

GST and financial services: draft guidelines for working with the new zero-rating rules

August 2004

*Prepared by the Policy Advice Division of the Inland Revenue Department
for consultation with affected taxpayers*

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Foreword

These draft guidelines on the operation of the new legislation have been prepared for purposes of consultation with affected taxpayers. Comments on the general application and practicality of the guidelines are particularly welcome.

Final guidelines are expected to be available in October 2004.

Submissions should be made by 3 September 2004 and should contain a brief summary of the main points and recommendations. Submissions received by the due date will be acknowledged.

Submissions may be made in electronic form to:

policy.webmaster@ird.govt.nz

Please put "GST guidelines" in the subject line for electronic submissions.

Alternatively, submissions may be addressed to:

GST guidelines
C/- General Manager
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

Please note that submissions may be the subject of a request under the Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you consider that there is any part of your submission that could be properly withheld under the Act, please indicate this clearly in your submission.

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Introduction

Overview of the new rules

1. The Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003 amended the Goods & Services Tax Act 1985 (the GST Act) to allow supplies of financial services by a GST-registered person to another GST-registered person to be zero-rated. The changes integrate the supply of financial services more fully into the GST system by taxing (at the rate of 0%) such supplies and allowing financial service providers to deduct input tax in respect of those supplies.¹ This is in contrast to the current “exempt” treatment of financial services, whereby GST is not charged and financial service providers cannot deduct input tax for GST paid on goods and services used in supplying financial services.

2. From 1 January 2005 the zero-rating rules² allow providers to elect to zero-rate supplies of financial services to customers that:

- are registered for GST if the level of taxable supplies³ made by the customer, in a given 12-month period (including the taxable period in which the supply is made), is equal to or exceeds 75 percent of their total supplies for the period;
- may not meet the 75 percent threshold but are part of a group that does meet the threshold in a given 12-month period (including the taxable period in which the supply is made) – for example, the treasury or finance function of a group of companies that receives financial services.

Note: The treatment of financial services supplied to final consumers remains unchanged. Supplies to final consumers in New Zealand are still exempt from GST and cannot be zero-rated under these guidelines.

3. From 1 January 2005 the GST Act also provides an additional deduction from output tax for supplies of financial services made to another financial service provider, which in turn makes supplies to businesses that qualify to receive zero-rated financial services.⁴ The amount that can be deducted will be determined by the ratio of taxable to non-taxable supplies made by the recipient financial service provider.⁵ The formula for calculating the value of the deduction is set out in these guidelines, but is generally based on the recipients’ relative proportions of business and non-business customers.

¹ Refer *Tax Information Bulletin* Vol. 16 No. 1 February 2004 pp 23 to 31 for a discussion on the legislative amendments contained in the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003.

² Refer sections 11A(1)(q) and (r).

³ Excluding supplies of financial services zero-rated under sections 11A(1)(q) and/or (r).

⁴ Refer section 20(3)(h).

⁵ Refer section 20C.

4. These guidelines set out Inland Revenue's generally approved method for zero-rating supplies of financial services under the zero-rating rules.⁶

5. The guidelines also set out the application of the various deductions allowed as input tax under the GST Act for financial service providers.⁷

What is a “financial service”?

6. While many activities may be thought of as a “financial service”, for the purposes of the GST Act the term “financial services”, as defined in the GST Act, generally applies to the following types of transaction:⁸

- dealings with money;
- certain dealings with securities;
- the provision of credit and loans;
- the provision of life insurance (including superannuation);
- the provision of non-deliverable futures contracts and financial options;
- the payment and collection of interest, principal, dividends and amounts relating to transactions involving securities; and
- intermediation and brokerage services relating to the supply of debt, equity and life insurance.

7. Services which are not treated as financial services include debt collection, equipment leasing, credit control, sales ledger and accounting services, provision of advice, investment guidance, and fire and general insurance.

Examples of financial services include:

- paying or collecting any amount of interest;
- providing mortgages and other loans;
- issuing securities such as stocks and shares;
- providing credit under a credit contract;
- exchanging currency (for example, changing US\$ into NZ\$);
- issuing financial options or non-deliverable futures contracts; and
- arranging or agreeing to do any of the above (for example mortgage brokering).

⁶ The authority for these guidelines is provided in section 20E of the GST Act.

⁷ Refer section 20(3).

⁸ Refer section 3.

Scope and purpose of the guidelines

8. These guidelines apply to financial service providers that are GST-registered, or liable to be registered for GST, who supply financial intermediation services. Financial intermediation services are those that bring together suppliers and consumers of financial services. Examples include deposit-taking intermediation, which involves bringing together suppliers and users of financial capital, and brokerage services involving the buying and selling of financial instruments and currencies.

9. The guidelines do not apply to persons that do not supply financial services as part of a taxable activity for GST purposes – for example, the mere provision of a loan, activities that involve only holding securities belonging to another entity or the issue of capital in a company or trust. These activities are generally not considered on their own to constitute a taxable activity. However, whether or not a particular financial service constitutes part of a taxable activity needs to be determined on a case-by-case basis. Any questions regarding whether or not a financial activity is a taxable activity should be directed to Inland Revenue or a tax advisor.

10. The application of the zero-rating rules requires providers to know, at a minimum, whether their customer is registered for GST and the ratio of taxable supplies to total supplies made by the customer. Under the GST Act, these tests must, in the first instance be applied on a transaction-by-transaction basis. However, to recognise the costs that could arise in meeting these requirements, the GST Act allows providers to apply an alternative method approved by Inland Revenue, either generally or by specific agreement.

11. Providers have the following choices if they elect to use the zero-rating rules and deduct input tax for GST paid on making those supplies.

