Act to increase the VAT registration threshold from $30,000 to $40,000.

Subsection (2) amends section 12(4) of the VAT Act to increase the floor on voluntary VAT registration from $15,000 to $20,000.

Subsection (3) inserts new section 12(8), which provides that the value of imported services is taken into account in determining whether the registration threshold is exceeded. For this purpose, the requirement in section 4A(1)(a) (inserted by the Bill) is ignored. This is necessary because, for a supply to be a "supply of imported services" under section 4A(1) (inserted by the Bill), the supply must be made to a registered person.

Clause 14 This section amends section 16 of the VAT Act, which provides for the computation of the VAT payable by a registered person for a calendar month. In broad terms, the amount payable is a net amount computed by adding up the amounts specified in section 16(3) of the VAT Act for the month (basically the VAT on taxable supplies made by the registered person) and deducting the amounts specified in section 16(4) for the month (basically, the VAT on taxable supplies made to the registered person to extent used to make taxable supplies).

Subsection (1) amends section 16(3) of the VAT Act by including the VAT payable by a registered person under section 10(2)(c) (inserted by the Bill) on supplies of imported services made to the person during a month. The VAT payable on supplies of imported services is taken into account in the month in which the supply takes place as determined under section 5 of the VAT Act.

Subsection (2) amends section 16(4)(c) and (e) of the VAT Act by changing the fraction specified from one-ninth to $^{3/23}$. The fraction represents the tax component of the amounts specified in section 16(4)(c) and (e). The tax component is computed according to the formula - r/1-r. In the formula, "r" is the VAT rate. With the increase in the VAT rate to 15%, the new fraction is $^{15/115}$, which reduces to $^{3/23}$.

Subsection (3) is a transitional rule relevant to the amendment in subsection (2) as it applies to section 16(4)(c) of the VAT Act, which provides a deduction for VAT in relation to the acquisition of second hand goods by a registered person. A registered person who deals in second hand goods will usually acquire the goods from unregistered persons. Section 16(4)(c) of the VAT Act recognises that there is VAT embedded in the acquisition price. The amount of embedded VAT is the tax fraction of the price. Subsection (3) makes clear that the new tax fraction applies only to second hand goods acquired on or after 1 April 2014. For second hand goods acquired before that date, the embedded tax will be based on the old tax rate and, therefore, fraction one-ninth continues to apply.

Clause 15 This section amends section 17A of the VAT Act, which provides for the treatment of a change in the use of goods or services acquired by a registered person. Section 17A(1) and (2) of the VAT Act apply when a registered person acquires goods or services other than to make taxable supplies and subsequently applies the goods and services to the making of taxable supplies. In this case, no deduction for VAT would have been allowed on acquisition of the goods or

services. Section 17A(1) and (2) of the VAT Act correct this by allowing a deduction for the tax fraction of the lower of: (i) the market value of the goods or services when applied to make taxable supplies; or (ii) the cost of the goods or services.

Sections 17A(3) and (4) of the VAT Act applies in the opposite case, namely when a registered person acquires goods or services to make taxable supplies and subsequently applies the goods and services for another purpose. In this case, a deduction would have been allowed on acquisition of the goods or services. Section 17A(3) and (4) corrects this by providing that VAT is payable equal to the tax fraction of the higher of: (i) the market value of the goods or services when applied other than to make taxable supplies; or (ii) the cost of the goods or services.

Subsection (1) amends section 17(2) and (4) of the VAT Act by changing the fraction specified from one-ninth to $^{3/23}$. As with the amendment to section 16 of the VAT Act, this is consequent upon the increase in the VAT rate from 12.5% to 15%.

Subsection (2) provides for a transitional rule in relation to the amendment in subsection (1). It is provided that the new tax fraction applies only to goods or services acquired on or after 1 April 2014. The old tax fraction, one-ninth, continues to apply to goods or services acquired before 1 April 2014.

Clause 16 This section amends section 18 of the VAT Act, which provides for tax invoices.

The section inserts new subsection (8), which obliges a registered person liable for VAT under section 10(2)(c) (inserted by the Bill) in respect of a supply of imported services made to the person to prepare a recipient-created tax invoice in respect of the supply in the form approved by the Collector for such invoices. A recipient-created tax invoice is as a "tax invoice" for the purposes of the Act.

Clause 17 This section amends section 24 of the VAT Act, which provides for additional tax in respect of late payments of VAT or underpayments due to fraud.

The section deletes paragraph (b), which provides for additional tax in the case of underpayments due to fraud. The paragraph has been deleted consequent upon the inclusion of a penal tax provision dealing with underpayments in section 41B (inserted by the Bill).

