

GST & financial services

A government discussion document

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TABLE OF CONTENTS

Chapter 1	Objectives of this review	1
	Introduction	1
	Key topics	2
	Summary of content in this discussion document	3
	Application date	6
	Submissions	6
Chapter 2	Background – the financial services exemption	8
	Policy development	8
	Implementing the exempt treatment of financial services	10
	The Advisory Panel on GST	10
	The government’s response	12
	The problems with the financial services exemption	12
Chapter 3	Recent studies on GST and the treatment of financial services	14
	The conceptual basis of GST	14
	Reason for excluding savings from the GST base	15
	The treatment of household consumption of financial services	16
	The treatment of business consumption of financial services	17
	Responses to the problems presented by exemption	17
	Taxing financial services	18
Chapter 4	The proposal to zero-rate business-to-business supplies	20
	General application	20
	Limitations to zero-rating	21
	Supplies of financial services between financial intermediaries	23
	Applying the zero-rating rules – a threshold for making taxable supplies	24
	Identifying customers based on the threshold	24
	Customers that make a mixture of taxable and exempt supplies from separate operations	25
	Zero-rating – an illustration	26
Chapter 5	Other matters relating to zero-rating business-to-business supplies	28
	Deduction of input tax	28
	The input tax recovery ratio and end-of-year adjustments	29
	Base maintenance	33
	Transitional arrangements	34
	Information requirements – tax invoices	34
Chapter 6	The scope of the definition of “financial services”	36
	Background	37
	Areas for reform	37
	Other issues	40
Chapter 7	Policy objectives of the grouping rules	42
	Role of the grouping rules	42
	Proposed role of the grouping rules	47

Chapter 8	Proposed amendments to the grouping rules	48
	Non-availability of input tax credits for disregarded supplies	48
	The requirement to make adjustments	54
	The value of adjustments	55
	Relationship with reverse charge proposals	55
Annex A	Causes and effects of tax cascades – an example	61
Annex B	Basic methodology of cash flow taxation as applied to different types of financial intermediation	63
Annex C	Numerical example comparing the treatment of taxable supplies and exempt supplies under current legislation with the proposed zero-rating environment	67
	Glossary of terms used in this document	69

Chapter 1

OBJECTIVES OF THIS REVIEW

This chapter outlines recommendations for the GST treatment of financial services and sets out the key issues on which the government seeks comment from interested parties.

Introduction

- 1.1 The term “financial services” covers a wide range of transactions including the provision of loans, the taking of deposits, trading in financial securities such as shares and debentures, the provision of life insurance, and charging interest on goods sold on credit. Businesses involved in the supply of financial services are also varied and include banking institutions, credit unions, financiers, life insurers, and, to a lesser degree, retailers and other businesses that sell goods on credit.
- 1.2 This discussion document considers the application of goods and services tax (GST) to the supply of financial services in New Zealand. It represents the second part of the post-implementation review of GST and was raised as an area for further review in the discussion document *GST: A Review*.¹
- 1.3 Since 1 October 1986, the date that GST first applied to goods and services supplied in New Zealand, supplies of financial services have been exempt from GST. Exemption, technically known as “exemption without credit”, means that GST is not charged on the supply of financial services. It also means that suppliers of financial services are not able to recover any GST paid on purchases in respect of supplying those services, that is, they are denied “input tax credits”. This treatment in effect taxes suppliers of financial services as if they were final consumers.
- 1.4 Although in New Zealand exemption is generally seen as undesirable as it departs from the policy of maintaining a broad-based GST, it is recognised internationally as a pragmatic solution for including financial services within an indirect tax system such as GST. Treating financial services in this way does, however, create a number of problems including the creation of “tax cascades” in the economy, which can lead to the overtaxation of the business sector. Another problem is the incentive for banks, financiers, life insurers and other financial service providers (financial intermediaries) to “self-supply” essential activities – that is, undertake the activity internally, rather than out-source it, so as to minimise the impact of GST. Exemption also generally increases compliance costs on financial intermediaries as they are required to apportion costs between exempt financial supplies and other supplies that are taxable.

¹ *GST: A Review - a tax policy discussion document*, published by the Policy Advice Division, Inland Revenue, March 1999.

- 1.5 In response to these problems the government is proposing in this discussion document that business-to-business supplies of financial services be zero-rated.² In other words, GST will not be charged on the supplies but the supplier will be able to recover GST on its purchases that are related to the supplies. The benefits of this proposal include the reduction in the potential for distortions to arise in respect of supplies of financial services to businesses. It should also go some way to relieve the GST burden on financial intermediaries that regularly provide financial services to the business sector, arising from the inability of the financial intermediaries to claim input tax credits. This document outlines in detail how the proposal will operate.
- 1.6 The proposal to zero-rate business-to-business supplies of financial services is accompanied by proposals for changing the definition of “financial services”. The reforms are directed at a future narrowing of the definition of financial services (section 3 of the Goods and Services Tax Act 1985) and should, in combination with the proposed zero-rating reform, reduce the bias that financial intermediaries have to in-source goods and services rather than acquire them from third parties.
- 1.7 Another area considered in this document is the application of the grouping rules for GST. Allowing related companies to return GST as if they were a single entity is intended to reduce distortions that would otherwise arise between different corporate structures and to reduce compliance costs. The rules become complex when a mix of taxable and exempt supplies is made in a group, so further clarification is, however, needed.

Key topics

- 1.8 The key topics discussed in this document are:
- the reasons financial services are exempt and the problems caused by exemption;
 - the conclusions reached by international studies and practices on whether financial services should be included in the base of an indirect tax such as GST, and, if so, what alternative treatments exist that could be applied to include financial services within the base; and
 - the scope and application of the proposal to zero-rate business-to-business supplies of financial services.
- 1.9 The document also makes recommendations for change in relation to:
- some aspects of the definition of “financial services”; and
 - the treatment of intra-group supplies.

² The treatment of exported financial services will remain unchanged.

- 1.10 Aside from the proposal to zero-rate business-to-business supplies of financial services, the government is not recommending a substantial departure from the current treatment of financial services supplied in relation to personal bank accounts. The government will instead leave issues in this area open for possible future discussion. For example, the document does not recommend that bank fees to final consumers should be taxed.
- 1.11 Internationally, the treatment of financial services under an indirect tax such as GST is the subject of continuing discussion. The New Zealand government continues to participate in this area at the OECD and to monitor developments in key jurisdictions such as Australia, Canada and the United Kingdom.

Summary of content in this discussion document

CHAPTER 2	<p><u>Background – the financial services exemption</u></p> <p>Chapter 2 looks at the policy debate that occurred between 1984 and 1985 in relation to GST and financial services.</p> <p>Despite the decision made in 1985 to exempt financial services, it is acknowledged that the current exemption creates a number of distortions, specifically:</p> <ul style="list-style-type: none"> • the potential for exemption to create tax cascades in the New Zealand economy, and • the bias that financial intermediaries have to in-source key activities.
CHAPTER 3	<p><u>Recent studies on GST and the treatment of financial services</u></p> <p>Chapter 3 considers the conceptual basis for GST, including the theoretical arguments for excluding savings (deferred consumption) from the GST base. It also considers the differing views internationally on whether the consumption of financial services by households should be included in the GST base.</p> <p>Given that there is no consensus view on these issues, the government is not proposing at this time either to tax financial services or exclude them from the tax base. However, given the present distortions that exemption is creating in relation to business-to-business supplies of financial services in New Zealand, the government is proposing to zero-rate these supplies in certain circumstances.</p>

The proposal to zero-rate business-to-business supplies

This chapter sets out the conditions under which it is proposed that the supply of financial services in New Zealand may be zero-rated. The purpose of the reform is to better align the supply of financial services from financial intermediaries to businesses with the supply between businesses of taxable, standard-rated goods and services.

It is proposed that the supply of financial services (as defined in section 3) by a registered person to another registered person who primarily makes supplies of standard-rated goods and services will be zero-rated.

Zero-rating will not apply when the recipient is not registered for GST. It is also proposed that zero-rating not apply where the recipient has more than an incidental activity of making exempt supplies.

A recipient will be treated as having a predominant activity of making taxable supplies if the level of taxable supplies (not including supplies that are zero-rated as a result of the proposals in this document) represents 75 percent or more of the recipient's total supplies in any twelve-month period. The application of this test will be able to be based on reasonable assumptions as to the nature of the business, rather than a consideration on a transaction-by-transaction basis.

Views are sought on whether it is feasible to develop a system to provide input tax credits to a supplier of financial services if the recipient of the service makes predominantly exempt supplies to registered persons that make predominantly taxable supplies. At this stage the proposal does not include a means by which the supplier in these circumstances could claim input tax credits.

Other matters relating to zero-rating business-to-business supplies

Chapter 5 looks at some of the practical problems with the proposal to zero-rate business-to-business supplies of financial services, including the deduction of input tax, transitional issues and information requirements.

Although significant changes to the current change-in-use adjustment rules are not proposed under the zero-rating proposal, the way in which financial intermediaries claim input tax credits is likely to change to some extent. The method of apportioning input tax credits between taxable and exempt supplies adopted by the taxpayer will need to be agreed with Inland Revenue.

The chapter addresses potential base maintenance concerns to ensure that the zero-rating proposals in this document do not create unintended tax advantages.

The scope of the definition of "financial services"

Issues discussed in chapter 6 are:

- achieving a further reduction in the self-supply bias through narrowing the definition of "financial services" to exclude third party activities;
- the competing arguments on the GST treatment of management fees charged in relation to long-term investment vehicles (such as unit trusts and group investment funds); and
- the extent to which the supply of participatory securities should be treated as a supply of exempt financial services.

Policy objectives of the grouping rules

The self-supply bias also has implications for the grouping rules contained in the GST Act. Chapter 7 sets out the proposed policy role of the grouping rules as they affect intra-group supplies of goods and services.

The grouping rules attempt to reflect a single entity approach for groups of companies when accounting for GST.

Proposed amendments to the grouping rules

It is proposed to clarify the application of the grouping rules in relation to change-in-use adjustments and intra-group supplies to better reflect this policy.

Chapter 8 discusses the relationship between the grouping rules and the proposed reverse charge as outlined in the discussion document *GST and imported services*.

SUMMARY OF PROPOSALS

- Supplies of financial services by a registered person will be zero-rated provided that the recipient:
 1. is registered for GST; and
 2. makes taxable supplies (not including supplies that are zero-rated as a result of the proposals in this document) in a given twelve-month period of 75 percent or more of total supplies in the period.
- Zero-rating will not apply to the supply of financial services if the recipient's level of taxable supplies cannot be determined or the recipient is a financial intermediary. The issue of supplies to financial intermediaries who in turn make supplies to other businesses will be further considered in consultation.
- An option will be allowed for zero-rating to be based on reasonable assumptions as to the nature of the customer's business. These assumptions will then be used to determine the level of input tax credits for supplying zero-rated financial services.
- Provisions will be introduced in respect of the timing of deductions of input tax credits, particularly in relation to transitional matters, and to address potential base maintenance issues.

- The definition of “financial services” in the GST Act will be narrowed to:
 1. subject to further consultation, exclude services provided by third parties (such as brokers); and
 2. clarify the definition of “participatory security” and the extent to which such transactions should be treated as financial services.
- The treatment of management fees for long-term investment vehicles, particularly group investment funds and unit trusts, is reviewed.
- The application of the grouping rules in relation to change-in-use adjustments and intra-group supplies is clarified in order to improve the alignment of these rules with the treatment of single entities.

Application date

- 1.12 Unless otherwise stated, the changes outlined in this discussion document are planned for inclusion in the first available tax bill in 2003. It is acknowledged that the proposals may require financial intermediaries to undertake considerable systems changes. To accommodate this, the government proposes to defer the application date of the proposals for approximately 12 months after the date the relevant legislation is enacted by Parliament.

Submissions

- 1.13 The government invites submissions on the proposals contained in this discussion document. 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.

- 1.14 Submissions may be made in electronic form to:

policy.webmaster@ird.govt.nz

Please put “GST and Financial Services” in the subject line for electronic submissions.

1.15 Alternatively, submissions may be addressed to:

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

1.16 Submissions should be made by 6 December 2002 and should contain a brief summary of the main points and recommendations. Submissions received by the due date will be acknowledged.

1.17 An electronic copy of this tax policy discussion document is available on-line at:

www.taxpolicy.ird.govt.nz/publications/index

or

www.treasury.govt.nz/

Chapter 2

BACKGROUND – THE FINANCIAL SERVICES EXEMPTION

This chapter discusses:

- The reasons financial services are treated as exempt supplies, including the policy debate and recommendations by the Advisory Panel on Goods and Services Tax.
- The difficulties caused by exemption, primarily:
 - the potential for the overtaxation of transactions with the business sector and the undertaxation of transactions with the household sector.
 - the bias that exemption creates for financial intermediaries to self-supply to minimise the impact of GST.
- The problems associated with the boundary between financial and non-financial supplies.

Policy development

- 2.1 During the policy development of GST in 1984-1985, a number of options were considered and evaluated to establish whether financial services could be fully integrated into the GST base. This began with a non-government discussion paper entitled *Financial Services and the GST*.³ The paper identified that integrating financial services within a credit-invoice⁴ GST framework was problematic.
- 2.2 Part of the difficulty with taxing the service component of a financial supply is measuring the payment for services supplied on a transaction-by-transaction basis. Financial intermediaries earn income from the margin between the price charged for applying funds and the price charged for receiving funds, as in the case of banking, lending and borrowing. The substantial component of that price will represent interest, which is generally outside the scope of a consumption tax.

³ Carl Bakker and Phil Chronican, *Financial Services and the GST – A discussion paper*, Victoria University Press for the Institute of Policy Studies, Victoria University of Wellington, 1985.

⁴ This is the most common form of GST/VAT. Otherwise known as the subtractive-indirect method, it is based on the formula $t(\text{outputs}) - t(\text{inputs})$ or in other words $t(\text{taxable sales}) - t(\text{taxable purchases})$. This method is preferred for four reasons: (i) the tax liability arises at each transaction in a production and distribution chain, making it technically superior to other forms, (ii) it creates a good audit trail, (iii) multiple rates can be used, and (iv) it is easy to calculate the tax liability.