Topic		Relevant sections in the GST Act	Options		
			Option 1 Use these guidelines	Option 2 Not use the guidelines	Option 3 Obtain a specific method
Zero-rating		Sections 3 and 11A(1)(q) and (r)	Refer paragraphs 21 to 51	Zero-rate on a transaction-by-transaction basis	Apply in writing to Inland Revenue to use an alternative method
Deductions from output tax	Principal purpose / change-in-use adjustments	Sections 20(3)(e) and 21 to 21G	Refer paragraphs 60 and 63 to 75	Use the principal purpose test or direct attribution to deduct input tax	Apply in writing to Inland Revenue to use an alternative method
	Deduction for supplies between financial service providers	Sections 20(3)(h) and 20C	Refer paragraphs 76 to 87		

Note: Financial services that are supplied to non-residents that are outside New Zealand are outside the scope of these guidelines because such supplies are already zero-rated.

Alternative approaches

12. Providers may seek approval from Inland Revenue to use an alternative method for zero-rating supplies of financial services provided that the alternative method produces a fair and reasonable result compared to identifying eligible customers on a transaction-by-transaction basis.⁹ Otherwise, providers may either apply these guidelines or zero-rate supplies of financial services on a transaction-by-transaction basis as required by the GST Act.

13. Inland Revenue may also agree to an alternative method for determining the extent to which goods and services are applied for making taxable and non-taxable supplies for the purpose of adjusting deductions of input tax. Approval will always require that the alternative produces a fair and reasonable result.¹⁰

References

14. Unless otherwise specified, all section references are to the Goods and Services Tax Act 1985.

Election into the new GST rules

15. The GST Act requires providers to give written notice to Inland Revenue if they wish to zero-rate supplies of financial services and/or be eligible to deduct input tax for supplies of financial services made to other financial service providers.

16. This means if the compliance costs of zero-rating outweigh the benefits providers can choose not to elect into the new provisions.

17. Elections will take effect from the first day of the taxable period in which Inland Revenue receives the written notice.

18. An election will cease from the end of the taxable period:

- in which the provider ceases to carry on a taxable activity; or
- that is nominated by the provider in a written notice, if the date nominated is after the taxable period in which Inland Revenue receives notice; or
- in which Inland Revenue receives written notice if the provider does not nominate a taxable period.

⁹ Refer section 20E.

¹⁰ Refer section 21A.

19. Elections should be addressed to:

Inland Revenue Corporates
Financial Sector
Private Bag 39984
Wellington

Fax (04) 802-6192

Who to contact

20. Any questions in relation to these guidelines should be directed to Inland Revenue on 0800 377 776. Corporates customers should contact their account manager or call Inland Revenue on 0800 443 773. (Generally, Corporates customers are companies or groups of companies with an annual turnover in excess of \$100 million or whose industry is governed by specific tax legislation).

Zero-rating

Paragraphs 21 to 51 set out Inland Revenue's approved method for applying the zero-rating rules in relation to supplies of financial services. Financial service providers that have elected to zero-rate supplies using the guidelines must comply with these paragraphs.

General application

21. The zero-rating rules allow providers to:

- Zero-rate supplies of financial services to customers that are registered for GST if the level of taxable supplies made by the customer,¹¹ in a given 12-month period (including the taxable period in which the supply is made), is equal to or exceeds 75 percent of their total supplies for the period.
- Zero-rate supplies of financial services to customers that may not meet the 75 percent threshold but are part of a group that does meet the threshold in a given 12-month period (including the taxable period in which the supply is made) – for example, the treasury or finance function of a group of companies that receive financial services.

¹¹ Excluding supplies of financial services zero-rated under sections 11A(1)(q) and/or (r).

22. Supplies of financial services cannot be zero-rated if:
- the financial services are supplied to businesses that have more than an incidental activity of making exempt supplies of financial services and other non-financial exempt supplies, that is, exempt supplies exceed 25 percent of total supplies; or
 - the financial services are supplied to non-registered persons (or final consumers).
23. When making a decision on whether or not a supply of financial services should be zero-rated all necessary steps must be undertaken to ensure that the decision is correct.

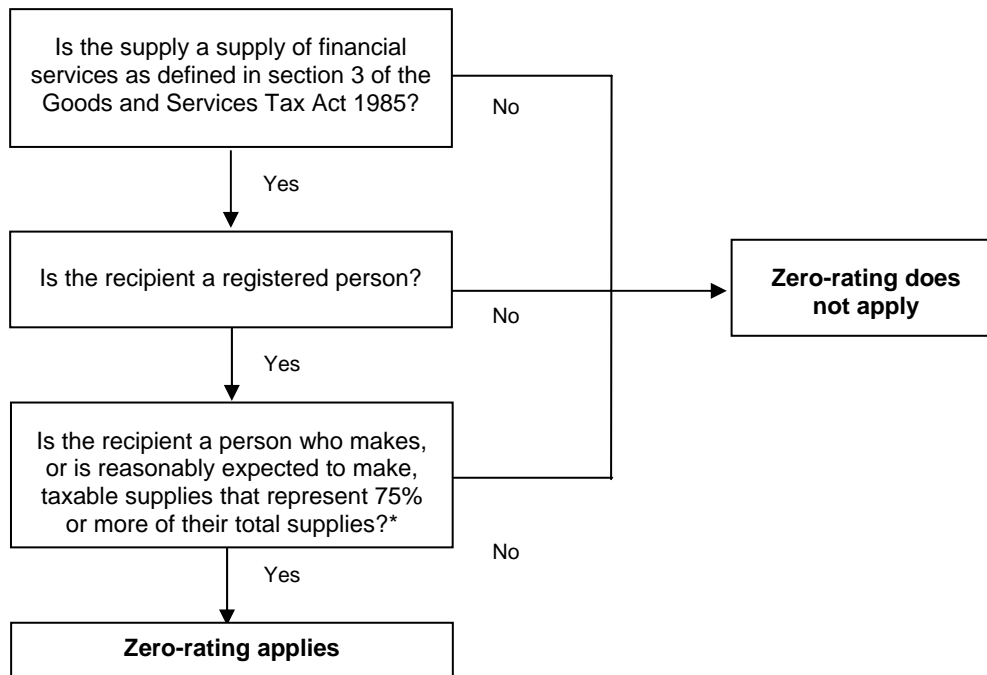
Evidential requirements

24. It is important to keep adequate books and records to substantiate any decisions to zero-rate financial services to customers, undertake regular reviews of any systems and procedures used to categorise customers and generally comply with the tax law. It is also necessary to have a process which reviews every year those decisions to zero-rate. Records that Inland Revenue expects to be maintained in relation to this part of the guidelines include notes relating to any dealing with the customer such as, client relationship notes, interview notes and application forms.