As a consequence of this amendment, the section also amends the heading of the section to delete to the reference to "or evasion".

The effect of the amendment to section 24 of the VAT Act is that additional tax on late payments imposed under section 24(a) is treated as the equivalent of interest (i.e. it is compensating the Government for being out of funds due to late

payment). The imposition of penal tax on a person under section 41B is punishing the person for wrongdoing.

Clause 18 This section repeals section 37 of the VAT Act and inserts new subsections (1)-(7)

Subsection (1) is a restatement of the repealed section 37(1). This subsection imposes VAT liability for all VAT and other statutory obligations on agents acting for absentees from the Cook Islands.

Subsections (2)-(7) provide for the appointment of a VAT representative by non-residents making taxable supplies above the registration threshold, but who do not have a fixed establishment in the Cook Islands. "Non-resident" is defined in subsection (7) to mean a person who is not a resident of the Cook Islands (see section 2 VAT Act definition of "resident of the Cook Islands").

The section is particularly relevant to a non-resident who is making supplies (other than exempt supplies) of services in carrying on a taxable activity to unregistered persons in the Cook Islands that are treated as being supplied in the Cook Islands under section 7(5) (inserted by the Bill) and which are, therefore, taxable supplies. If the annual value of such supplies exceeds the registration threshold, the non-resident is required to apply for registration under section 12 (amended by the Bill). This section applies if the non-resident person does not have a fixed establishment in the Cook Islands.

Subsection (2)(a) obliges the non-resident to appoint a VAT representative in the Cook Islands. Subsection (6) provides that the Collector may prescribe the mode, manner and requirements for the appointment of a VAT representative of a non-resident. Further, subsection (2)(b) empowers the Collector to require the non-resident to provide security for payment of VAT. The security may be in the form of a bond, deposit or other security, and be for such amount as the Collector thinks fit having regard to all the circumstances.

Subsection (3) provides that the VAT representative of a non-resident is responsible for doing all things required of the non-resident under the Act, including applying for registration, the furnishing of VAT returns, and the payment of VAT. While subsection (3) obliges the VAT representative to apply for registration on behalf of the non-resident, subsection (4) provides that registration is in the name of the non-resident and not the representative.

Subsection (5) provides that a person may be a VAT representative of more than one non-resident person. However, the representative must have a separate registration for each non-resident.

Section 39(1)(m) (inserted by the Bill) provides that a non-resident who fails to appoint a representative or provide security as required under section 37(2) (inserted by the Bill) commits an offence.

Clause 19 This section amends section 39 of the VAT Act, which provides for offences for breaches of the Act.

The section amends section 39(1) by inserting new paragraph (m) to provide that a non-resident who fails to appoint a representative or provide security as required under section 37(2) (inserted by the Bill) commits an offence.

Clause 20 This section inserts new section 41B, which provides for the imposition of penal tax for breaches of the Act.

Subsection (1) imposes penal tax in the following cases:

(1) A person is liable for penal tax if the person, without reasonable excuse, fails to apply for registration as required under section 12 (paragraph (a)). Section 12(1) specifies that a person is liable to be registered: (i) when the value of taxable supplies made by the person for the previous twelve months exceeds $40,000; or (ii) when there are reasonable grounds for believing that the total value of taxable supplies to be made the person in the following twelve months will exceed $40,000. In the case of (i), the liability to register arises at the end of the last month of the twelve-month period and, in the case of (ii), the liability to register arises at the start of the first month in the twelve-month period.

The maximum amount of penal tax payable is treble the amount of VAT payable for the period commencing on the day on which the person was first required to apply for registration and ending on the earlier of the day the person files an application for registration or the person is registered by the Collector on the Collector's own motion (subsection (2)(a)).

(2) A person is liable for penal tax if the person, without reasonable excuse, fails to keep, retain or maintain records or documents as required under the Act (paragraph (b)). Section 42 of the VAT Act (amended by the Bill) specifies the records and documents that must be kept for the purposes of VAT.

The maximum amount of penal tax payable is treble the amount of VAT payable for the period in which records and documents were not kept, retained or maintained (subsection (2)(b)).

(3) A person is liable for penal tax if the person, without reasonable excuse, fails to submit a return or other document as required under the Act (paragraph (c)). Section 15 of the VAT Act sets out the obligations of registered person to file monthly returns.

The maximum amount of penal tax payable is treble the amount of VAT payable under the return (subsection (2)(c)).