- 2.3 Applying GST to supplies of financial services on an individual transaction basis is difficult because the service element, as distinct from the interest or other components, is often not separately identifiable in the charges made.
- 2.4 Acknowledging that the inclusion of financial services within GST would require a different approach from the credit-invoice method proposed in the *White Paper*,⁵ the following options were considered:
- **Zero-rating:** This option does not tax the consumption of financial services by households. No tax is paid on the supplies of financial services, and a full refund is given for GST paid in making those supplies.
 - **Exemption:** No tax is charged on the supply of financial services, and no GST refund is allowed for tax paid in making those supplies. By not allowing input tax credits, household consumption of financial services is taxed at the intermediary stage, as is consumption by the business sector.
 - **Additive approach:** Under this approach, financial services are calculated by reference to the sum of salary and wages, other labour expenses, rates, levies (and other indirect taxes) and the net operating surplus, less depreciation incurred. This method correctly measures the tax base, but does not directly identify the tax charged on supplies. Not identifying the tax charged on a supply makes it difficult to provide input tax credit relief to other businesses for the GST cost of the financial service.⁶
 - **Net operating income:** The GST is calculated on the basis of the net operating income of the financial intermediary. Input tax credits are allowed to the financial intermediary. The tax is not necessarily related to transactions. This means that it suffers from the same problems as the additive approach in terms of its effect on businesses.
 - **Full invoicing:** Under this option, depending on the nature of the financial service, the value would be the consideration (the fees and commission) or the dollar amount the transaction represents (in the case of deposits or withdrawals). This approach fits within a credit-invoice framework but is inconsistent with the aim of GST as the time-value of money, which is neither goods nor services, is included in the tax base. Although businesses would be able to recover the GST paid by way of input tax credits, final consumers would be overtaxed on their consumption of financial services.

⁵ *White Paper on Goods and Services Tax: Proposals for the Administration of the Goods and Services Tax*; New Zealand government, March 1985.

⁶ This method is applied in Israel and is widely referred to as a wages plus profits tax. Under the Israeli method no input tax credits are allowed to the financial intermediary. This effectively taxes the supply of financial intermediation but does not remove production distortions resulting from the additional layer of unrelieved tax.

- **Separate tax rates:** Under this option, the tax rate is determined in relation to the value of the service. For example, if the margin (treated as the value of the service) is based on a lending rate of 12% and a borrowing rate of 8%, it would represent one-third of the lending rate, or 4%. A GST rate of one-third of the full rate could then be applied to the total interest rate. This rate would be $4\frac{1}{6}\%$, (one-third of the 12.5% GST rate). This method is likely to create additional economic distortions and costs, although it is more accurate than full invoicing in determining the value of the services provided by financial intermediaries.

Implementing the exempt treatment of financial services

- 2.5 In early 1985 the then government consulted with the financial services industry on the various options for the GST treatment of financial services. Using the discussion paper *Financial Services and the GST* as a means of summarising the government's work, it became evident that no ideal solution existed because of the compliance and measurement difficulties associated with each of the taxing options proposed.
- 2.6 In June 1985 the government announced that suppliers of financial services would pay GST on the same basis as final consumers⁷ and, therefore, that financial services were to be exempt from GST. This announcement was accompanied by a government discussion paper,⁸ which acknowledged that although GST was intended to apply to a broad range of goods and services at a single uniform low rate, the design of any tax involved an element of compromise between theory and practicality. The treatment of financial services was one such area where the practical difficulties associated with correctly applying the tax could not easily be resolved. Exemption was seen as the best option given these constraints as it included financial services within the GST base but did not have to address the measurement difficulties associated with charging GST on supplies of financial services.
- 2.7 Submissions on the discussion paper were considered by the Advisory Panel on the Goods and Services Tax.⁹

The Advisory Panel on GST

- 2.8 In its report to the government dated July 1985, the advisory panel expressed a number of concerns about the proposed exempt treatment of financial services, namely:

⁷ Press statement, Hon R O Douglas, Minister of Finance, "Proposals released for GST and Financial Services", 6 June 1985.

⁸ *Proposed application of Goods and Services Tax to financial services*, The Treasury, June 1985.

⁹ The advisory panel was an independent panel of individuals from the private sector that was formed to receive and consider submissions on the government *White Paper on Goods and Services Tax* and the later *Proposed application of GST to financial services*. The role of the panel was to provide an external opinion to the government that reflected public concerns and identified possible areas of reform.

- The high compliance costs caused by the need to allocate purchases between taxable and exempt activities. This was perceived to be in conflict with the government’s objective of keeping the tax as simple as possible.
- The potential avoidance opportunities that could arise if financial institutions arranged to provide services from abroad. For example, a New Zealand institution could lend to its offshore affiliate, thereby exporting the financial service. This would be zero-rated and therefore permit the New Zealand institution to claim a credit for the GST incurred in making the supply. The offshore affiliate would then on-lend to the New Zealand customer. The price charged by the offshore affiliate would include no tax component as the supply would be outside the New Zealand GST base.
- The incentives that the exemption without credit would create for financial institutions to provide in-house services, rather than to obtain them from third parties.
- The possibility that tax cascades might occur in the economy, as a result of financial services including a tax cost that cannot be claimed back by a business recipient of a financial service. This arises because the inability to claim an input tax credit increases the costs faced by financial intermediaries when supplying financial services. Depending on the level of competition in the financial services market, the financial institution could pass on that cost by way of higher prices.

2.9 For these reasons the advisory panel did not favour the exemption without credit approach. It developed its own option of applying GST to the full price (the advertised interest rate or fee) of the financial services. The premise of this option was that if the “value added” to goods and services is generally the difference between the consideration received from the sale of those goods and services and the costs incurred in making the supply of those goods and services, this should also apply to the supply of financial services.¹⁰

2.10 Under this option, therefore, GST would have applied to interest payments. Transactions where money was exchanged for no specific fee (for example, a foreign exchange, where the financial institution’s profit is the margin between the rate at which the currency is bought and sold) would be exempt, but with a credit for purchases. Specific fees and charges would be taxable, including brokerage fees in relation to equity instruments.

¹⁰ This proposed treatment is similar to “full invoicing”, as described on page 9.

The government's response

- 2.11 The government considered the advisory panel's report but concluded that the full taxation of financial services would not appropriately value the supply of financial services and was concerned about the impact that taxing financial services would have on the wider economy. Given the long history of exemption in Europe, and the preference for exemption as expressed by jurisdictions that operated a value added tax (VAT) or GST, the government decided to exempt financial services.

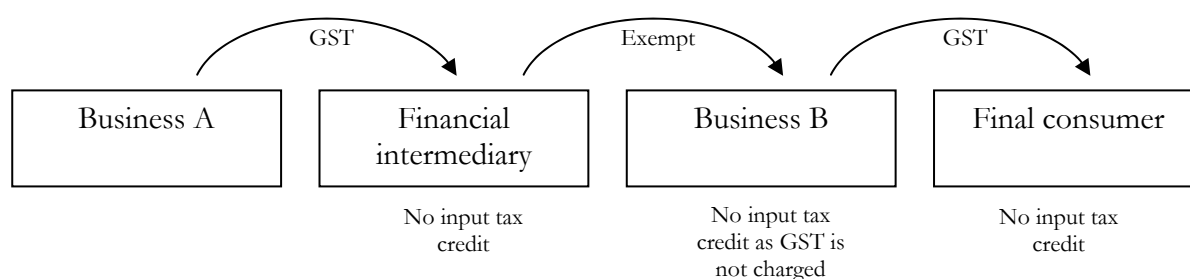
The problems with the financial services exemption

- 2.12 The two key difficulties caused by exemption are the potential for GST to "cascade" in relation to supplies by the financial services sector to the business sector and the incentive that exemption creates for financial intermediaries to "self-supply" key activities. Exemption also creates a number of practical difficulties in relation to the definition of "financial services" and apportioning costs between taxable and exempt activities.

Tax cascades

- 2.13 Tax cascades arise when a supplier of a financial service cannot recover the GST paid on goods and services purchased. The non-creditable GST will then form part of the cost of production. To compensate, the financial intermediary either raises the price of the service or absorbs the GST cost. If the cost is passed on to businesses through higher prices, businesses face the same decision, to increase the prices charged for their products or absorb the additional tax cost. This may increase prices faced by final consumers, as illustrated in figure 1. Alternatively, if the non-creditable GST is absorbed, the GST is effectively being paid by the business through reduced profits rather than being shifted onto the price of goods and services supplied to final consumers.

Figure 1: How tax cascades arise



As the GST cannot be recovered from the transaction between Business A and the financial intermediary, the GST is included in the cost of the financial service supplied by the financial intermediary to Business B. This higher cost may then be passed through to the products sold by Business B to its customers.¹¹

¹¹ A numerical example of how tax cascades arise is included in Annex A.

Self-supply bias

- 2.14 A bias for a financial services provider to provide all key services in-house may arise if the provider is unable to recover the GST paid on goods and services purchased. The provider may see this as preferable to obtaining those services from a third party that is likely to charge GST on the supply. This bias has implications in relation to both the zero-rating proposal and the grouping rules.

Definition of “financial services”

- 2.15 The first main problem to arise with the definition of “financial services” related to the supply of accounting and processing services by a third party to various trading and savings banks. The issue concerned the extent to which exemption applied to such services provided by a third party. Although amendments enacted in 1989¹² and the decision of the Privy Council in *Commissioner of Inland Revenue v Databank Systems Limited*¹³ have provided some guidance on the boundary between financial and non-financial services, it remains a complex area of the GST Act, particularly in relation to third party supplies.

Apportionment

- 2.16 A boundary between exempt and taxable supplies makes it necessary for taxpayers that make a combination of supplies to apportion purchases between the two activities when claiming input tax credits. This imposes compliance costs and can be difficult to achieve accurately. In practice, apportionment is the most difficult issue facing financial intermediaries when complying with GST. This has been compounded by uncertainties in the application of the grouping rules.

¹² Refer sections 3(5) and 14(1).

¹³ (1990) 12 NZTC 7,227.

Chapter 3

RECENT STUDIES ON GST AND THE TREATMENT OF FINANCIAL SERVICES

This chapter discusses:

- the conceptual basis of GST and why savings are not included in the GST base;
- the arguments for and against the inclusion of household consumption of financial services in the GST base;
- alternatives to exemption presented by overseas studies and practices; and
- the policy reasons for zero-rating domestic business-to-business supplies of financial services.

The conceptual basis of GST

- 3.1 Chapter 2 outlined the options and decisions faced by the then government in 1985 when considering the cost treatment of financial services. The ultimate adoption of exemption was based on the widespread view that financial services were appropriately classified as taxable consumption and, therefore, should be included in the scope of the GST base. The key problem with this was how to tax financial services under a credit-invoice method and keep savings outside the GST base. Some commentators have, however, developed alternative views and models that argue that it is not always appropriate to classify financial services as taxable consumption.¹⁴
- 3.2 Commentators suggest that the arguments for and against the inclusion of financial services in the GST base should be dependent on how the concept of GST is viewed. Indirect taxes such as GST are based substantially on the sum of private and government consumption, investment in capital goods and net exports (exports less imports).¹⁵ This, in principle, is representative of the spending within New Zealand, which can be used to determine the quantity of goods and services demanded in New Zealand. It also means that the GST base can be largely defined by using sales and allowing an offsetting credit for purchases. This is reflected in the credit-invoice mechanism, which creates a high level of accuracy in the measurement of GST because transactions are based on the prices agreed by the parties to the transaction.

¹⁴ Most recently: Ngee Choon Chia and John Whalley, *Treatment of Financial Intermediation*, Journal of Money, Credit and Banking, Vol. 31 No. 4 (November 1999), Ohio State University Press; Harry Grubert and James Mackie, *Must Financial Services be Taxed under a Consumption Tax*, National Tax Journal Vol. 53 No. 1 (March 2000); William Jack, *The Treatment of Financial Services under a Broad-Based Consumption Tax*, National Tax Journal Vol. 53 No. 4 (December 2000); and Alan J Auerbach and Roger H Gordon, *Taxation of financial services under a VAT*, American Economic Review (May 2002).

¹⁵ For a similar discussion refer Ian Roxan, *The nature of VAT supplies of services in the twenty-first century*, British Tax Review (2000) No. 6.

3.3 The credit-invoice mechanism is also important to ensure that double taxation does not arise in respect of the following items and that GST largely remains a tax on consumption:¹⁶

- ***Intermediate production:*** Some activity does not give rise to direct consumption but, rather, to the production of goods and services that are later consumed. The removal of intermediate production from GST is usually dealt with by providing input tax credits.
- ***Investment goods (non-consumption items):*** In principle, investment goods, as with intermediate production, should be excluded from GST. This is because these goods do not in themselves represent production but are used more broadly to generate production. Although these items are generally included in the GST base of most jurisdictions, neutrality is preserved as the GST impost is removed by an input tax credit.

Reason for excluding savings from the GST base

3.4 As GST can largely be characterised as a tax on private and government expenditure on final goods and services, savings (or deferred consumption) should not be included in the GST base. This is not to say that the services supplied by financial intermediaries to consumers, which may be complementary to savings products, should not be included in the tax base but that the treatment of savings needs to be considered in the same manner as non-consumption items.

3.5 In principle, GST should apply only at the time that savings are applied to purchase goods and services. This is because the return on savings largely compensates for the time value of money or “pure interest” (the return required for someone to be indifferent about whether to spend now or some time in the future). Taxing the time value of money within the GST base would likely result in double taxation. This would occur as the compensation for deferring consumption would be taxed, and then taxed again when the funds were applied to acquire goods and services in a later period. The issue with regard to the treatment of financial services is the extent to which the process of deferring consumption should or should not be subject to GST.

¹⁶ New Zealand’s GST, like many other GST and VAT systems used in other jurisdictions, includes investment goods and services (particularly those purchased by households) in addition to goods and services that economists typically characterise as consumption goods and services.