Identifying eligible customers

25. Unlike the usual operation of GST, the zero-rating rules impose a requirement that providers obtain information about their customers. This is intended to ensure that the deductions of input tax that result from applying the zero-rating rules relate only to supplies made to qualifying businesses. Supplies to non-business customers – households and other final consumers – remain treated as exempt supplies. Input tax cannot be recovered in respect of supplies to these customers.
26. It is expected that the determination of the taxable status of a customer will be made by the provider supplying the financial services. The reason for this is that the difference between the supply of zero-rated financial services and exempt financial services is the respective ability or inability to deduct input tax in respect of those supplies. The deduction of input tax is therefore a matter for the provider to determine – not the recipient.
27. Figure 1 illustrates the questions that should be considered when determining whether a supply of financial services should be zero-rated.

**FIGURE 1:
Applying the zero-rating rules**



* The test of reasonable expectation applies if providers adopt the Inland Revenue approved method of using ANZSIC codes as described at paragraphs 35 to 47.

Zero-rating supplies of financial services

28. The zero-rating rules therefore require that providers consider two questions in relation to their customers' activities:

- **The registration test:** Is the customer registered for GST?
- **The 75 percent test:** Has the customer made, or is likely to make, in the relevant taxable period supplies of goods and services that are taxable supplies which represent 75 percent or more of total supplies?

Note: When establishing whether or not a customer qualifies under the 75 percent test all taxable supplies made by the customer should be considered except for supplies of financial services that are zero-rated under the new rules.

29. Assessing whether the customer qualifies under both limbs must occur in the taxable period in which the supply of financial services is made.

30. If the customer is part of a group, the tests should be applied by reference to the group of which the customer is a member.¹²

31. Two options may be adopted in relation to the application of the new zero-rating rules – a transaction-based approach or a customer account approach. The option selected should best suit the customer and the type of financial service supplied.

32. Both options require providers to enquire directly whether or not the customer is registered for GST. Whether the customer meets the 75 percent test must be determined either on the basis of information held by the provider on the customer or by using the Australian and New Zealand Standard Industrial Classification codes (ANZSIC codes). A full list of ANZSIC codes may be found on the Statistics New Zealand website.¹³

	Option A Determine eligibility per transaction	Option B Determine eligibility per customer account
The registration test	Direct enquiry	Direct enquiry
The 75 percent test	Direct enquiry or ANZSIC codes	Direct enquiry or ANZSIC codes

Determining eligibility per transaction

33. If the supply is in relation to a one-off transaction, hire-purchase or lease, the assessment of whether the customer qualifies to receive zero-rated financial services should be established at the time agreement is reached on the contractual terms of the financial service. As GST is a tax on transactions involving the supply of goods and services any future cash flows arising from the contract should be ignored because the supply of money is excluded from the GST base.¹⁴ An exception to this rule applies when there is a change in the terms and conditions under which those cash flows arise.

¹² In section 11A(1)(r) the term “group” is defined by reference to section IG 1 of the Income Tax Act 1994. A group is defined as two or more persons that have an aggregate common voting interest greater than or equal to 66 percent.

¹³Refer: <http://www.stats.govt.nz/domino/external/web/carsweb.nsf/94772cd5918085044c2567e6007eec2c/5b3e1b99a0d86615cc256cec007e6b14?OpenDocument>

¹⁴ An exception applies to finance lease contracts. See GST and finance leases – classification, method of accounting and treatment of residual value clause, *Tax Information Bulletin* Volume Eight, No. 1 July 1996.

Determining eligibility per customer account

34. If a number of financial services are likely to be supplied to the same customer and/or the cash flows arising under the financial transaction are uncertain, such as an account facility – for example a revolving credit facility or regular transactions involving financial instruments/assets, applying the zero-rating rules on a transaction-by-transaction basis is likely to be difficult. To address this, the customer's initial eligibility to receive zero-rated financial services must be established at the time the account is created and may be used going forward, provided that the customer's eligibility is reviewed every year.

Zero-rating using ANZSIC codes

35. Acknowledging the difficulties that may arise when seeking information from customers in relation to their level of taxable supplies, Inland Revenue will accept the following as complying with the second limb (the 75 percent test) of the zero-rating rules. This should mean that it is not necessary, in all cases, to seek any information from customers directly in respect of their level of taxable supplies. Providers are still expected to enquire as to whether their customers are registered for GST.

36. For the purposes of the 75 percent test, customers that can be allocated an ANZSIC code, other than those listed in tables A and B,¹⁵ may be treated as making taxable supplies that exceed the threshold. If a customer cannot be allocated an ANZSIC code providers can either seek information from the customer directly or treat any supplies of financial services to that customer as an exempt supply.

37. If the customer cannot be identified or allocated an ANZSIC code any supplies of financial services to that customer must not be zero-rated. This allows providers to assess, in less straightforward situations, the trade-off between the benefits of zero-rating and the compliance costs associated with identifying and determining the mix of taxable and exempt supplies made by the customer.

38. Any system or procedure used to allocate an ANZSIC code must provide the necessary accuracy and be subject to yearly internal audit and review.

Note: In recognition that businesses change it is important that providers review the classification given to their customers on a yearly basis.

39. If the customer is part of a group, the ANZSIC code applied should be representative of the predominant activity undertaken by the group of which the customer is a member.

¹⁵ Refer paragraph 44.