Subsection (3) imposes penal tax when a person is liable for additional tax under section 24 of the VAT Act for the failure to pay VAT by the due date. The additional tax imposed under section 24 of the VAT Act is similar to interest in that it is compensating the Government for late payment of VAT. On the other hand, penal tax is punishment for non-compliance with the Act. Thus, a person may be liable for both additional tax and penal tax in respect of the same conduct.

The amount of the penal tax imposed depends on the culpability involved in underpaying VAT. If the underpayment is due to fraud or evasion, the maximum amount of penal tax payable is treble the amount of underpaid VAT. In any other case, the maximum amount of penal tax payable is 20% of the underpaid VAT. No penal tax is imposed if the person has a reasonable excuse for the underpayment.

Subsection (4) provides that sections 210-216 of the *Income Tax Act 1997* (the **Income Tax Act**) apply, with the necessary changes made, in relation to the administration of penal tax. The main necessary changes are that the reference in sections 210-216 of the Income Tax Act to (i) "deficient tax" is treated as a reference to the underpaid VAT (referred to below as the "deficient VAT") resulting from the conduct that has given rise to the liability for penal tax; and "year of assessment" is treated as a reference to the calendar month.

The effect of subsection (4) is that the following applies:

(1) Section 210 of the Income Tax Act: for all purposes of the VAT Act (particularly the collection and recovery provisions), penal tax is treated the same as the deficient VAT.

(2) Section 211 of the Income Tax Act: the Collector assesses penal tax in the same way that the deficient VAT is assessed, but as a separate liability. Penal tax, therefore, is an assessed liability and a liability for penal tax arises only if the person has been served with a notice of the assessment of the penal tax. An assessment of penal tax can be amended in the same way as an assessment of VAT can be amended (see section 21(4) of the VAT Act). The time limit for assessing penal tax is 10 years after the month in which the deficiency in VAT occurred.

(3) Section 212 of the Income Tax Act: a person assessed to penal tax can object to the assessment.

(4) Section 213 of the Income Tax Act: an assessment of penal tax can be made, and the penal tax recovered, before the assessment and recovery of the deficient VAT to which it relates.

(5) Section 214 of the Income Tax Act: provides for the assessment and recovery of penal tax from the executors and administrators of the estate of a deceased person.

(6) Section 215 of the Income Tax Act: the conviction of a person for an offence does not affect the liability for penal tax for the same or any other offence. However, if a person has been assessed to penal tax, the person cannot be prosecuted for an offence for the same act or omission.

(7) Section 216 of the Income Tax Act: provides for the publication of the names of persons liable for penal tax.

Clause 21 This section amends section 42 of the VAT Act, which provides for VAT record keeping.

The section amends section 42(3) of the VAT Act to expressly require records and documents to be kept in English and New Zealand currency.

Clause 22 This section amends section 43 of the VAT Act, which provides for a general anti-avoidance rule applicable to VAT.

The section has been amended to apply also to schemes intended to cause a taxable supply not to be a taxable supply, a taxable import not to be a taxable import, or supply of imported services not to be a supply of imported services. For this purpose, an import subject to VAT is referred to as a "taxable import".

Clause 23 This section provides for the repeal of sections 48-52 of the VAT Act, which provided for transitional measures on the introduction of VAT in 1997. These sections have been repealed, as they are now redundant. The section inserts two new sections that provide transitional rules in relation to changes in the rate or imposition of VAT. The sections will apply for the purposes of the increase in VAT rate in the Bill, and any future changes in the rate of imposition of VAT.

New section 48 provides for the adjustment of prices on a change to the rate or imposition of VAT. Subsections (1) and (2) apply when a registered person has entered into an agreement for the supply of goods or services and, after the agreement is entered into, there is a change to the VAT treatment of the supply.

Subsection (1) applies when either: (i) VAT is imposed on a supply that was not previously subject to VAT (e.g. an exempt supply is made a taxable supply); or (ii) the rate of VAT on a supply has increased. In this case, the registered person is entitled to recover the additional VAT payable on the supply even if the terms of the agreement do not permit any changes to be made to the price of the supply.

Subsection (2) applies when either: (i) VAT that was previously imposed on a supply is withdrawn (e.g. a taxable supply is made an exempt supply); or (ii) the

rate of VAT on a supply has decreased. In this case, the registered person is obliged to reduce the amount of VAT payable on the supply even if the terms of the agreement do not permit any changes to be made to the price of the supply.