The treatment of household consumption of financial services

- 3.6 Both studies which take the view that financial services should be subject to GST,¹⁷ and studies which argue that they should not,¹⁸ share the view that GST should generally preserve the neutrality between current and deferred consumption. There is no agreement, however, on the extent to which complementary services relating to savings should be excluded from the GST base.
- 3.7 The traditional view is that the margin of a financial intermediary should be subject to GST. However, unless the margin is correctly measured on a transaction-by-transaction basis, as required under the credit-invoice method, there is the possibility that GST would apply to pure interest and overvalue the amount that should be properly taxed.
- 3.8 The alternative view treats the entire margin as being part of the cost associated with transferring consumption between periods (either in the form of savings or investment) and concludes that complementary services as well as deferred consumption should generally be excluded from GST. The arguments are based on whether financial services enter the utility function of households and conclude that a household's consumption of financial services should not be classified as taxable consumption if the purpose of financial intermediation is to facilitate and smooth consumption. Therefore financial intermediation, which allows inter-temporal consumption of goods, should not be taxed as tax is collected at the point when the savings are used by the household to purchase goods and services. As such, it is inappropriate to include financial services in the GST base.
- 3.9 Even if the non-consumption categorisation of financial services is accepted, views may still differ across a range of intermediation fees as to what should and should not bear GST. One consideration is whether the fee is explicitly charged or included in the margin.
- 3.10 The government notes that these academic arguments on whether the household consumption of financial intermediation should be treated as taxable or non-taxable consumption are inconclusive. Comment from interested parties on this debate is encouraged but, in the face of these differing views, the government does not propose to review the current treatment of household consumption of financial services in the immediate future.

¹⁷ Refer Ernst & Young, *Treatment of Financial Services under a VAT Prepared of the Commission of the European Communities* (August 1993); *Treatment of Financial Services under a VAT: Further exploration of the cash-flow method of taxation, prepared for the Commission of the European Communities* (September 1994); Satya Podder and Morley English, *Taxation of financial services under a Value-Added Tax: Applying the Cash Flow Approach*; National Tax Journal Vol. 50 No. 1 (March 1997) and, Ernst & Young, *The TCA System – A detailed description*, Taxation and Customs Union, Reports and Studies commissioned for the European Commission, Brussels (1998).

¹⁸ Ibid footnote [14](#).

The treatment of business consumption of financial services

- 3.11 Although there are differing opinions on the proper treatment of household consumption of financial services, it is generally agreed that, in principle, GST should not apply to the business consumption of financial services. This is for the same reasons that input tax credits are allowed in respect of intermediate production and investment goods consumed by businesses.
- 3.12 In chapter 2 it was highlighted that the current exemption creates a number of problems in the New Zealand economy and affects the neutrality of production decisions. Two problems have been identified for consideration, the creation of tax cascades and the self-supply bias. These two problems have a single cause – the inability of financial intermediaries to recover GST paid on their purchases.

Responses to the problems presented by exemption

- 3.13 Some jurisdictions have specifically sought to address the self-supply bias. For example, Singapore allows financial intermediaries to claim input tax credit relief on a prescribed recovery percentage, provided that the supplies relate to business-to-business supplies. Australia allows a notional input tax credit of 75 percent (a “reduced input tax credit”) to financial intermediaries on certain prescribed purchases.¹⁹ Another means of addressing the self-supply bias could be by way of a self-supply tax.
- 3.14 In the consultative paper *The Application of Goods and Services Tax to Financial Services*,²⁰ the Australian government noted that many jurisdictions included within the scope of the exemption fee-based charges that could otherwise be included directly in the tax base. It considered this level of exemption to be undesirable as it increased the compliance burden of exemption to those that supply financial intermediaries and has, therefore, opted to tax “agents” (generally third parties) who supply financial services. Narrowing the potential scope of exemption in this manner addresses similar concerns to, and is complemented by, the reduced input tax credit for financial intermediaries in respect of certain services.
- 3.15 The government considers that, in practical terms, the most serious difficulty with exemption is the overtaxation of businesses caused by the inability to recover input tax. Tax cascades are the direct result of this and should, therefore, be the initial focus for reform. Reducing tax cascades will, however, in turn reduce the self-supply bias, which is equally caused by the inability to recover input tax. The government is in any event concerned as to the risk of arbitrariness in a self-supply focus through such mechanisms as the reduced input tax credit, as this is inconsistent with the precise measurement of GST under the credit-invoice mechanism.

¹⁹ Refer A New Tax System (Goods and Services Tax) Act 1999, Regulation 70-2, Commonwealth of Australia.

²⁰ *The Application of Goods and Services Tax to Financial Services – Consultation Document*, August 1999, Commonwealth of Australia.

Taxing financial services

- 3.16 Taxing financial services using the credit-invoice methodology requires considerable information flows. A financial intermediary's core business activity involves bringing together borrowers and lenders and supplying services to both parties. The charge for these services may be included in the difference between the interest rate charged on borrowing and the interest rate paid on lending. Such margins will represent the payment for services supplied to both borrowers and lenders.
- 3.17 To charge GST directly on the services supplied by the financial intermediary to the two parties it is necessary to know the margin between the rate of interest offered to lenders and the rate of interest charged to borrowers. It is also necessary to calculate the way that the margin is allocated between the two parties. This is problematic because financial intermediaries do not directly link individual lenders and borrowers, and they have a number of borrowing and lending rates applicable to each party.
- 3.18 Under these circumstances, it is not easy to identify the charge applicable to an individual transaction, let alone determine the portion of the difference that represents the fee for the services to a particular customer.
- 3.19 International work on approaches to taxing financial services has sought to approximate the allocation of these margins.
- 3.20 The cash flow method of taxing financial services as developed by Satya Podder and Morley English,²¹ called the "truncated cash flow method with tax calculation account" specifically includes both households and businesses within the scope of the base. Broadly, under the cash flow method, cash inflows from financial transactions are treated as taxable sales, and cash outflows are treated as taxable purchases. In the case of simple deposit-taking intermediation, the cash flow method measures and taxes the implicit fee for financial margins and allocates the margin between borrowers and lenders. (An explanation of this method of taxing financial services under a GST is included in Annex B).
- 3.21 Despite its promising features, the cash flow method makes a number of assumptions as to the rate of interest ("pure interest") on which to index the intermediation fee charged for the services supplied to lenders and borrowers. Although these assumptions reduce the extent of the compliance burden faced by businesses, the use of an indexing rate to allocate financial margins between lenders and borrowers raises concerns about accuracy. Although the government will continue to monitor international studies on the truncated cash flow method, it is not convinced that its implementation would resolve the difficulties presented by exemption. They may indeed increase compliance costs above those imposed by exemption.

²¹ Ibid footnote [17](#).

- 3.22 The government has also considered the option of taxing explicit fees, while continuing to exempt margin-based charges. This would be a practical response to the problems associated with exemption, as it attempts to address the undertaxation of households and the overtaxation of businesses (as an input tax credit would be allowed for any GST charged). However, a potential problem with taxing explicit fees is the ability of financial intermediaries to substitute fee and margin income. Although the deregulated and competitive state of the financial services market would suggest that the opportunities to substitute are limited, given the unresolved debate concerning the treatment of household consumption of financial services it would be inappropriate, at this time, to advance this option.
- 3.23 Acknowledging that the correct treatment of household consumption of financial services has yet to be resolved, and, in the absence of a comprehensive GST on financial services, the government considers that the next best policy option is to address the overtaxation of financial services supplied to businesses arising from tax cascades and the self-supply bias.

Chapter 4

THE PROPOSAL TO ZERO-RATE BUSINESS-TO-BUSINESS SUPPLIES

This chapter sets out the key features of the proposal to zero-rate business-to-business supplies of financial services. It discusses when zero-rating should apply and when it should not apply.

The main proposals are:

- The supply of financial services (as defined in section 3) by a registered person to another registered person who has a predominant activity of making taxable supplies of goods and services will be zero-rated.
- Zero-rating will not apply when the recipient is not registered for GST, nor if the recipient has more than an incidental activity of making exempt supplies.

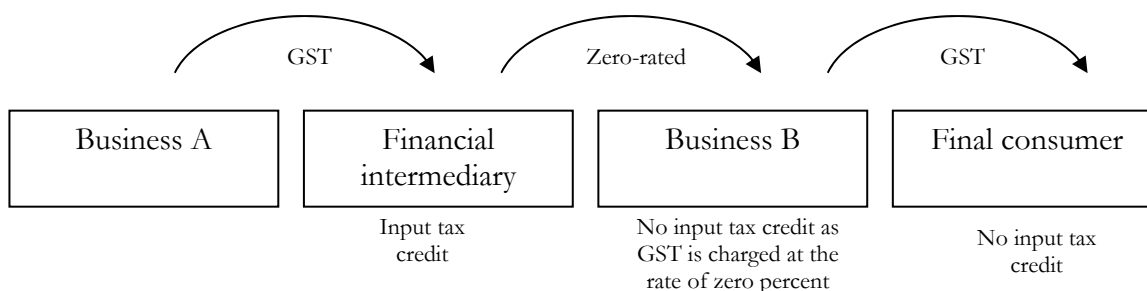
A recipient will be treated as having a predominant activity of making taxable supplies if the level of taxable supplies (not including supplies that are zero-rated as a result of the proposals in this document) represents 75 percent or more of the recipient's total supplies in a given twelve-month period. The application of this test will be able to be based on reasonable assumptions as to the nature of the business, rather than a consideration on a transaction-by-transaction basis.

Views are sought on whether it is feasible to develop a system to provide input tax credits to a supplier of financial services if the recipient of the service makes predominantly exempt supplies to registered persons that make predominantly taxable supplies. At this stage the proposal does not include a means by which the supplier in these circumstances could claim input tax credits.

General application

- 4.1 In March this year the government announced a proposal to zero-rate business-to-business supplies of financial services. This chapter examines the application of the proposal in more detail, including the circumstances in which zero-rating should and should not apply.
- 4.2 In general, the supply of a financial service (as defined in section 3 of the GST Act) made by a registered person to another registered person will be treated as a zero-rated supply. "Zero-rating" means that financial services will be taxed at the rate of zero-percent. This means that no tax is payable on the supply of financial services, but input tax credits will be allowed for GST paid on purchases used to make the supply. This is illustrated in figure 2.

Figure 2: How zero-rating will work



Being zero-rated the supply by the financial intermediary to Business B is a taxable supply and the financial intermediary will be able to claim an input tax credit on its purchases from Business A used to make that supply.

- 4.3 This proposal is designed to address concerns that New Zealand businesses are being overtaxed in relation to their consumption of financial services. Overtaxing financial services can create tax cascades in the economy, which may result in higher prices being charged for some goods and services.
- 4.4 As shown in figure 3, zero-rating business-to-business supplies of financial services achieves parity with other (non-financial) supplies, if the financial services are used for the purpose of making taxable supplies, other than supplies that are zero-rated as a result of the proposals in this document. The previously irrecoverable tax paid by the financial intermediary does not cascade and no longer results in the final consumer potentially paying a higher price for non-financial goods and services sold by registered persons.²²

Limitations to zero-rating

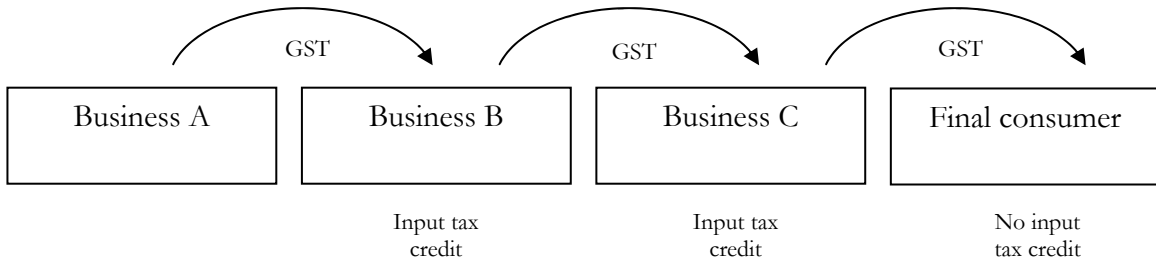
- 4.5 The main aim of the proposal is to retain exemption (and deny input tax credits) for supplies made by a financial intermediary to a non-registered person but to zero-rate (and thus allow input tax credits) for supplies made by a financial intermediary to a registered person.
- 4.6 The supply of financial services by a registered person will **not**, therefore, be able to be zero-rated if the recipient is not registered for GST.

²² This is subject to the relative incidence of GST and competition in the financial services market.

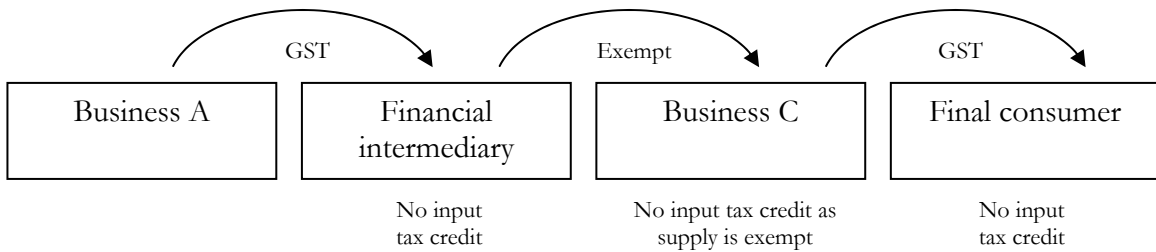
Figure 3: Comparison of the treatment of taxable supplies and exempt supplies under current and proposed legislation

Current treatment

1. Supply of taxable goods and services by Business B

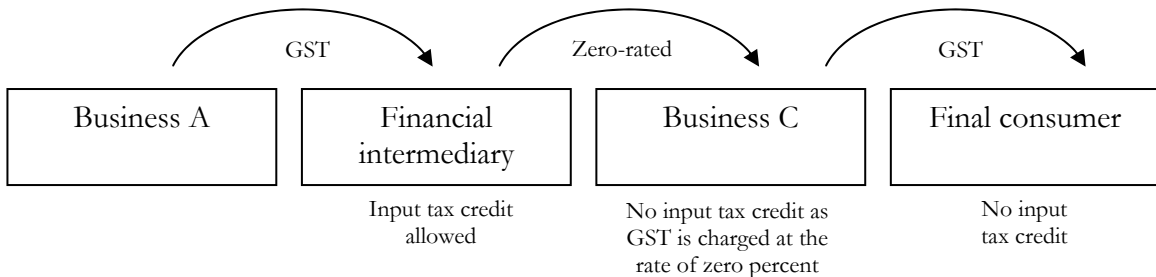


2. Supply of financial services by financial intermediary



Proposed treatment²³

3. Supply of financial services by financial intermediary

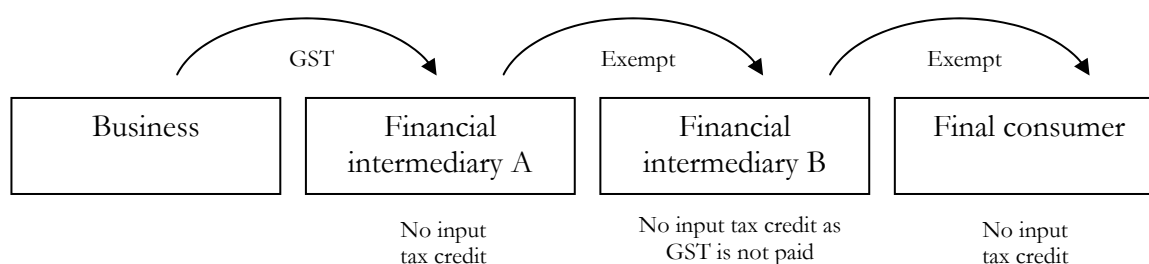


Under the proposal, the supply of financial services by the financial intermediary to Business C is equivalent to a supply of standard-rated goods and services.