ANZSIC codes – an explanation

40. ANZSIC codes are used in New Zealand and Australia for the production and analysis of industry statistics. The objective of the codes is to identify groupings of businesses which carry out similar economic activities. Each code defines an industry and the similar economic activities which characterise the businesses involved in that industry by reference to the primary activity undertaken. In principle, any individual business can be assigned an appropriate industry category on the basis of its predominant activity.

41. When applying the ANZSIC codes for the purposes of the zero-rating rules the term “business” includes companies, partnerships, trusts, non-profit organisations and government departments.

42. ANZSIC codes are structured according to divisions (the broadest level), subdivision, groups and classes (the finest level). At the division level there are 17 divisions that are identified by an alphabetical character.

A	Agriculture, forestry and fishing
B	Mining
C	Manufacturing
D	Electricity, gas and water supply
E	Construction
F	Wholesale trade
G	Retail trade
H	Accommodation, cafes and restaurants
I	Transport and storage
J	Communication services
K	Finance and insurance
L	Property and business services
M	Government administration and defence
N	Education
O	Health and community services
P	Cultural and recreational services
Q	Personal and other services

43. The subdivision, group and class levels provide increasingly detailed classification of the broad categories. For example, in the case of fire and general insurance, any business that is involved in this activity would be allocated ANZSIC code K7422, which is derived from the following:

<i>Division</i>	K
<i>Subdivision</i>	74
<i>Group</i>	742
<i>Class</i>	7422

Using ANZSIC codes

44. When using ANZSIC codes to determine whether a customer meets the 75 percent test providers should refer to the class level, represented by a four-digit code, that is relevant to the customer’s predominant activity. It is possible that that some class codes will have more than four digits – if this occurs refer only to the first four. The codes will also sometimes appear with or without the alphabetical character. For the purposes of these guidelines, read the class code as including the alphabetical character.

45. If a customer’s activity is represented by a code that appears on either tables A or B (subject to paragraph 46) providers will not be able to zero-rate supplies of financial services to that customer. For conciseness, certain activities listed on tables A and B are referred to only by the first two or three digits (representing the subdivision or group classification). Any customer that is allocated a code that starts with those digits cannot receive zero-rated financial services.

Note: Providers that have knowledge concerning the actual activity of a customer must use this information instead of relying on ANZSIC codes.

46. Customers that are allocated a code that is listed on table B will be treated as not having an activity that will comply with the 75 percent test unless information is received from the customer that clearly demonstrates otherwise. If the customer provides written evidence of having an activity of making taxable supplies of goods and services exceeding 75 percent or more of total supplies providers may zero-rate any supplies of financial services to that customer.

47. Codes that are not contained in tables A or B may be treated as complying with the 75 percent test.

**TABLE A:
Excluded ANZSIC codes – No zero-rating**

Excluded codes	Reason
<i>Codes beginning with</i>	
K73 or 73 <i>Finance</i>	<i>Financial services</i>
K7411 or 7411 <i>Life insurance</i>	<i>Financial services</i>
K7412 or 7412 <i>Superannuation</i>	<i>Financial service</i>
K75 or 75 <i>Services to finance and insurance</i>	<i>Financial services</i>
M813 or 813 <i>Foreign government representation</i>	<i>No taxable activity</i>
Q97 or 97 <i>Private households employing staff</i>	<i>No taxable activity</i>
R99 or 99 <i>No response/refusal</i>	<i>No information</i>
0000 or unknown <i>Miscellaneous</i>	<i>No information</i>

TABLE B:
Excluded ANZSIC codes – No zero-rating unless activities suggests otherwise

Excluded codes		Reason
B1314 or 1314	<i>Gold ore mining</i>	<i>Fine metal</i>
B1317 or 1317	<i>Silver-lead-zinc ore mining</i>	<i>Fine metal</i>
C2723 or 2723	<i>Copper, silver, lead and zinc smelting, refining</i>	<i>Fine metal</i>
C2941 or 2941	<i>Jewellery and silverware manufacturing</i>	<i>Fine metal</i>
E4111 of 4111	<i>House construction</i>	<i>Residential accommodation/5 year rule</i>
E4112 or 4112	<i>Residential building construction</i>	<i>Residential accommodation/5 year rule</i>
F4792 or 4792	<i>Jewellery and watch wholesaling</i>	<i>Fine metal</i>
G5255 or 5255	<i>Jewellery and watch retailing</i>	<i>Fine metal</i>
H5710 or 5710	<i>Accommodation</i>	<i>Residential accommodation</i>
L7711 or 7711	<i>Residential property operators</i>	<i>Residential accommodation</i>
Q961 or 961	<i>Religious organisations</i>	<i>Donated goods and services</i>
Q9629 or 9629	<i>Interest groups</i>	<i>Donated goods and services</i>

Example of zero-rating supplies of financial services using ANZSIC codes

Allocating ANZSIC codes:

A finance company provides financial services to small businesses and households in the company's local community. The company conducts a review of its business clients that are involved in a number of activities and categorizes them as follows:

Client	Registered for GST?	ANZSIC code	Zero-rate?
Bakery	Y	G5124	Y
Builder	Y	E4111	Y
Butcher	Y	G5121	Y
Café	Y	H5730	Y
Cash loan business	Y	K7330	N
Cattery	?	Q9529	?
Charity	Y	Q9629	?
Dairy	Y	G5110	Y
Florist	Y	G5254	Y
Fruiter	Y	G5122	Y
Hairdresser	N	Q9526	N
Health food shop	Y	G5129	Y
Independent bookseller	Y	G5243	Y
Lawyer	Y	L7834	Y
Pharmacist	Y	G5251	Y
Second-hand goods dealer	Y	G5252	Y
Sports club	Y	P9319	Y
Toymaker	Y	C2329	Y
Watchmaker	Y	G5255 or G5269	?

Making further inquiries:

From the review, the finance company decides that it needs to gather more information from the cattery, charity and watchmaker in order to work out whether or not they can receive zero-rated supplies of financial services.

The cattery

The finance company has some doubt about whether or not the cattery is registered for GST. It telephones the cattery owner to establish whether it is registered for GST and the nature of the supplies made. The cattery owner confirms that the business is registered for GST and has a taxable activity. The finance company makes the assessment, that the cattery qualifies to receive zero-rated financial supplies.