Subsection (3) applies when a supply is subject to a fee, charge or other amount imposed by law and the VAT treatment of the supply changes (VAT may be imposed on, or withdrawn from, the supply, or the rate of VAT may be increased or decreased). When VAT is imposed on the supply or the VAT rate increases, subsection (3) permits the supplier to recover the extra VAT payable in respect of the fee, charge or other amount. When VAT is withdrawn in respect of the supply or the VAT rate decreases, subsection (3) obliges the supplier to reduce the fee, charge or other amount by the amount of the reduced VAT.

Subsection (3) is subject to subsection (4), which provides that subsection (3) does not apply when the fee, charge, or other amount is altered by law to take account of the changed VAT treatment.

Subsection (5) provides that nothing in subsection (3) is to be construed so as to permit any further increase or require any further decrease, as the case may be, in a fee, charge, or other amount when the fee, charge, or other amount is calculated as a percentage or fraction of another amount that represents the price in money for a taxable supply.

New section 49 applies to successive supplies under section 5(5) and (6) of the VAT Act (a supply of goods under an agreement for hire, a supply of services under an agreement requiring periodic payments, or a supply of goods or services progressively or periodically when payment is in instalments computed by reference to the stage of supply). Subsection (1) applies when the period of successive supply occurs before a change in the VAT treatment of a supply even if the time of the supply is after the change (i.e. the payment for the successive supply may be due and paid after the end of the period of the successive supply). In this case, the change in VAT treatment does not apply to the successive supply.

Subsection (2) applies when the change in VAT treatment occurs during the period of a successive supply. In this case, the successive supply is, in effect, treated as two supplies: (i) that part of the supply before the VAT change; and (ii) that part of the supply after the VAT change. The consideration for the supply must be apportioned between the two parts of the supply on any fair or reasonable basis (such as the period of each separate part of the successive supply). The former VAT treatment applies to the part of the successive supply before the VAT change and the new VAT treatment applies to the part of the successive supply after the VAT change.

Clause 24 This section amends the First Schedule of the VAT Act, which lists supplies that are treated as exempt supplies. An exempt supply is a supply on which no VAT is charged. As no VAT is charged on the supply, the registered person making the

supply is not entitled to any deduction of VAT incurred in relation to the making of the supply.

The section amends the First Schedule by inserting a new paragraph 5, which treats a deemed supply under section 3(2A) (inserted by the Bill) as an exempt supply. A section 3(2A) deemed supply is the supply that a person is deemed to have made in return for a grant or subsidy given to the person by a foreign government, or an international organisation or other non-government organisation. The treatment of the deemed supply as an exempt supply means that the person making the supply: (i) does not charge VAT in respect of the supply; and (ii) cannot claim a deduction for the VAT payable on taxable supplies to, or imports by, the person for the purposes of making the deemed supply.

Clause 25 This section amends the Second Schedule of the VAT Act, which specifies imports that are treated as exempt imports.

Paragraph (2) of the Second Schedule is amended to change "Bonded Warehouse" to "Controlled Area". This aligns the VAT Act with the terminology in the new Customs legislation.

Clause 26 This section provides for a special transitional rule applicable to the tourism sector for the purposes of the VAT rate increase in the Bill.

The section applies to a taxable supply of tourism services made in the period 1 April 2014 – 20 September 2014 (i.e. during the first six months of the VAT rate increase). "Tourism services" is defined in subsection (3) to mean accommodation, meals, transportation, or tours supplied to non-residents. "Non-resident" is defined in subsection (3) to mean a person who is not a resident of the Cook Islands (see section 2 VAT Act definition of "resident of the Cook islands").

Subsection (1) provides that VAT must be charged on the supply at the new VAT rate, but the supplier is entitled to a special deduction under section 16(2)(b) of the VAT Act. The special deduction is available only if the following conditions are satisfied:

(1) The Collector must be satisfied that the supply of tourism services was booked and confirmed before 30 November 2013 (i.e. the date the increase in the VAT rate was announced). All tourism services booked and confirmed on or after that date for supply on or after 1 April 2014 must be subject to VAT at the new rate.

(2) Under the contract of service, the supplier is entitled to receive, and does actually receive, VAT only at the rate of 12.5%. This is the case despite the operation of section 48(1) (inserted by the Bill) allowing for an increase in price on a change in the rate of VAT.

If the conditions in subsection (1) are satisfied, the supplier is entitled a deduction under section 16(2)(b) equal to 1/6 of the VAT paid at the 15% rate. The net effect of imposing VAT at the 15% rate and the deduction is that VAT is imposed at the 12.5% rate for the supply. The deduction is allowed in the month in which the supplier is required to report the VAT on the supply under section 16(3) (amended by the Bill). This depends on whether the supplier reports VAT on a payments or invoice basis.

_____