4.7 A further limitation arises for supplies made by a financial intermediary to another financial intermediary or registered person making exempt supplies. If such supplies were also zero-rated, financial intermediaries could make GST-free supplies to final consumers by interposing another financial intermediary between themselves and the final consumer. This is illustrated in figure 4.

²³ A numerical example is included in Annex C.

Figure 4: Supply of financial services between financial intermediaries



The difference between this example and that in figure 2 is that the supply by financial intermediary A is not a taxable supply. Financial intermediary B does not, in this example, make standard-rated supplies and overtaxation does not therefore arise.

- 4.8 This concern would be met by not allowing zero-rating if the recipient (in the financial intermediary B in figure 4) makes exempt supplies. There are two problems with such a response. First, many registered persons provide ancillary exempt supplies (for example, consumer finance) but their main business is providing taxable supplies. Disallowing zero-rating in such cases would penalise such firms and reintroduce the problem of tax cascades. Allowing zero-rating in such cases would allow some supplies to be provided to final consumers free of any GST but not to a substantial extent.
- 4.9 A second problem is that disallowing zero-rating as described would reintroduce a cascading effect where a financial intermediary provides exempt supplies to a second financial intermediary that adds value and then makes further supplies to a registered person who makes taxable supplies.
- 4.10 It is necessary to find a practical approach to deal with both issues. The approach needs to balance compliance and administrative costs against the need to avoid tax cascades as far as possible and to ensure that opportunities are not created to make GST-free supplies to final consumers.

Supplies of financial services between financial intermediaries

- 4.11 The government has given consideration to ways that the zero-rating of financial services between financial intermediaries could be achieved without creating a tax advantage to final consumers. The information that the financial intermediary would need in order to determine whether financial services it supplies would be used by the immediate recipient for its taxable, exempt or non-business customers would impose high compliance costs that would seem to outweigh any efficiency gains.

- 4.12 One option would be to establish an industry average for input tax credits to compensate for any zero-rated financial supplies possibly made further down the chain. The government is concerned, however, that this would be inconsistent with the high level of measurement accuracy normally associated with GST and would, in any event, give rise to its own set of compliance cost problems.
- 4.13 The government is interested in receiving submissions on how these compliance cost and other concerns can be addressed.

Applying the zero-rating rules – a threshold for making taxable supplies

- 4.14 It is proposed that zero-rating will be allowed if the recipient is registered and does not have a more than incidental activity of making exempt supplies.
- 4.15 In the absence of a threshold-based test, it would be almost impossible for a financial intermediary to determine whether its customers make more than incidental supplies of exempt services to final consumers. Many registered persons make exempt supplies of some description. An appropriate threshold would allow for the receipt of zero-rated financial supplies by most registered persons except those that have as a significant part of their business an activity of making exempt supplies, such as the supply of financial services to final consumers.
- 4.16 Having regard to the trade-offs between compliance costs and the extent to which a business ought reasonably to be regarded as an entity that makes mainly taxable supplies, the government is proposing that this threshold be set at 75 percent of total supplies. Therefore businesses that supply standard-rated goods and services and/or zero-rated exports of goods and services, but also make supplies of exempt services and/or financial services zero-rated as a result of the proposed reforms, will be able to receive zero-rated financial services provided that the level of the former services represents 75 percent or more of their total supplies in a given twelve-month period. This period could be retrospective or prospective, depending on the nature and circumstances of the business.
- 4.17 The government accepts that a percentage threshold is necessarily a matter of judgement and that, as with all thresholds, opinions will vary as to where it is best set. On balance, the government has opted for a generous threshold, reflecting the importance it places on compliance cost reduction.

Identifying customers based on the threshold

- 4.18 When applying the threshold test a financial intermediary will need to know at a minimum the status of the customer and their ratio of taxable supplies to total supplies. Recognising the costs that would arise under a transaction-by-transaction approach the government prefers an approach that would allow financial intermediaries to categorise their customers and apply the categorisation for a set twelve-month period which is based on the nature of

the customer's business and reasonable assumptions as to the level of their taxable supplies.

- 4.19 Financial intermediaries that elect to categorise their customers will be required to review that categorisation at regular intervals which will be administratively determined.
- 4.20 The proposed threshold should not prevent financial intermediaries from applying the zero-rating tests on a transaction-by-transaction basis if they choose to do so.
- 4.21 It is expected that the determination of the taxable status of the recipient will be made by the financial institutions. The reason for this is that the difference between zero-rating and exemption can generally be described as the respective ability or inability of financial intermediaries to claim input tax credits. The deduction of input tax credits is a matter for the supplier of financial services to determine – not the recipient. As far as the recipient of a financial service is concerned, GST does not currently apply to the receipt of financial services, and this position will remain with zero-rating. Therefore it is expected that the recipient of a financial service should not have any direct involvement in this determination, although this should not preclude financial intermediaries from seeking information from customers as needed.²⁴
- 4.22 The government is interested in receiving submissions on what information financial intermediaries may require to determine the taxable status of their customers and whether these requirements should be included in legislation.
- 4.23 If the recipient cannot be identified or categorised as outlined zero-rating will not apply. This allows financial intermediaries to assess, in less straightforward situations, the trade-off between the benefits of zero-rating and the compliance costs associated with identifying the customer and determining the mix of taxable and exempt supplies made by their business customers.

Customers that make a mixture of taxable and exempt supplies from separate operations

- 4.24 It has been assumed that a business customer of a financial intermediary represents a single company or other entity which may carry on a range of taxable and exempt operations. The 75 percent test ensures that the customer is treated as either taxable (and entitled to receive zero-rated supplies) or exempt (and not entitled to receive zero-rated supplies).

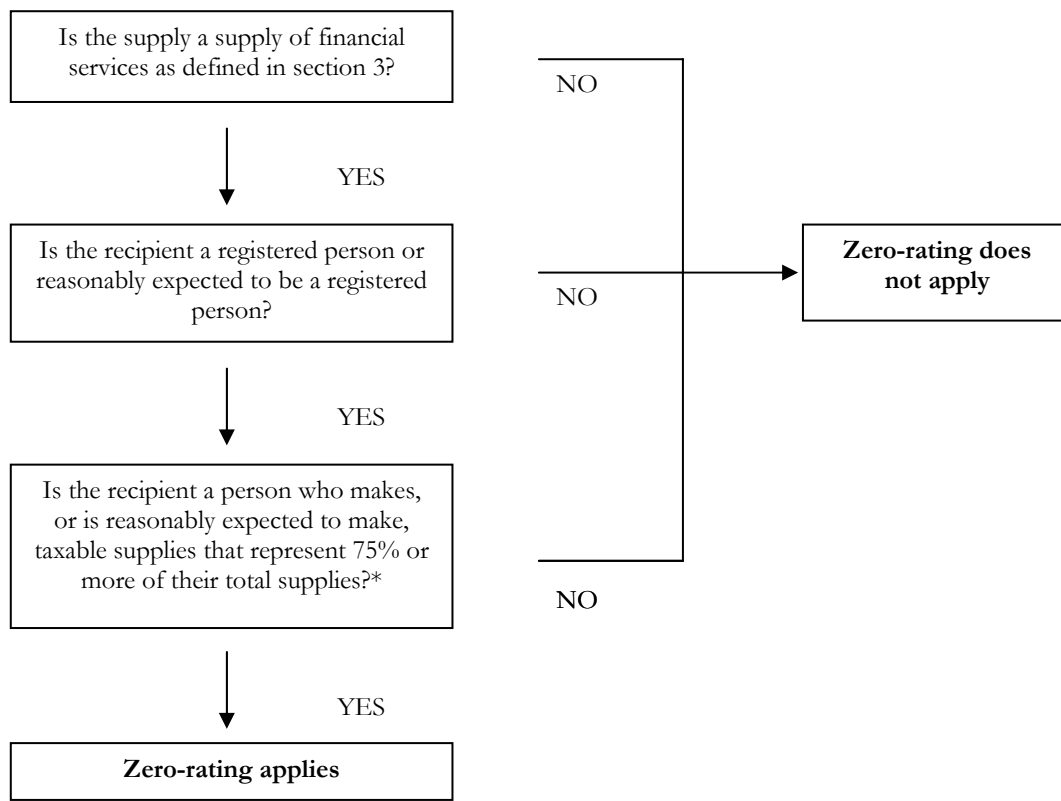
²⁴ It is recognised that allowing input tax credits for zero-rated supplies is likely to reduce the cost faced by financial intermediaries in supplying financial services. The extent to which these cost savings are passed on to customers is a matter for each financial intermediary to determine.

- 4.25 In practice, however, the customer bases of a financial intermediary may include one or more branches of an entity or a consolidated group of two or more entities. In either case, if the 75 percent threshold were applied, a different result would occur, depending on whether the different activities were aggregated or treated as separate.
- 4.26 This difference may result in an incentive for businesses to treat their taxable and exempt operations as separate if they do not already do so, to ensure that the taxable operations are able to receive zero-rates supplies. This would, in principle, achieve the intended result of removing the tax cascades when financial services are supplied to those making standard-rated supplies.
- 4.27 To allow a business categorisation approach to zero-rating, it may be necessary for the legislation to refer to the financial intermediary's customer base. This raises the issue of whether and, if so, how, the term "customer" should be defined. Submissions are sought on this point.

Zero-rating – an illustration

- 4.28 Figure 5 illustrates the questions that should be considered when determining whether a supply of financial services should be zero-rated. It is not a definitive view of how the proposal should work but is included for the purposes of discussion.

Figure 5: Applying the proposed zero-rating of domestic business-to-business supplies of financial services



* When considering the application of the 75 percent threshold there will need to be administrative rules to determine when registered persons need to closely examine certain customers to assess whether or not they are appropriately categorised as businesses that are entitled to receive zero-rated financial supplies. The main determinant should be the nature of the customer's business. Thus:

- A customer that is a financial intermediary or a supplier of residential accommodation would not generally be categorised as entitled to receive zero-rated supplies as it is reasonable to expect that the volume of exempt supplies and zero-rated financial services would exceed 25 percent of its total turnover.
- Most manufacturers, primary producers and retailers, on the other hand, would be expected to be entitled to receive zero-rated supplies.
- Businesses that make a mixture of taxable and exempt supplies such as general and life insurers will need to be categorised on a case-by-case basis.

Chapter 5

OTHER MATTERS RELATING TO ZERO-RATING BUSINESS-TO-BUSINESS SUPPLIES

This chapter discusses other matters relating to the zero-rating of business-to-business supplies of financial services, including:

- the deduction of input tax – outlining possible adjustment mechanisms;
- base maintenance issues – a reduction in input tax credit recovery for supplies that are in substance made to final consumers;
- transitional issues; and
- information requirements.

5.1 The purpose of this chapter is to outline proposals for changes to the rest of the GST Act to cater for the zero-rating of business-to-business supplies of financial services. The effects of the zero-rating reforms on the definition of “financial services” and the grouping provisions are discussed in later chapters, which also contain proposals to ensure that the legislation is achieving its policy intent.

Deduction of input tax

5.2 Registered persons are generally able to claim an input tax credit for the GST paid on their purchases provided they can establish that the purchased goods and services have been acquired for the principal purpose of making taxable supplies. Although financial intermediaries make a mixture of taxable and exempt supplies, the fact that they are predominantly exempt suppliers means that they are generally unable to claim input tax credits at the time goods and services are acquired. This makes financial intermediaries dependent on the change-in-use provisions to recover some of the GST paid (sections 21E to 21H).

5.3 Under the current legislation, financial intermediaries may face significant compliance costs in determining an allowable level of input tax credit entitlement and the value of adjustments required under the change-in-use provisions. This is unlikely to change as a result of the proposed reforms.

5.4 It is expected that claims for input tax credits will continue to vary among financial intermediaries, depending on their internal accounting systems and ability to allocate input tax credits between taxable and exempt supplies.

5.5 Section 21A sets out the methods of allocating input tax credits to making taxable and other (including exempt) supplies.

- **Actual use:** This method of allocation requires the taxpayer to directly attribute the use of the goods and services to the extent that those goods and services are used for a purpose of making taxable supplies.
- **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.

5.6 In all cases, section 21A requires that the method of allocation used must result in a fair and reasonable allocation of input tax credits between taxable and other supplies. It is expected in cases where financial intermediaries are able to identify when zero-rating applies on a transaction-by-transaction basis that they will also be able to match the deduction of input tax credits to those zero-rated supplies.

The input tax recovery ratio and end-of-year adjustments

Input tax recovery ratio

5.7 In some instances it may be difficult to match purchases to particular taxable supplies owing to the nature of expenditure such as overhead items, which can be attributed to a number of activities. To assist in the allocation of overhead purchases between taxable and exempt supplies, financial intermediaries may adopt either the turnover method or a special method of allocating input tax credits.

5.8 The turnover method uses supplies in calculating the numerator and the denominator. This means of calculating the level of adjustment includes the so-called “value added” created by the taxpayer by the payment of salary and wages. Thus an activity that involves a minimum of purchases that are subject to GST but requires a high labour content may skew the rate of input tax recovery. The reverse situation can equally apply so that the rate of recovery of input tax is insufficient.

- 5.9 The use of the turnover method may not, therefore, always be appropriate. Instead, a new method of calculation may need to be developed, as agreed between Inland Revenue and the taxpayer. Further, the use of a “business categorisation” approach to implement the proposals in this document requires a review of how input tax credits are in practice apportioned.
- 5.10 The formulae illustrate two different approaches that could be considered when apportioning input tax credits. The first is based on a turnover methodology but uses the ratio of net income from taxable supplies to net income from total supplies. The second formula approaches the question of input tax apportionment from the position of cost allocation between taxable activities and total activities.
- 5.11 The calculation of input tax credits from activities involving non-residents and interest will also be a matter for the taxpayer to discuss with Inland Revenue. Once agreement is reached, the input tax recovery ratio may be used on a day-to-day basis. This will be familiar to some financial intermediaries that currently have agreed a similar mechanism with Inland Revenue.
- 5.12 It is proposed that financial intermediaries will also be able to rely on the input tax recovery ratio for an agreed period before a new calculation will be required. Both the initial and subsequent periods will need to be agreed with Inland Revenue.
- 5.13 Figure 6 illustrates the way in which input tax credits may be claimed. This illustration should not be taken as a determinative view but is included for the purposes of discussion.