The charity

The charity has an activity that largely involves the provision of emergency housing and supplying donated goods. It does not charge for the provision of emergency housing and receives a small revenue stream from the sale of donated goods. The charity is very dependent on donations to maintain its operations. As most of the supplies made by the charity are exempt, the finance company decides that the charity cannot receive zero-rated financial services.

The watchmaker

The watchmaker sells and restores watches and clocks, including repairing and servicing personal watches and selling watch accessories. The watchmaker holds some fine gold as stock for restoration purposes but does not sell it separately. The watchmaker also sells a number of restored pieces on credit and estimates that 15 percent of his annual income is from interest on those accounts. The watchmaker makes input tax adjustments in respect of those supplies. The finance company seeks further confirmation of the level of exempt supplies made by the watchmaker and, on the basis of that information, decides that the business is eligible to receive zero-rated financial services as the level of exempt supplies does not exceed 25 percent.

The 12-month period and start-up businesses

48. The zero-rating rules require providers to give consideration to the registration status and activities of their customer over a 12-month period, including the taxable period in which the supply of financial services is made.

49. This 12-month period could be problematic for those customers that have recently started business, been restructured or merged with another organisation. To assist in the application of the zero-rating rules to these customers, providers may make an initial assessment based on information supplied to them by the customer provided that the customer's business is reasonably expected to make its first taxable supplies of goods and services within 28 days from the date when the financial services were supplied. The initial assessment may then be applied for the next 12-month period, provided that it is reviewed at the end of that period to ensure that the customer has been correctly treated.

50. If the customer is unlikely to be making taxable supplies of goods and services within 28 days, any supplies of financial services to that customer should be treated as exempt.

Example – new bridal store

The finance company provides a cash advance to a new client that is just starting up. The client is not yet registered for GST, and the owner is still completing feasibility studies as to whether the local community and surrounding population can support a new bridal store. The finance company treats the advance as an exempt supply because the bridal store owner noted on the finance application form that it was not registered for GST. The finance company advises the owner to contact it once they register for GST.

Three months later, after outfitting a new premises and purchasing stock, the bridal store owner advises the finance company that it is registered for GST and is likely to be opening in two weeks' time. The finance company may zero-rate the interest accruing on the advance from the date that it receives notice from the bridal store that it is registered for GST, as it reasonably expected that it will be making taxable supplies within the next 28 days.

Households and unregistered persons

51. Supplies of financial services to households or unregistered persons (final consumers) cannot be zero-rated. In some instances, however, final consumers may be provided with financial products and services as part their association, either as the owner of a business or other relationship such as a client of a business customer. In these circumstances care must be taken that supplies of financial services to final consumers are not zero-rated and continue to be treated as exempt supplies.

Example – loan for private purposes

The local builder approaches the finance company to secure a loan to renovate and modify the family home. On the application form the builder gives her business bank account as the account into which the funds should be deposited. As the reasons specified for the loan relate to the private assets of the builder, the finance company cannot zero-rate the interest in respect of the loan.

Deductions from output tax

Paragraphs 63 to 75 set out Inland Revenue's approved method for claiming input tax in relation to any taxable supplies made. Financial service providers that have elected to zero-rate supplies of financial services using the guidelines must comply with those paragraphs.

Paragraphs 76 to 87 provide guidance on the application of section 20C.

Overview

52. The effect of the zero-rating rules is to increase the extent to which providers are able to deduct input tax. This is in contrast to the previous broad exempt treatment of financial services that has applied since 1 October 1986, when GST first applied to goods and services supplied in New Zealand. Exemption means that GST is not charged, and providers are unable to claim input tax credits.

53. Under the GST Act the deduction of input tax depends on whether the goods and services on which GST was paid were acquired either principally or in part for making taxable supplies. Taxable supplies include zero-rated supplies.

54. Providers are generally able to claim a full input tax credit for GST paid on purchases provided it can be established that the purchased goods and services have been acquired for the principal purpose of making taxable supplies. If the purchase is not for the principal purpose of making taxable supplies some of the GST paid can be recovered using the change-in-use provisions to the extent that the purchase is applied for a purpose of making taxable supplies.

55. A further special deduction is allowed in respect of supplies of financial services made to other financial service providers (direct suppliers). This deduction is calculated using the formula in paragraph 76.¹⁶

Evidential requirements

56. In the context of deducting input tax under these guidelines, providers must exercise reasonable diligence to determine the correctness of a GST return. Inland Revenue expects providers to hold tax invoices and any necessary calculations, samples and ratios that are used to support the deduction of input tax when apportioning input tax between taxable and non-taxable supplies.

Principal purpose test

57. If the majority of a provider's supplies are to qualifying GST-registered customers (over 50 percent) it will be able to deduct input tax on the basis that its principal purpose is that of making taxable supplies. The principal purpose test allows providers to claim 100 percent of the GST paid as an input tax credit on goods and services acquired in making those taxable supplies. Adjustments to input tax may still be required to the extent that there are non-taxable supplies.

58. If the provider's principal purpose remains that of making exempt supplies, it will not be able to claim 100 percent of the GST paid as an input tax credit but may, instead, recover a proportion of the GST paid using the rules concerning adjustments for change in use.

¹⁶ Refer section 20C.