Notes to formulae

- The formulae are included for the purposes of discussion. They are not definitive, and it is expected that some variation may be required.
- The information required to apply the formulae should be able to be sourced from financial statements. Determining the margins from foreign exchange and derivative transactions to businesses and non-residents will, however, 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.
- The reference to “business” means those registered persons that qualify to receive zero-rated supplies – that is, the business does not have more than an incidental activity of making exempt supplies (less than 25 percent of total turnover in a given twelve-month period).

1. The input tax recovery ratio based on supplies

$$\frac{\text{Net income from taxable supplies}}{\text{Net income from total supplies}} = \text{Input tax recovery ratio}$$

Net income from taxable supplies

Net income from total supplies

Domestic services

Net interest from businesses
Foreign exchange and derivatives margins from businesses
Net fees and commissions from businesses
Other net/margin revenue from businesses
Standard-rated net fees and commissions

Exported services

Foreign exchange and derivatives margins from non-residents
Net interest from non-residents
Net fees and commissions from non-residents
Other net/margin income from non-residents

Foreign exchange and derivatives margins
Net interest
Net fees and commissions
Other net/margin income

2. The input tax recovery ratio based on cost allocation

$$\frac{A + B}{C} = \text{Input tax recovery ratio}$$

Where:

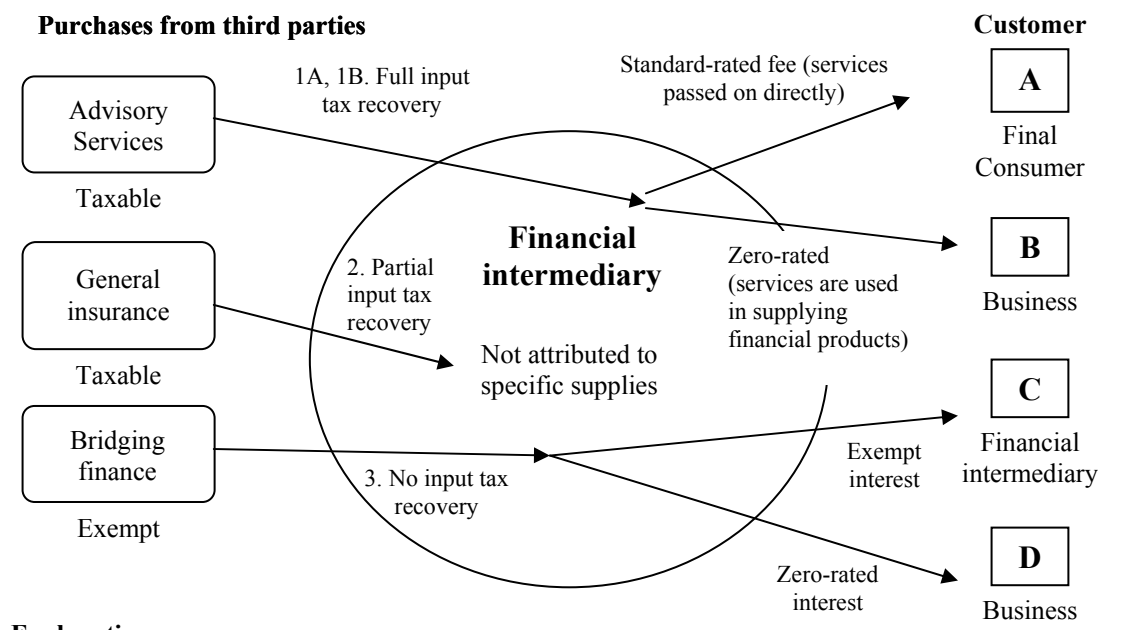
A = Costs attributable to exported services

B = Costs attributable to zero-rated supplies to businesses and standard-rated supplies

C = Total costs

For the purpose of this formula the term “cost” is defined as purchases that have been subject to GST (that is, excluding salary and wages, depreciation, interest and profit margins).

Figure 6: Applying the input tax recovery ratio



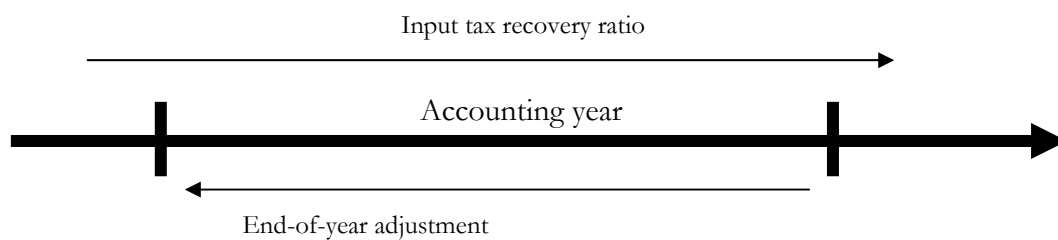
Explanation

- 1A. The advisory services are purchased and supplied directly to a final consumer for a standard-rated fee. As the services were acquired for the principal purpose of making taxable supplies, an input tax credit can be claimed for the GST paid.
- 1B. The advisory services provided to the business are not directly on-supplied but the cost of the purchase is recovered through the zero-rated financial product. As the services were acquired for the principal purpose of making taxable supplies (including zero-rated supplies) an input tax credit can be claimed for the GST paid.
- 2. General insurance is taken out for the operations of the financial intermediary. As it cannot be attributed to any specific supply, a partial rate of input tax recovery is allowed as agreed between the financial intermediary and Inland Revenue.
- 3. As the purchase is an exempt supply, no GST is charged and, therefore, no input tax credit is allowed, irrespective of zero-rating.

End-of-year adjustments

- 5.14 To ensure that the input tax recovery ratio used by financial intermediaries for overhead expenditures is a reasonable reflection of the mix of the taxable and exempt supplies made during an accounting year, an adjustment will need to be calculated at the end of the financial intermediary’s accounting year.
- 5.15 Unlike the input tax recovery ratio, which is forward-looking, the end-of-year adjustment will look back at the supplies actually made by the financial intermediary during the period covered at the close of each accounting year, as illustrated in figure 7.

Figure 7: Application of the input tax recovery ratio and end-of-year adjustment



5.16 Differences in the two figures will result in either further output tax (reflecting the over-deduction of input tax during the accounting year) or further input tax (reflecting the amount of input tax that should have been deducted during the accounting year). The end-of-year adjustment will be required to be calculated and returned to Inland Revenue in the second month of the new accounting year.

Base maintenance

5.17 As with the proposal to zero-rate business-to-business supplies of financial services, it is important to prevent the tax base from being eroded by exploitation of the boundary between zero-rated and exempt supplies. Therefore the government is concerned not to increase the recovery of input tax by financial intermediaries by effectively allowing final consumers to access zero-rated financial services.

5.18 An anti-avoidance provision will be necessary to prevent arrangements that would treat a supply of financial services that, in substance, is received by an unregistered person as being received by a registered person. In this situation it is proposed to allow the Commissioner to cancel in respect of any supply the amount of input tax to which the financial intermediary would otherwise be entitled.

5.19 A related issue is the situation where a business might acquire zero-rated financial services for the purpose of benefiting an employee, shareholder or director. The government considers that this is a particular risk in the case of sole proprietors and other business structures where individuals, in their private capacity, are closely related to the trading activity of the business. A specific anti-avoidance provision is, however, seen as unnecessary in this instance as the change-in-use provisions should apply to any application of the financial service to an individual and would require the business to begin apportioning input tax credits.²⁵

²⁵ Refer sections 21 to 21C.

Transitional arrangements

5.20 As zero-rating mainly concerns the recovery of input tax credits by financial intermediaries, it is not expected that the transitional impact for customers will be significant.

5.21 In relation to financial intermediaries, the main issue to be addressed is the timing and availability of input tax credits in respect of certain supplies:

- ***Supplies that span the application date:*** The new rate of input tax recovery will apply to supplies that span the application date of these proposals according to the following rules:
 - Goods will be treated as being supplied when delivered or available for delivery or removal by the customer.
 - Services will generally be treated as being supplied when they are performed.

The transitional provisions will, therefore, be broadly similar to those that applied at the time GST came into effect, on 1 October 1986.

- ***Goods held at application date:*** The timing of input tax credits for goods, such as office equipment and consumable items, held at application date will continue to be determined by way of the change-in-use provisions as follows:
 - Input tax credits claimed under the change-in-use provisions for consumable items will be calculated at the time that they are acquired. For example, no adjustment will be allowed in respect of the input tax credit claimed for goods, such as stationery, purchased before the application date to reflect any increase in taxable supplies after that date.
 - Input tax credits claimed under the change-in-use provisions for fixed assets under a period-by-period basis or annual basis will be allowed to reflect any increase in taxable supplies in and from the first period, or year, in which the change-in-use adjustment is made after the application date.
 - One-off change-in-use deductions to take account of any increase in taxable supplies resulting from these reforms will not be allowed.

Information requirements – tax invoices

5.22 Section 24 requires a tax invoice to be issued by a registered person when making a taxable supply to another registered person. For the purposes of zero-rated business-to-business supplies of financial services, such a requirement is unnecessary. Tax invoices play a key role in establishing the deduction of input tax. When zero-rating applies to supplies between registered persons it is not necessary to consider the deduction of input tax by the recipient. For this reason it is proposed that financial intermediaries will

not be required to comply fully with section 24 in respect of zero-rated supplies. Inland Revenue will provide administrative guidelines under section 24(6) on the type of information that will need to be provided.

Chapter 6

THE SCOPE OF THE DEFINITION OF “FINANCIAL SERVICES”

This chapter outlines potential areas for reform to the scope of the definition of “financial services”, with particular emphasis on:

- services provided by third parties;
- management fees for long-term investment vehicles;
- services relating to underlying taxable supplies;
- the distinction between arranging and advising; and
- using a generic definition.

It recommends that:

- The definition of “financial services” be narrowed so that services provided by third parties (such as brokerage) are subject to GST. Having regard to the potential scope of this change, it will be implemented only after full consultation has been undertaken.
- The definition of “participatory security” be amended so that services relating to underlying taxable supplies are not included.

In considering the treatment of management fees for long-term investment vehicles, the chapter does not make a recommendation as to whether such services should be treated as taxable services or as financial services, but invites comment on the policy justifications and relative costs and benefits of each option.

- 6.1 Although it is proposed that the scope of the exemption for financial services will be reduced by zero-rating business-to-business supplies, the definition of “financial services” will continue to apply to the boundary between standard-rated and zero-rated supplies for business-to-business transactions. It will also continue to apply to the boundary between taxable and exempt supplies for other than business-to-business supplies.
- 6.2 This chapter discusses some of the remaining difficulties with the application of the definition and how they might be resolved.

Background

- 6.3 The scope of the definition of “financial services” was originally set out in the 1985 discussion paper *Proposed application of GST to financial services*.²⁶ This document outlined the government’s reasons for treating financial services as exempt supplies and detailed the expected application of the definition.
- 6.4 It was envisaged that the exemption would apply to five broad categories of financial services. These were:
- dealings with money;
 - dealings with securities;
 - granting credit and making loans;
 - brokerage and/or intermediary services relating to the above; and
 - the provision of life insurance.
- 6.5 The government considers that these broad categories remain appropriate, but that the policy developed in 1985 has led to a number of inconsistencies in respect of the treatment of third parties and the treatment of certain substitutable supplies provided by the financial services industry. The reforms proposed in this chapter are designed to clarify and narrow the scope of the definition, particularly in respect of brokerage and intermediary services provided by third parties.

Areas for reform

Third party activities

- 6.6 The current definition of “financial services” does not, in the main, draw a distinction between “non-core” financial services (such as arranging the issue of securities) that are supplied by an entity in relation to supplies of “core” financial services (such as the issuing of securities) that the entity makes, and supplies of the same non-core services by third parties. For example, arranging the provision of credit under a credit contract is included in the definition, regardless of whether the entity which provides the credit or a third party supplies the arranging services.²⁷
- 6.7 The lack of a distinction was an attempt to reduce the bias that financial service providers would have to self-supply non-core financial services if such services were treated as taxable when provided by third parties.

²⁶ Ibid footnote 8.

²⁷ The provision of credit under a credit contract is included by section 3(1)(f), arranging the provision by section 3(1)(l).

- 6.8 When non-core financial services are self-supplied by the supplier of the core financial services, they may either be charged an explicit fee, or an implicit fee may be included in the margin on the supply of the core financial service. A third party which does not provide the core financial service cannot bundle the charge for other services with any margin-based charge for the core financial service. The ability to substitute services and the accompanying valuation difficulties which underpin the exemption of financial services do not occur, therefore, when third parties supply non-core financial services.
- 6.9 In certain circumstances services provided by third parties are already excluded from the definition of financial services when they would be within the definition if provided by a supplier of financial services. For example, debt collection services, which may be included in the definition under section 3(1)(ka) when carried out by the entity to which the debt is owing, are specifically excluded from the definition when provided by a third party.²⁸ More generally, the Australian GST legislation draws a distinction between services provided by principals, which are included in the definition of financial services, and services provided by agents, which are not.
- 6.10 The proposals in this discussion document relating to zero-rating business-to-business supplies of financial services are primarily aimed at reducing the tax cascades that arise from the exemption of financial services. These proposals will, in turn, reduce the self-supply bias. Narrowing the definition of “financial services” as far as practicable would be consistent with these reforms. It would also be consistent with the fact that a primary driver for exemption is the concern with substitutability and valuation. Self-supply does not, of itself, create a justification for exemption, as there will always be distortions wherever GST sets a boundary.
- 6.11 The government therefore proposes to remove non-core financial services provided by third parties from the scope of the financial services definition. When a person other than the person supplying the core financial service has an involvement in the supply of that financial service, in the form of arranging, facilitating, or executing the service, that service will be excluded from the definition of “financial services”.
- 6.12 The activities of brokers and other intermediaries, except underwriters and sub-underwriters,²⁹ will be affected by the proposal. As it is uncertain what the impact of the proposal will be for these businesses, the government does not propose that it be introduced until full consultation has been undertaken. It is proposed that any credit management by a third party, such as checking creditworthiness, making decisions about whether to offer credit, monitoring creditor payments or managing overdue payments, will be outside the scope of the definition and will, therefore, be subject to tax. Services relating to the provision of advice are already subject to GST.

²⁸ Section 3(4)(b), as inserted by the Taxation (GST and Miscellaneous Provisions) Act 2000.

²⁹ Section 3(1)(e).

- 6.13 In the case of corporate finance, brokerage activities will be included in the definition of “financial service” if the activities relate to the entity’s own securities. This is provided that the intermediation between buyers/investors and sellers/issuers is coordinated and concluded by the same party to which the securities relate.
- 6.14 Some third party services, however, may remain exempt when treating them as taxable would create competitive distortions between different types of financial services. For example, management services provided by third parties to long-term investment vehicles, such as superannuation schemes, might remain within the definition of “financial services”. This is discussed further below.

Management services

- 6.15 Management services are generally excluded from the definition of financial services, as they are discrete services that can be valued and they are not inherently financial services. They are also often provided by third party suppliers. The management of a superannuation scheme is, however, included in the definition by section 3(1)(j). This is an attempt to prevent any distortion between the treatment of superannuation schemes and the treatment of life insurance, which does not usually involve a separate management charge. Generally, both are long-term investment vehicles with a substantial savings component.
- 6.16 The treatment of management services for other investment vehicles, such as unit trusts and group investment funds, which are not currently included in the definition, is more problematic.
- 6.17 Management services for these investment vehicles could be included in the financial services definition, whether supplied by the provider of the investment vehicle or by a third party. This would ensure there are no distortions between the treatments of different long-term investment vehicles.
- 6.18 On the other hand, the government considers that there are good arguments for treating management fees for unit trusts and group investment funds as taxable. This is on the basis that, as with other third party supplies, these fees are not inherently for financial services and do not suffer significantly from valuation difficulties.
- 6.19 Both possible treatments of management services involve distortions. The government is interested in submissions on which approach is more sound and the relative magnitude of the distortions involved.
- 6.20 If such management services were included in the financial services definition, the scope of section 3(1)(l) (agreeing or arranging financial services) would need to be narrowed so that these services are excluded from the provision of management services for long-term investment vehicles. Agreeing to do or arranging the management of an investment vehicle is a step removed from the actual management of a long-term investment vehicle and should, therefore, be treated as taxable.

Services relating to underlying taxable supplies

- 6.21 The definition of financial services excludes the supply of certain services which would otherwise be exempt when they involve the supply of taxable goods or services. For example, the definitions of “debt”, “equity” and “participatory securities” exclude an interest or estate in land or shares in the share capital of flat-owning or office-owning companies.³⁰ Deliverable futures contracts are not included in the definition if they provide for the delivery of a taxable commodity.³¹
- 6.22 These exclusions attempt to better define the financial services boundary and to ensure that taxable supplies cannot be recharacterised as exempt supplies with a consequent tax advantage. Some investment vehicles, particularly participatory securities, continue to involve the recharacterisation of otherwise taxable supplies of goods and services as exempt supplies. Of particular concern are situations where ownership of an otherwise “taxable” asset is, in substance, transferred without participation in the investment vehicle’s capital or assets.
- 6.23 The term “security” is generally defined as an interest in the property of another person. The High Court in *R v Smith*³² made the observation that the term “security” implied more than just a contractual right to delivery and involved some element of participation in the capital, assets, earnings, royalties or other property of a person. It is such situations that the inclusion of the supply of a participatory security in the definition was meant to encompass, not the bare transfer of ownership of an asset.
- 6.24 It is therefore proposed that the definition of “participatory security” be amended to reflect a boundary between participation in property and the transfer of ownership.

Other issues

Arranging and advising

- 6.25 The distinction in section 3(1)(l) between agreeing to and arranging the supply of a financial service (which is exempt), and advising on the supply of a financial service (which is taxable), is problematic for many taxpayers. They often find the distinction a difficult one to make and may, as a result, incur significant compliance costs. However, the distinction does delineate an important difference between services which are closely related to the supply of the financial services by the financial institution and, therefore, properly included in the definition, and services which are a step removed from the actual supply of the financial services and properly taxable.

³⁰ Section 3(3)(b) and (c) respectively.

³¹ Section 3(1)(k).

³² (1991) 5 NZCLC 67,120.

- 6.26 Therefore it is not proposed to remove this distinction, at least as it relates to arranging services provided by the supplier of the financial services to which the arranging services relate.
- 6.27 It is expected that the removal of third party suppliers from the definition of “financial services” will limit the extent to which this distinction is a problem in practice. The legislation will be easier for brokers and other affected parties to apply. Taxpayers who have an incidental involvement with financial services, such as lawyers involved in conveyancing, will also be able to treat all of their activities as taxable.
- 6.28 As noted earlier, however, the scope of section 3(1)(l) may be narrowed so that the agreeing to do, and the arranging of, the management of long-term investment vehicles is not included in the definition.

A generic definition

- 6.29 Consideration has been given as to whether the current prescriptive definition in section 3 could be either replaced or supplemented by a more purposive, generic definition. A generic definition, instead of listing specific services within its scope as section 3(1) does at present, could describe the fundamental characteristics of a financial service.
- 6.30 A generic definition would have the advantage of being flexible enough to cater for innovations in the financial services sector, which constantly create new types of services. The current prescriptive definition runs the risk of becoming outdated and subjecting services to GST which should not be subject to GST, as has occurred in the past in relation to certain derivative products.
- 6.31 The government does not, however, consider it appropriate to replace the current prescriptive definition with a generic definition. This could create uncertainty and increase compliance costs by unnecessarily disturbing the existing treatment of financial services. A generic definition could, however, supplement the prescriptive definition, providing guidance for the treatment of new products, such as new derivatives.
- 6.32 The generic definition could be in the nature of a purpose provision, particularly for products not covered by the prescriptive definition. Such a definition would require careful consideration of the inherent characteristics of financial instruments, ensuring that supplies of services that are properly taxed are not inappropriately included within the scope of the financial services definition.
- 6.33 Some of these characteristics could be drawn from accounting practices which define financial assets.
- 6.34 The government is interested in receiving submissions on this issue.

Chapter 7

POLICY OBJECTIVES OF THE GROUPING RULES

This chapter describes the GST grouping rules in section 55 of the GST Act and the policy role the government intends them to fulfil.

- 7.1 Many taxpayers are structured as groups of companies. For GST purposes they are able to take advantage of group registration to reduce any possible distortions between a single entity, a branch structure and a group structure and reduce compliance costs by treating the group as a single entity. For most taxpayers the grouping rules operate well and achieve this compliance cost reduction aim. However, for groups that make a mix of taxable and exempt supplies, such as financial institutions, the application of the rules is far more complex.

Role of the grouping rules

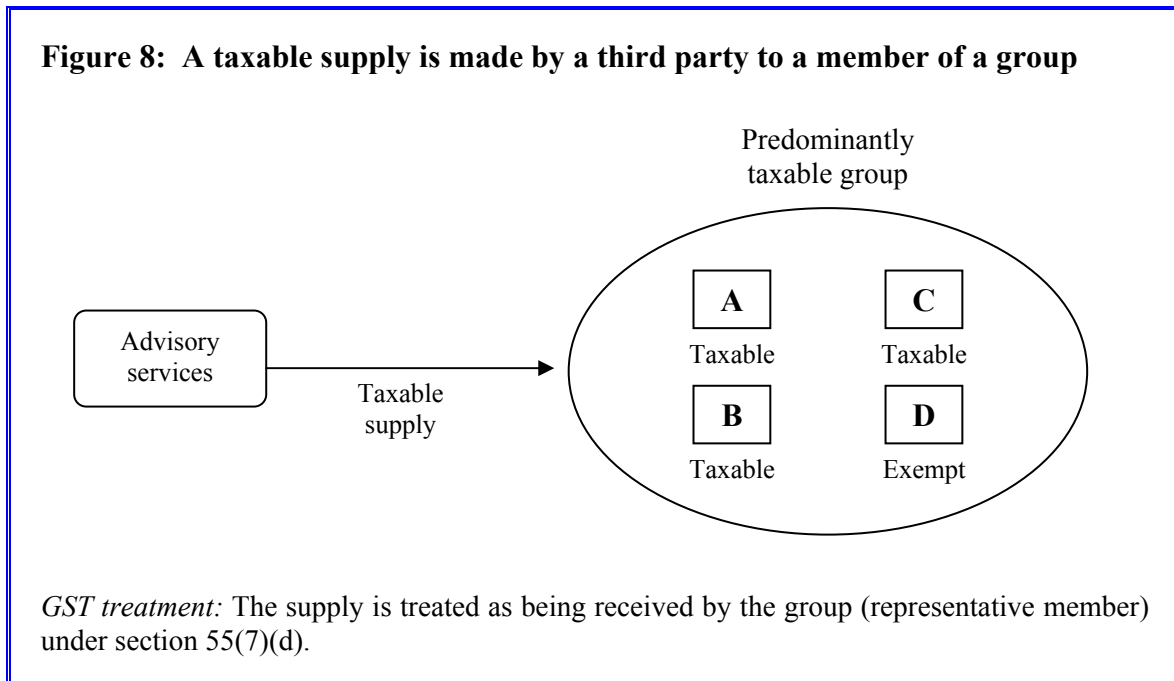
Original policy intent – 1986 to 1989

- 7.2 Section 55 was intended to ensure that there was no distortion between the GST treatments of a single entity, a branch structure and a group structure. The grouping provision allows groups of companies to reduce compliance and administrative costs by requiring that only one GST return be filed. It was broadly modelled on the equivalent United Kingdom VAT provision.³³
- 7.3 The section was intended to reflect a “single entity” approach for groups of companies accounting for GST – the group was to be treated as if it were one company for GST purposes. This ensured that intra-group supplies sourced completely from the group’s resources were not subject to GST, in the same way that the “self-supply” of those services within a single company or between branches would not be subject to GST.
- 7.4 Once a group of companies is registered as a group for the purposes of section 55, one member of the group is nominated as the “representative member”. The supplies made by the members of the group are, in effect, aggregated and attributed to the representative member.
- 7.5 This is achieved through section 55(7) providing as follows:
- **Section 55(7)(a)** treating all taxable activities of all members as being carried on by the representative member, and not by any other member of the group.

³³ Section 43 of the Value Added Tax Act 1983.

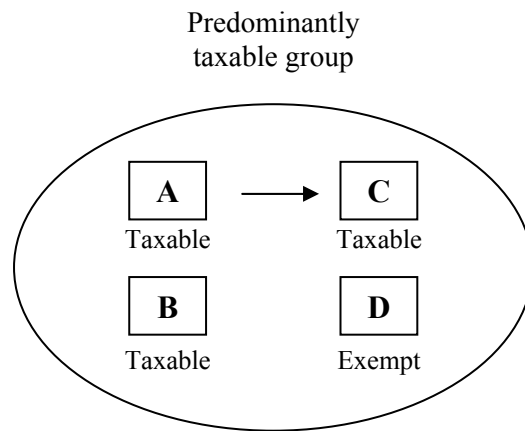
- **Section 55(7)(c)** allowing taxable supplies between members of a group to be disregarded to the extent that the recipient of the supply would have been entitled to deduct input tax in respect of that supply, had it not been a member of the group.
- **Section 55(7)(d)** treating all taxable supplies made by a member of the group, or to a member of the group, as being made by the representative member or to the representative member respectively.
- **Section 55(7)(da)** treating all other supplies made by a member of the group as being made by the representative member.

7.6 Figures 8 to 10 illustrate the intended operation of the grouping rules. Note that the terms “taxable member” and “exempt member” refer to companies which make predominantly taxable and predominantly exempt supplies, respectively. The group in the examples is predominantly “taxable”, based on supplies made by the group (turnover).



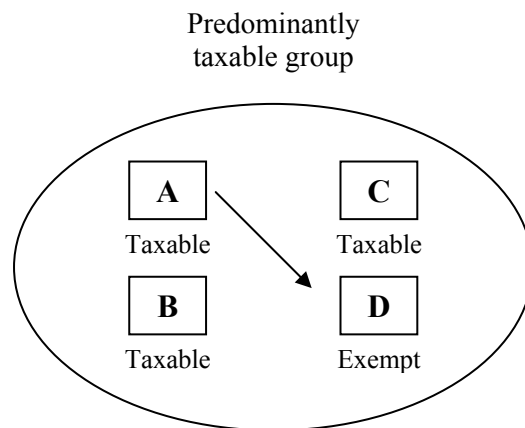
7.7 The availability of input tax credits in relation to this supply depends on how the services are used. The requirement that the supply be acquired for the principal purpose of making taxable supplies still applies to determine whether input tax credits are available. If the supply is used principally to make intra-group taxable supplies which are not disregarded, or are to make taxable supplies to persons outside the group, an input tax credit would be available. Intra-group taxable supplies that are disregarded cannot be said to have been acquired for the principal purpose of making taxable supplies, as the supplies are disregarded. Therefore input tax credits would not be available.

Figure 9: A taxable member of the group makes a taxable supply to another taxable member of the group



GST treatment: GST may or may not be charged, at the election of the group. The supply may be disregarded under section 55(7)(c), as it is a taxable supply between two taxable members of a group.

Figure 10: A taxable member of the group makes a taxable supply of services to an exempt member of the group

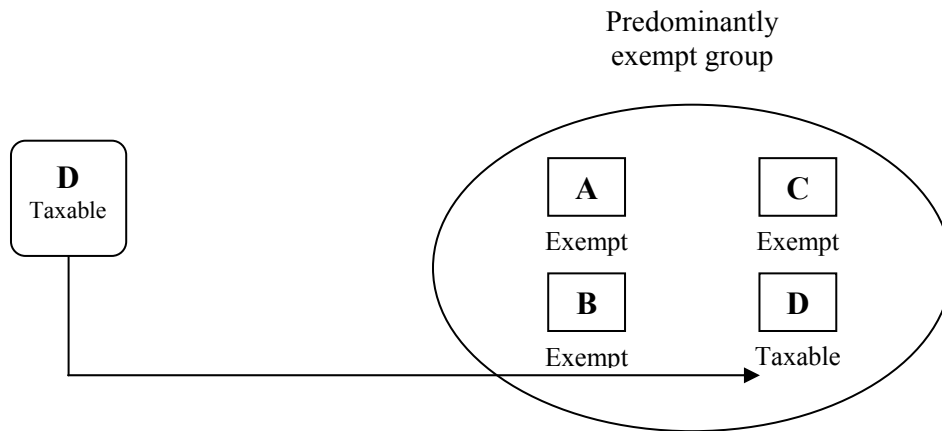


GST treatment: GST must be charged on the supply, as it is a taxable supply to an exempt member of a group and cannot be disregarded under section 55(7)(c). If the recipient member of the group was only partially exempt, the supply could be disregarded to the extent that an input tax credit would be available to the member.