Adjustments for change in use

59. If a provider cannot deduct input tax using the principal purpose test, an adjustment may be permitted using the change-in-use provisions.¹⁷ These provisions allow a deduction when goods and services acquired for the purpose of making non-taxable supplies are applied to making taxable supplies. The deduction allowed under these sections is proportionate to the use to which those goods and services are put. There are a number of adjustment methods by which input tax is allocated between taxable and non-taxable (including exempt) supplies

60. The methods of allocating input tax are:

- **Actual use:** This method of allocation requires the taxpayer to attribute the use of the goods and services directly to the extent that they are used for a purpose of making taxable supplies. This method should be used in preference to others whenever possible.
- **Turnover method:** This method is used in cases where the actual use method is too difficult to apply – for example, in the case of overhead expenses. The formula, as shown in the legislation, is:

$$\frac{\text{Total value of exempt supplies for taxable period}}{\text{Total value of all supplies for taxable period}}$$

- **An alternative (or special) method:** This method is available, provided that the Commissioner approves it, if its use results in allocated amounts that are fair and reasonable in comparison with actual use. If providers are unable to allocate input tax on the basis of actual use they should use the special method described in paragraphs 63 to 75 rather than the turnover method. If a provider has been using a method that is approved by Inland Revenue and it produces a fair and reasonable result it may continue to use that method instead of the one recommended in these guidelines.

61. In all cases the method of allocation used must result in a fair and reasonable allocation of input tax between taxable and other supplies.¹⁸

Note: Adjustments for change in use are not required if, in the next 12 months, the value of exempt financial services is the lesser of \$90,000 or 5 percent of the total consideration of all supplies made for the period.¹⁹

62. The amount of input tax that can be deducted in respect of any GST paid on goods and services used in making supplies of financial services is therefore determined by the following tests.

¹⁷ Refer sections 21E to 21G.

¹⁸ Refer section 21A(3).

¹⁹ Refer section 21(4).

Test	Input tax that can be claimed	Further adjustment required?
The goods and services were acquired for the principal purpose of making taxable supplies	100 percent of the GST paid.	Yes, if those goods and services are applied for a purpose of making supplies of non-taxable goods and services
The goods and services were directly attributed to specific taxable and non-taxable supplies	The GST paid should be split according to actual use.	Yes, if providers have made a one-off adjustment and the use of those goods and services changes by more than 20 percent.
The goods and services were applied to many different taxable and non-taxable supplies	The GST paid should be apportioned using the method specified in paragraphs 63 to 75.	Yes, if the goods and services are capital items

Valuing supplies of financial services and adjusting for changes in use

63. Providers that do not allocate input tax according to actual use will have to value their supplies of financial services for the purposes of allocating input tax between taxable and exempt supplies. These supplies will need to be valued every time an adjustment for any change in use is made.

64. Under the GST Act, providers may choose to calculate any adjustments for change in use either on the basis of every taxable period or each year. If the adjustment relates to goods that cost less than \$18,000 providers may make a single one-off adjustment in the taxable period in which the goods are applied for making taxable supplies.²⁰

The objective – valuing financial intermediation services

65. The objective of valuing the supplies of financial services when adjusting for changes in use is to identify charges for financial intermediation rather than valuing the underlying financial instruments involved in the transaction.²¹ This is because it is the value of the services that is being measured for GST purposes, not the value of the financial products.

66. It is therefore important when valuing financial intermediation services that providers do not include amounts received as a result of non-financial transactions and non-financial asset sales such as land, buildings, vehicles and equipment. A non-financial transaction is a supply of goods and services that is not included within the scope of the definition of “financial services” for GST purposes.

²⁰ Refer section 21G.

²¹ Also see Case C-172/96, *Commissioners of Customs and Excise v First National Bank of Chicago* [1998], European Court of Justice, 14 July 1998.

67. Financial service providers price their intermediation services either by setting a specific, explicit fee or by setting a margin based on a proportion of a set figure, such as an interest rate or commission percentage (for example, 10% of funds managed) or a difference between rates or percentages (for example, a 2% charge, the difference between a lending rate of 6% and a borrowing rate of 4%). The value of any financial intermediation services supplied should be either the explicit fee charged or the net margin received.

68. If the turnover method is used to measure the value of intermediation services supplied over the period providers will need to value continually any debt or equity instruments supplied over the period. It may not be appropriate to use the turnover method to value intermediation services because it will increase the time required to calculate any necessary change-in-use adjustments. As an alternative, providers should use the method explained in paragraphs 69 to 75. This method is still based on a turnover methodology but uses the ratio of net income from taxable supplies to net income from total supplies to measure the value of any intermediation services made over the period.

Special adjustment method using net margins and gross fees to value financial intermediation services

69. Inland Revenue will accept calculations using net margins and gross fees to value financial intermediation services when making adjustments for changes in use for GST paid on goods and services that are not otherwise directly attributed to taxable or exempt supplies.

Example – value of supplies as a net margin

Trust account	Interest received from advances	\$10,000
	Interest paid to account holder	<u>\$8,000</u>
	Net interest margin	\$2,000

70. This special method of valuation requires providers to value the margin derived from interest income, net proceeds from transactions in securities and gross fees. It is not necessary to review loan balances continually or periodically value holdings in securities.

71. Services that are directly charged by way of transaction fees and commissions should be valued at their invoiced price or the gross amount recognised as income for financial reporting purposes.

Formula for valuing change-in-use adjustments using net margins and gross fees

$$\frac{\text{Total value of taxable supplies}}{\text{Total value of all supplies}} = \text{Input tax recovery ratio}$$

The total value of taxable supplies is calculated using:

- net interest from transactions to businesses
- net margins from exchange and derivatives transactions to businesses
- gross fees and commissions from businesses that have been zero-rated
- other net/margin revenue from businesses
- standard-rated gross fees and commissions (supplies that are subject to GST at the rate of 12.5%)

The total value of all supplies is calculated using:

- all net interest
- all net margins from exchange and derivative transactions
- all gross fees and commissions
- all other net/margin income
- all standard-rated gross fees and commissions (supplies that are subject to GST at the rate of 12.5%)

The information required to apply the formula should be able to be sourced from financial statements. Determining the margins from treasury transactions such as foreign exchange and derivative transactions to businesses may require sampling. Any sampling period will need to include the last day of a financial quarter (such as 31 March, 30 June, 30 September and 31 December), as this day is typically busier than others. Providers should contact Inland Revenue to ascertain whether sampling is appropriate to their circumstances.

The reference to “business” means those registered persons that qualify to receive zero-rated supplies – meaning the business does not have more than an incidental activity of making exempt supplies (less than 25 percent of total turnover in a given 12-month period).