1989 amendments – section 55(7)(c), (db) and (dc)

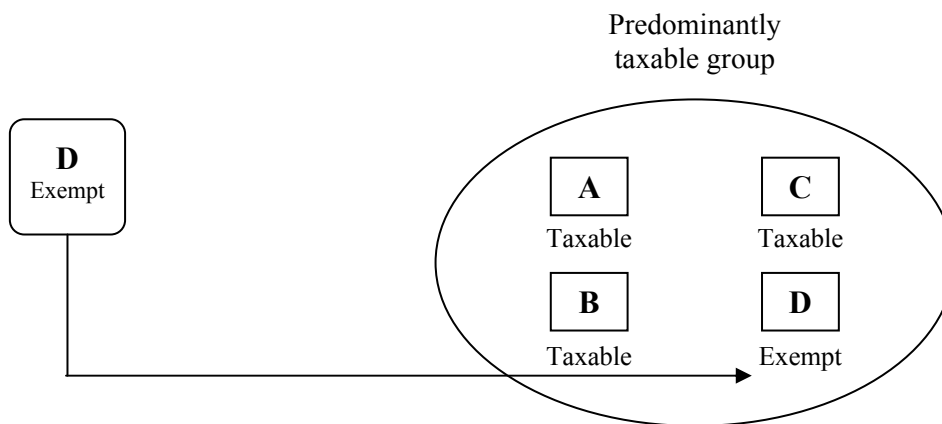
- 7.8 In the late 1980s structural reforms to certain sectors of the financial services industry were undertaken. As a result, some entities which had in-sourced certain taxable supplies re-formed in a group structure using a subsidiary to provide the taxable services to all other members of the group.
- 7.9 Under the legislation as it stood, the taxable supply of those services would not have been disregarded for grouping purposes. Section 55(7)(c) would have applied to prevent the supply from being disregarded to the extent that input tax credits would not have been available to the recipient of the supply. This meant that entities which had in-sourced the supplies with little or no GST impost would be subject to GST on intra-group supplies which were unable to be disregarded.
- 7.10 The government of the day decided to amend the grouping rules to reduce the GST cost to those companies in the financial services sector adopting a group structure.
- 7.11 This was achieved through the following amendments to section 55(7):
- **Section 55(7)(c)** was amended to allow taxable supplies between members of a group to be disregarded, subject to sections 55(7)(db) and (dc).
 - **Section 55(7)(db)** was inserted to treat a change in use as having occurred when a member of a group (not being a member of the GST group) acquires a supply for taxable purposes, joins the GST group, and then any other member of the group (deemed to be the representative member) uses the supply for other than taxable purposes. This was intended to ensure that an output tax adjustment under the then section 21(1) would be required so that GST would, in effect, be paid on the supply of those goods or services between group members, in the same way as would occur if a single entity made a change in use.
 - **Section 55(7)(dc)** was inserted to treat a change in use as having occurred when a member of a group (not being a member of the GST group) acquires a supply for non-taxable purposes, joins the GST group, and then any other member of the group (treated as being the representative member) uses the supply for taxable purposes. This was intended to ensure that an input tax adjustment under the then section 21(5) would be allowed, in the same way as would occur if a single entity made a change in use.
- 7.12 Figures 11 to 13 illustrate the intended operation of the grouping rules after the 1989 amendments. As discussed later, clarification is needed in some areas.

Figure 11: Taxable company joins predominantly exempt group – treatment of pre-existing assets of the taxable company



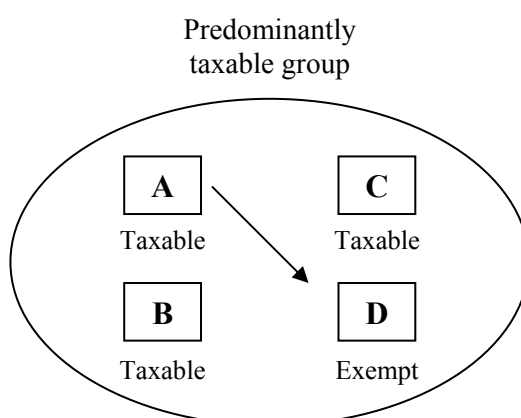
GST treatment: On joining the exempt group, the taxable company has pre-existing assets for which it has claimed input tax credits. If the group uses those assets to make exempt supplies, the representative member must make an output tax adjustment for the change in use.

Figure 12: Exempt company joins predominantly taxable group – treatment of pre-existing assets of the exempt company



GST treatment: On joining the taxable group, the exempt company has pre-existing assets for which it was unable to claim input tax credits. If the group uses those assets to make taxable supplies, the representative member is entitled to make an input tax adjustment for the change in use.

Figure 13: A taxable member of the group makes a taxable supply of services to an exempt member of the group



GST treatment: GST may or may not be charged, at the election of the group. The supply may be disregarded under section 55(7)(c), as it is a taxable supply between two members of a group. As the exempt member uses those services to make exempt supplies, the representative member may be required to make an output tax adjustment for the change in use.

Proposed role of the grouping rules

- 7.13 The GST grouping rules continue to play an important role in alleviating potential distortions between the treatment of single entities (companies), branch structures and group structures, and reducing the compliance costs of accounting for GST for groups of companies. The rules should continue to ensure that intra-group supplies sourced completely from a group's resources are not subject to GST, in the same way that the "self-supply" of those services within a single company or between branches would not be subject to GST. The rules should not, however, result in any advantages for groups of companies over other entity structures.
- 7.14 The government does not propose to make any substantive changes to the GST grouping rules.
- 7.15 In certain areas, however, there is uncertainty as to whether the intended operation of the grouping rules is clearly expressed in section 55. The next chapter proposes amendments to ensure that the intended policy of the grouping rules is clearly set out in section 55.

Chapter 8

PROPOSED AMENDMENTS TO THE GROUPING RULES

This chapter proposes amendments to clarify the application of the grouping rules as expressed in section 55, by:

- clarifying when input tax credits are available for supplies used in turn to make disregarded intra-group supplies;
- clarifying the situations in which adjustments will be required; and
- requiring that adjustments for assets held by companies which join a group be made at market value.

It also discusses the relationship between the grouping rules and the proposed reverse charge on imported services, and proposes that cross-border intra-group charges, other than salaries and interest, be subject to the reverse charge.

- 8.1 This chapter identifies areas where the grouping rules are not in line with the policy (as outlined in chapter 7) that they are intended to implement, and recommends clarifying amendments to ensure that the policy intention is met. The chapter also discusses the relationship between the grouping rules and the proposed reverse charge on imported services as regards cross-border-related party transactions.

Non-availability of input tax credits for disregarded supplies

Issue

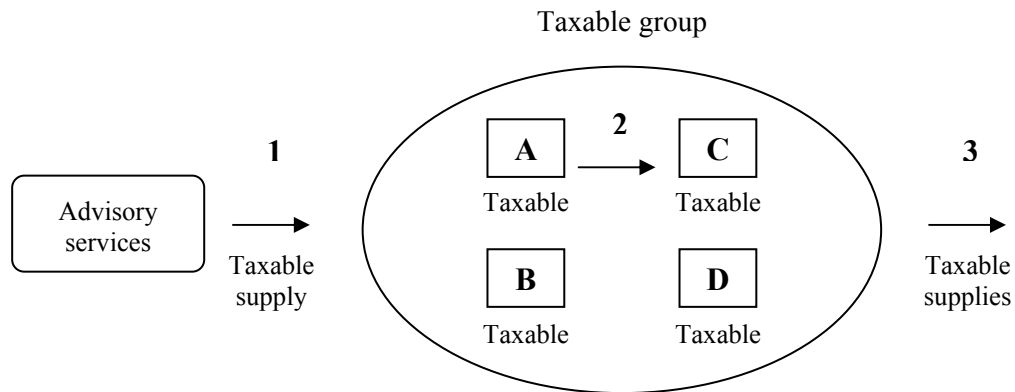
- 8.2 As stated in chapter 7, there is no entitlement to an input tax credit when goods and services acquired from a third party by a group are used to make intra-group supplies which are disregarded under section 55(7)(c). An entitlement to input tax credits would amount to the zero-rating of intra-group supplies, which was not the intention of the grouping rules. It is not sufficiently clearly understood, from the wording of section 55, that input tax credits should not be allowed in relation to a disregarded intra-group supply.
- 8.3 This issue arises from the use of the term “disregarded” in section 55(7)(c), and the status of an otherwise taxable supply which is disregarded and for which no output tax is charged. The disregarding of an intra-group supply should result in there being both no output tax charged by the supplier and no input tax being able to be claimed by the supplier.

- 8.4 Further, although an inability to claim input tax credits is appropriate when exempt activities are carried on by a group, it is not appropriate for a group which only makes taxable supplies. The grouping rules currently allow a group to disregard supplies at its own discretion – if the supply is not disregarded an input tax credit may be available to the supplier (through the representative member).
- 8.5 Therefore a fully taxable group has the choice of either claiming input tax credits and not disregarding intra-group supplies, thereby losing the compliance cost savings of grouping, or not claiming input tax credits and disregarding intra-group supplies, which results in a tax cascade within the group. This occurs as tax is charged on the supply made to the group by the third party, no input tax credit is available for the tax paid, and the group then charges tax on the supplies it makes to third parties. This can result in the overtaxation of a fully taxable group.

Proposal

- 8.6 The grouping rules should ensure that a single company, a group of companies and branches are treated in the same manner. They should also reduce compliance costs for groups of companies. The current rules arguably do not achieve these outcomes, because of the treatment of disregarded supplies, principally with respect to the availability of input tax credits.
- 8.7 The availability of input tax credits for acquisitions made by a group should be judged on the basis of the supplies that group makes outside the group (that is, to third parties), with adjustments required for changes in use within the group. This will place a group of companies in a similar position to single companies. Disregarded supplies should not be determinative of the availability of input tax credits.
- 8.8 It is proposed to amend section 55(7) to provide that input tax credits are available on purchases acquired for the principal purpose of making taxable supplies outside the group, and that intra-group taxable supplies are to be ignored.
- 8.9 As part of these changes the discretion to disregard taxable supplies will be removed. If a group registers for GST purposes it will be required to disregard all intra-group taxable supplies.
- 8.10 Figures 14 to 17 illustrate the intended operation of the grouping rules as regards the availability of input tax credits for purchases from third parties:

Figure 14: A fully taxable group



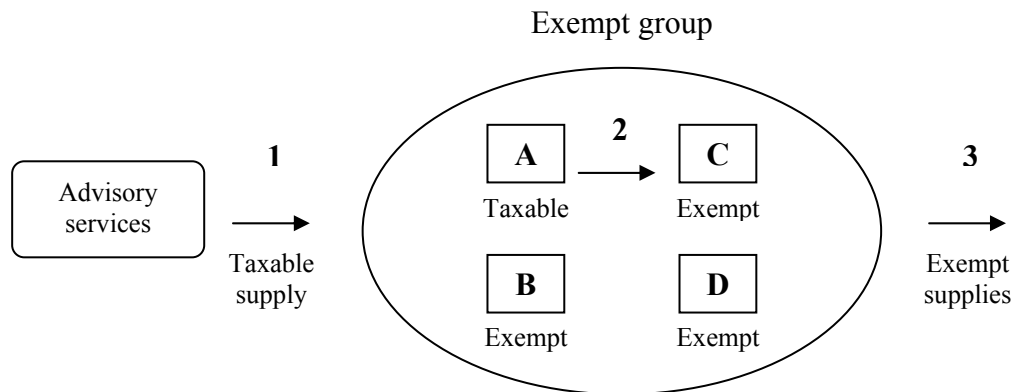
Transactions

1. A third party supplies taxable services to a group member.
2. This group member then uses those services to make supplies (or on-supplies them) to another group member.
3. The group makes only taxable supplies to third parties.

Proposed GST treatment

- Intra-group supply (2) disregarded, no output tax charged.
- Input tax credit available to representative member on the supply from the third party (1), on the basis of the supplies the group makes (3) being solely taxable.

Figure 15: A fully exempt group



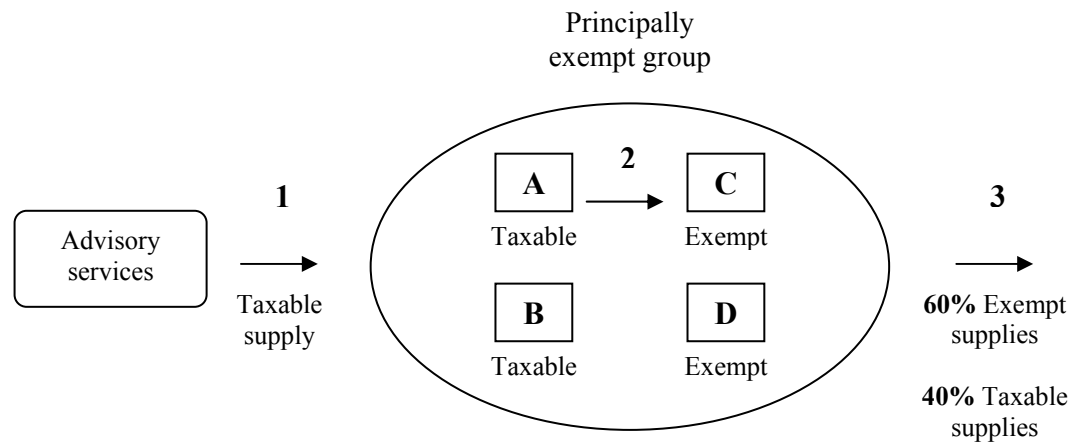
Transactions

1. A third party supplies taxable services to a group member.
2. This group member then uses those services to make supplies (or on-supplies them) to another group member.
3. The group makes only exempt supplies to third parties.

Proposed GST treatment

- Intra-group supply (2) disregarded, no output tax charged.
- No input tax credit available to representative member on the supply from the third party (1), on the basis of the supplies the group makes (3) being solely exempt.