Special transactions

72. When valuing supplies of financial services using net margins and gross fees some transactions may present special difficulties.

Transactions with associated persons

73. For the majority of transactions, the value of any intermediation activity will be determined by the gross fee charged or the difference between the price paid for borrowing (otherwise known as “cost of funds”) and the price charged for lending. Special valuation rules²² apply to financial services supplied to an “associated person”.²³

²² Refer to sections 10(3), 10(3A) and 10(3B).

²³ Refer section 2A.

Transaction	Agreed value of supply under contract	Must be valued at
Supply to associated financial institutions	Agreed value is less than market	Agreed value
Supply to associated financial institutions	Agreed value is more than market	Market value
Supply to associated business customer	Agreed value is less than market	Agreed value
Supply to associated business customer	Agreed value is more than market	Market value
Supply to associated final consumer	Agreed value is less than market	Market value
Supply to associated final consumer	Agreed value is more than market	Agreed value

Net loss margin

74. At times, the net margin from a financial instrument will be a net loss – for example, when a financial instrument is realised at a loss or a movement in foreign exchange gives rise to a loss under a foreign exchange hedging contract. If this occurs, the margin should be treated as zero for the purposes of the valuation formula.

Net treasury income

75. Most financial service providers will engage in transactions using reserves to derive income in addition to that received from any core intermediation activity. This is done as a means of reducing exposures to risk that may arise in respect of transactions with customers that are undertaken as part of that core activity. These transactions will involve other parties such as other financial service providers, businesses, and the government. The tax treatment of these transactions will depend on the status of the counterparty in terms of whether or it should be treated as a zero-rated or exempt supply of financial services. Such transaction should be valued for the purposes of the formula when financial contracts are closed or financial instruments are realised. The net realised amount is the value that should be included in the valuation formula.

Example of making change-in-use adjustments under these guidelines

Adjusting for changes in use

The finance company makes adjustments for changes in use every year in the taxable period after its end of financial year. The adjustments are based on the accounting reports prepared by the company for the financial year.

Adjustments are required for both revenue and capital expenditure.

Adjustment worksheet for the period 1/1/2006 to 31/12/2006

<i>Income</i>	<i>% taxable</i>	<i>\$'000</i>	<i>\$'000</i>
Interest received (exempt)		14,500	
Less interest expense (exempt)		8,700	
Net interest (exempt)			5,800
Interest received (taxable)		13,800	
Less interest expense (taxable)		11,600	
Net interest (taxable)	100%		2,200
Treasury income		7,100	
Less Treasury expense		5,100	
Net treasury income	80%		2,000
Commissions and fees (exempt)			5,400
Commissions and fees from advisory service	100%		2,820
Total income			18,220
Less provision for doubtful debts			220
Income after provisions			18,000
<i>Operating expenses</i>	<i>% taxable use</i>		
Wages and salaries		7,850	
Insurance		2,600	
Rental		570	
Consultants	100%	1,700	
Phone		30	
Travel	100%	44	
Power		560	
Depreciation		240	
Agents' commissions	40%	2,580	
Total operating expenses			16,174
Operating surplus before taxation			1,826

Example – direct attribution

Travel

All travel expenses were incurred in relation to the finance company's business clients and were acquired for the principal purpose of making zero-rated financial services. As the travel expenses could be directly attributed to making taxable supplies, the finance company deducted input tax in the taxable period in which those expenses were incurred.

Consultants

As part of providing an advisory service to its clients, the finance company contracted consultants when required. The cost of these consultants could be directly attributed to providing standard-rated advisory services, so the finance company deducted input tax on the consultants' fees in the taxable period in which those expenses were incurred.

Agents' commissions

The finance company directly attributes 40 percent of its agents' commissions in respect of supplies of zero-rating financial services to its business clients.

Example – revenue adjustment

The finance company is adjusting office overheads for the taxable supplies made over the year. Over the year the finance company has not deducted input tax in respect of overhead items because these costs have been acquired for the principal purpose of making non-taxable supplies. The company works out whether it is required to make an adjustment.

- Exempt supplies for 12 months \$11.6 million (\$5.8 + \$5.4 + 0.4 million)
- Taxable supplies for 12 months \$6.62 million (\$2.2 + \$2.82 + 1.6 million)
- Total supplies for 12 months \$18.22 million
- 5 percent of total supplies \$911,000

The value of the exempt supplies is more than 5 percent of total supplies and \$90,000, so an adjustment is needed.

Step 1	Work out the percentage of taxable use for the year. <u>Total value of taxable supplies for period</u> Total value of all supplies for period =% of total supplies that are taxable	<u>\$6.62 million</u> = 36 percent \$18.22 million This is the percentage of taxable supplies
Step 2	Add up expenses over the year on which GST has been paid. Call this amount E.	The overheads to be adjusted for the year are: Insurance \$2.6 million Rental \$0.57 million Phone \$0.03 million Power \$0.56 million Total \$3.76 million
Step 3	Multiply E by the taxable percentage from step 1.	\$3.76 million x 36 percent is \$1.3536 million
Step 4	Divide this amount from step 3 by nine. This is the adjustment to show on the IR372 calculation sheet under “Goods and services used in making exempt supplies for annual or period-by-period adjustments”. Transfer the totals to Box 9 of the GST return.	The adjustment the finance company shows on the IR372 calculation sheet is \$150,400 (\$1.3536 million/9).

Example – capital adjustment

In the same year, the finance company purchases a new office building to cater for new business. The cost of the new building is \$8 million including GST. The building is reinforced concrete. As it is required to make adjustments in respect of its exempt supplies, the finance company will also have to make an adjustment for the new office building.

Step 1	Work out the percentage of taxable use for the year. <u>Total value of taxable supplies for period</u> Total value of all supplies for period =% of total supplies that are taxable	<u>\$6.62 million</u> = 36 percent \$18.22 million This is the percentage of taxable supplies
Step 2	For the taxable period in question, take the lower of the cost or current market value of the goods to be adjustment for taxable supplies. Call this L.	The lesser of the cost or open market value is \$8,000,000.
Step 3	Find out the straight-line depreciation rate for the asset. Call this S.	The general straight line depreciation rate for reinforced concrete buildings is 3 percent.
Step 4	$\frac{L \times S}{N}$ x percentage of taxable use from step 1 N is the number of taxable periods each year.	$\frac{\$8 \text{ million}}{1} \times 3 \text{ percent} \times 36 \text{ percent} = 86,400$
Step 5	Divide the amount from step 4 by nine. This is the adjustment to show on the IR372 calculation sheet under “Goods and services used in making exempt supplies for annual or period-by-period adjustments”. Transfer the total to box 9 of the GST return	The adjustment the finance company shows on the IR372 calculation sheet is \$9,600 (\$86,400/9).

Effect on operating profit

The adjustments for change in use, made in the first taxable period after 31 December 2006, have the following effect on the finance company's operating surplus.

Income after provisions	<i>GST content</i>	<i>Deductible input tax</i>	<i>Revised expenses</i>	18,000
Operating expenses				
Wages and salaries	-	-	7,850	
Insurance	288.9	104.0	2,496	
Rental	63.3	22.8	547.2	
Consultants	212.5	212.5	1,700	
Phone	3.3	1.2	28.8	
Travel	5.5	5.5	44	
Power	62.2	22.4	537.6	
Depreciation	26.6	9.6	230.4	
Agents' commissions	300.0	120.0	2,580	
Total operating expenses				16,014
Operating surplus before taxation				1,986

Supplies between financial service providers

Application

76. Financial services supplied to another financial service provider generally cannot be zero-rated under the zero-rating rules because most financial service providers will not satisfy the requirement that 75 percent of their supplies are taxable supplies. Instead, the GST Act provides a further deduction from output tax in relation to supplies of financial services made to another financial service provider (the direct supplier). The deduction relates only to exempt supplies of financial services made to the direct supplier and is limited to the extent that the direct supplier makes taxable supplies, including supplies of zero-rated financial services. The deduction is calculated according to a formula.²⁴

Formula for calculating the deduction for supplies of exempt financial services to other financial service providers

$$a \quad \times \quad \frac{b}{c} \quad \times \quad \frac{d}{e}$$

Where:

- a is total GST that would be recoverable under section 20(3), other than under section 20(3)(h), in respect of the taxable period if all financial services supplied by the financial service provider were taxable supplies;
- b is the total value of exempt supplies of financial services made to the direct supplier in respect of the taxable period;
- c is the total value of supplies made in respect of the taxable period;
- d is the total value of taxable supplies made by the direct supplier in respect of the taxable period as determined under section 20D;
- e is the total value of supplies made by the direct supplier in respect of the taxable period as determined under section 20D.

²⁴ Refer section 20C.

77. This proportional deduction from output tax is in addition to that which can be recovered as a deduction from output tax using the principal purpose test or by way of a change-in-use adjustment.

78. The proportion is found by multiplying two fractions. The first fraction is the proportion of the total value of supplies made by the provider that consists of exempt supplies of financial services to a recipient financial services provider (the direct supplier). The second fraction is the proportion of the total value of supplies made by the direct supplier that consists of taxable supplies (including zero-rated supplies of financial services).

79. The formula is limited to the activities of the direct supplier. Further supplies of financial services – for example, by the direct supplier to a third or subsequent financial services provider are not included in the formula.

Information required from the direct supplier

80. The method used to determine the deduction is based on statistical information that is provided by the direct supplier in relation to its ratio of taxable supplies to total supplies (items d and e of the formula).²⁵ The presentation of this statistical information can be in the form of a percentage or fraction.

81. Providers must obtain the ratio from the direct supplier before making the deduction. If a ratio is not provided, the deduction cannot be claimed.

Note: The GST Act does not require the direct supplier to provide this ratio.

82. If the direct supplier agrees to provide the necessary statistical information, the GST Act requires that the ratio must be current to each taxable period in which supplies of financial services are made.²⁶ This will require communication between the provider and the recipient of the financial service regarding the correct ratio to be applied to that taxable period.

83. If the direct supplier provides statistical information which, in the direct supplier's opinion, represents its activities over the last 12 months, that ratio may be applied by the provider for a further 12 months. Accompanying the ratio must be a written statement from the direct supplier that the ratio is a fair reflection of its activities over the last 12 months, including the taxable period in which the ratio is first sought. A new ratio from the direct supplier must be sought at the end of those 12 months.

84. If providers receive notice from the direct supplier that its ratio is no longer considered appropriate providers must immediately cease using that ratio and seek an updated one.

²⁵ Refer section 20D.

²⁶ Refer section 20C.

Evidential requirements

85. In respect of claiming the deduction, it is expected that providers have written notice, or other permanent records, of the direct supplier's ratio of taxable to total supplies.²⁷ This written notice can be in the form of an e-mail or letter. If the information is given by telephone, it must be followed up in writing for evidential purposes. The direct supplier must also state the period of time to which the ratio applies.

Disclosing a direct supplier ratio

86. If providers choose to disclose their ratio of taxable to total supplies to other financial service providers, Inland Revenue expects, in addition to providing the ratio in writing, the provider to maintain a regularly updated database of those persons that have received that ratio. The database should also detail the date that ratio was disclosed and the period to which it applies.

87. If providers become aware that the disclosed ratio is materially incorrect they must notify those financial service providers on their database advising them to cease using the ratio until a new correct ratio is provided.

Other matters

Tax invoices

88. The GST Act requires that registered persons issue a tax invoice in relation to any taxable supplies made to another registered person, if requested. This obligation also applies in relation to zero-rated supplies. In the context of zero-rated financial services there is no practical purpose in requiring that tax invoices be issued in respect of such supplies. A tax invoice does not, therefore, need to be issued in relation to zero-rated financial services.

²⁷ Refer items d/e as set out in section 20C.