Figure 16: A “mixed” group – principally exempt



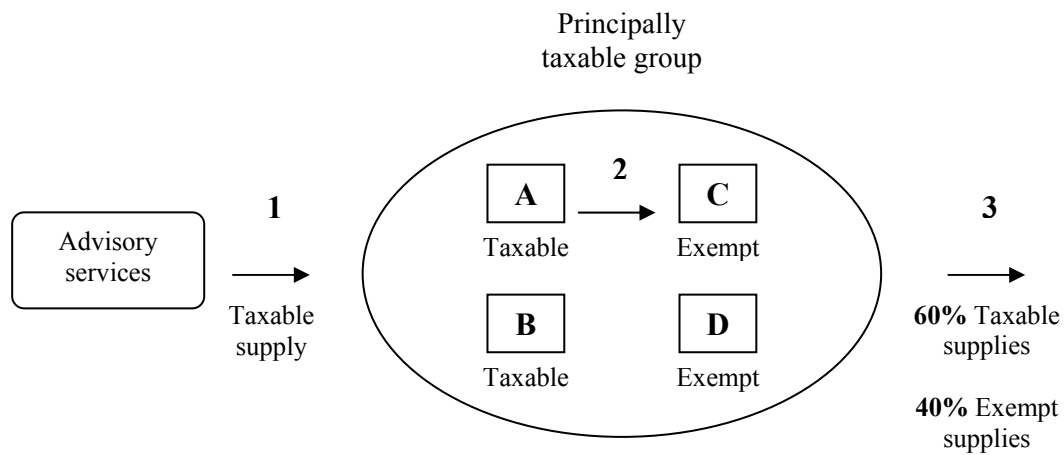
Transactions

1. A third party supplies taxable services to a group member.
2. This group member then uses those services to make supplies (or on-supplies them) to another group member.
3. The group makes taxable and exempt supplies to third parties.

Proposed GST treatment

- Intra-group supply (2) disregarded, no output tax charged.
- No input tax credit available to representative member on the supply from the third party (1), on the basis of the supplies the group makes (3) being principally exempt.
- Input tax adjustment allowed for 40% taxable application.

Figure 17: A “mixed” group – principally taxable



Transactions

1. A third party supplies taxable services to a group member.
2. This group member then uses those services to make supplies (or on-supplies them) to another group member.
3. The group makes taxable and exempt supplies to third parties.

Proposed GST treatment

- Intra-group supply (2) disregarded, no output tax charged.
- Input tax credit available to representative member on the supply from the third party (1), on the basis of the supplies the group makes (3) being principally taxable.
- Output tax adjustment required for 40% exempt application.

8.11 The treatment of companies joining a group will remain the same as outlined in figures 12 and 13 in chapter 7. If intra-group supplies are made entirely out of the group's resources, with no external inputs (for example, merely using staff), there will be no GST impact, in the same way that the "self-supply" of those services within a single company or between branches would not be subject to GST.

The requirement to make adjustments

8.12 A group is intended to be required to make adjustments for changes in use in the following circumstances (as outlined in chapter 7):

- For goods and services held before a group is formed, or held by a new member entering a group, where the use by the group differs from that for which the goods and services were acquired (sections 55(7)(db) and (dc)).
- For goods and services acquired by the group for a particular purpose and used either within or by the group for another purpose (sections 21 and 21E).

8.13 Sections 55(7)(db) and (dc) apply to deem the requirements of sections 21 and 21E to have been met when goods and services are "subsequently applied" for a purpose other than the purpose for which they were originally acquired. It is questionable whether goods and services can be said to have been "subsequently" applied if the goods or services are consumed in making supplies or in some way change in form. For instance, a diverse range of inputs is required to make an internal supply of record-keeping services such as computers and staff time.

8.14 This bundling can change the nature of the goods and services originally acquired, and may mean that the goods and services are not subsequently applied – rather the product of their application is subsequently applied. Under this argument, a subsequent application would only happen in relation to enduring assets – for instance an asset that is leased to an entity which uses it for a taxable purpose and the asset is then subleased, on the same terms, to another entity which uses it for a non-taxable purpose.

8.15 This interpretation is inconsistent with the intention of the grouping rules. An adjustment should be required so that a group of companies is in the same GST position as a single company when it changes the use of any goods and services. It is notable that the word "subsequently" was removed from the change-in-use adjustment provisions for similar reasons.³⁴ The wording of section 55(7)(db) is also inconsistent with the wording of section 21(1), referring only to the application of goods and services, whereas section 21(1) refers to application, acquisition and production of goods and services.

³⁴ Taxation (GST and Miscellaneous Provisions) Act 2000.

- 8.16 It is proposed to align the wording of sections 55(7)(db) and (dc) with the wording of sections 21 and 21E. This will involve removing the references to “subsequently” and adding the terms “acquired” and “produced” to “applied” in section 55(7)(db).

The value of adjustments

- 8.17 Output tax adjustments can be made based on either the lesser of the cost of an asset or the open market value of the deemed supply of the asset. When made using the cost³⁵ option, a depreciation methodology is usually adopted. This can result in a timing advantage, based on the difference between the depreciation rate of the asset and the open market value of the deemed supplies made.
- 8.18 The use of the depreciation methodology raises an issue in relation to assets which have a high depreciation rate. Some taxpayers hold assets, such as computers, which depreciate at a high rate and have a zero value for depreciation purposes. In relation to a change from taxable to exempt use, the argument has been made that a zero output tax adjustment can, therefore, be made, as previously there has been an “over-adjustment”. Taxpayers argue that as the asset has been fully depreciated, the depreciation rate is zero, with the result that a nil adjustment is made.
- 8.19 This may give an undue advantage to groups of companies over other entity structures, particularly when new members join a group. The government therefore proposes that the adjustments made under sections 55(7)(db) and (dc) when a new member joins a group of companies be made at market value.

Relationship with reverse charge proposals

Background

- 8.20 The discussion document *GST and imported services* was released in June 2001. Since then further consultation has been undertaken with interested parties and it is planned that the proposals in that discussion document will be implemented alongside the proposal for zero-rating business-to-business supplies of financial services. The remainder of this chapter outlines the main issues arising from that discussion document and the government’s response.

³⁵ Note that for the purposes of such adjustments Inland Revenue does not view the cost of the goods and services to be merely their original cost.

- 8.21 The discussion document outlined the government’s proposed reforms to the treatment of imported services by the introduction of a reverse charge on such services. The discussion document also raised certain issues relating to grouping. It proposed that a New Zealand entity or presence should be treated as separate from its offshore presence in relation to services that would be subject to GST if supplied in New Zealand. This requires not disregarding supplies within a group of companies which include offshore entities.
- 8.22 Thus, subject to any appropriate exclusions, management fees or cost allocations charged from offshore to a New Zealand arm of an international group of companies would be subject to the reverse charge.
- 8.23 Those who made submissions on the discussion document largely accepted the theory that the reverse charge will remove the current distortions arising from the fact that GST is imposed on domestic supplies but not on supplies of imported services. However, some submitters questioned whether the current non-taxation of imported services distorts decisions in practice. Those who believe that no distortions exist base their view on the belief that there are no ready substitutes in New Zealand for the services provided by most offshore service providers. They therefore consider that, at the least, the application of the reverse charge should be limited to those services which do have New Zealand substitutes.
- 8.24 This would generally exclude management fees and cost allocations by an offshore affiliate, which could be achieved by allowing the offshore affiliate to be grouped for GST purposes with New Zealand companies that met the requirements for grouping.
- 8.25 The alternative view is that submitters’ arguments on the lack of New Zealand-sourced substitutes for services provided from overseas are based on a static view of the market for services, instead of recognising that the market is continually changing. The submitters’ arguments also do not recognise the possibility that the GST disadvantage New Zealand suppliers face may well be a factor in any potential lack of New Zealand substitutes for overseas services.
- 8.26 The government considers that there is no completely distortion-free option for the treatment of cross-border intra-group supplies. Both the proposed treatment and submitters’ preferred treatment would result in distortions in the treatment of supplies of services depending on the supplier of those services.
- 8.27 GST grouping in the context of the reverse charge needs to be limited in any event because of concerns over:
- the substitutability of services; and
 - circumvention of the reverse charge.

Substitutability

- 8.28 It is not necessarily always valid to compare the treatment of supplies within a New Zealand group with supplies between an offshore parent (or head office) and a New Zealand subsidiary (or branch). In the context of the policy of the reverse charge the question is the risk of offshore supplies creating distortions relative to domestic supplies. Supplies by an offshore parent or head office can create this risk since they may compete with domestically generated supplies which may be sourced from outside the New Zealand group.
- 8.29 Although the government understands concerns that this competition is in practice limited, in most instances there is nothing in the inherent nature of those services which would preclude their supply by a third party. Therefore the distortionary effects of not imposing GST on such supplies cannot be ruled out. The government is concerned to reduce the risk of offshore supplies creating distortions relative to domestic supplies from outside a group. However the impact of distortions in relation to related-party charges is viewed, the reverse charge cannot operate unless potential avoidance problems are dealt with.

Circumvention of the reverse charge

- 8.30 If related party charges were not subject to the reverse charge, the use of offshore associated entities through which New Zealand entities were able to access supplies from offshore third party entities could very easily undermine the effectiveness of the reverse charge more generally.
- 8.31 Thus, even if submitters' approach were accepted, not all internal charges would necessarily be removed from the reverse charge. A conservative approach would be needed. Thus only charges that could be identified as internal would be excluded. Salaries would seem to be the main such charge. Other charges can too readily include third party elements because they are made up of any number of components. While salaries are also open to substitution, they are likely to carry less of an avoidance risk because they involve a single charge.
- 8.32 As stated in the imported services discussion document, interest could also be excluded, not on the basis of arguments over substitutability, but because, to the extent that it retains its nature as interest, it represents a non-taxable supply which will always be excluded from the reverse charge. Therefore if interest forms part of a cost allocation it could be excluded from the scope of the reverse charge.

Proposal

- 8.33 The government proposes that, having regard to the need to reflect a continually changing market and the practical concerns raised by submitters, internal charges will be subject to the reverse charge but there will be an exclusion for salaries and interest.

ANNEXES

ANNEX A

CAUSES AND EFFECTS OF TAX CASCADES – AN EXAMPLE

The following example shows how tax cascades increase the price of commodities sold to final consumers. The example compares the effect of two supplies from registered persons to a local retailer. The first supply is a taxable supply of goods by a manufacturer. The second supply is a supply of financial services by a bank.

The cost to the manufacturer and financial intermediary to supply their products is \$900.00 (including GST of \$100.00). As the manufacturer makes taxable supplies, it can claim an input tax credit – this reduces the cost of the purchases. The bank, on the other hand, cannot recover this cost.

When determining the price for the manufactured goods, the manufacturer requires a return of \$200.00. GST is charged on this price. The bank requires a similar margin but is not required to charge GST.

Manufacturer		Bank	
Purchases to provide goods	900.00	Purchases to provide service	900.00
GST Input Tax Credit	(100.00)	GST Input Tax Credit	-
Total cost	800.00	Total cost	900.00
Operating margin	200.00	Operating margin	200.00
Base cost of goods	1,000.00	Interest	1,100.00
GST at 12.5%	125.00	GST (Exempt)	-
Price of goods sold	1,125.00	Interest charged	1,100.00

A local retailer purchases the goods and services from the manufacturer and the financial intermediary.³⁶ The higher purchase price from the bank is a result of the exempt supply. This has the effect of increasing the base price on which the retailer charges GST. The GST that could not be recovered by the bank has cascaded, meaning that the retailer is collecting \$162.50 in GST rather than \$150.00, as is the case when selling only the manufacturer's goods.

³⁶ Unlike the manufacturer's goods which are sold directly to final consumers, the interest cost forms part of the retailer's cost of operation. The retailer seeks to recover the interest cost by adding the \$1,100 interest charge across all goods and services sold by the retailer. For the purposes of this example, this has been disregarded.

Retailer	
Purchase from manufacturer	1,125.00
GST Input Tax Credit	(125.00)
Total cost	1,000.00
Operating margin	200.00
Base price of goods sold	1,200.00
GST at 12.5%	150.00
Price of goods sold to consumers	1,350.00

Retailer	
Interest payable to bank	1,100.00
GST Input Tax Credit	-
Total cost	1,100.00
Operating margin	200.00
Base price of goods sold	1,300.00
GST at 12.5%	162.50
Price of goods sold to consumer	1,462.50

ANNEX B

BASIC METHODOLOGY OF CASH FLOW TAXATION AS APPLIED TO DIFFERENT TYPES OF FINANCIAL INTERMEDIATION³⁷

This annex summaries the basic methodology underlying the GST treatment of financial services under a cash flow taxation model, as developed by Satya Podder and Morley English. As noted in chapter 3, the model includes both household and business financial transactions within the tax base and attempts to measure the implicit fee for financial margins and allocate that margin between borrowers and lenders.³⁸ The model predominately addresses the taxation of financial services in the context of deposit-taking intermediation but can also be applied to:

- securities transactions;
- derivative transactions; and
- life insurance.

The methodology outlined in this annex applies to financial services provided by “financial institutions”, which are taxpayers defined as mainly having an activity of supplying financial intermediation services or regularly trading in financial assets.

By measuring and allocating the margin for financial intermediation, it is generally expected that the normal rules for calculating and returning GST under the credit-invoice method could be applied. This means that as the financial margin is identified, and GST charged, the financial intermediary would be entitled to claim an input tax credit in the ordinary way. Business customers of the financial intermediary would, in turn, be entitled to claim an input tax credit for the GST paid on the financial services, hence removing the tax cascade. Final consumers would expect to receive an invoice showing the GST charged with, say, a monthly bank statement.

Taxing deposit-taking intermediation

The basis of taxing financial services under the truncated cash flow method with tax calculation account involves allocating the margin earned by a financial institution between borrowers and depositors. The allocation is performed by the tax calculation account (TCA), which measures the margin over the life of financial contracts. An indexing rate is applied to the TCA to allocate the margin, in the case of deposit-taking intermediation, between depositors and borrowers. The indexing rate is intended to be an approximation of a “pure” rate of interest, that is, a rate that does not contain a charge for intermediation or credit risk.

³⁷ This annex is based on a report by Ernst and Young to the Taxation and Customs Union for the European Commission. Refer, *The TCA System – a detailed description*, Brussels (1998).

³⁸ Explicit fees are generally taxed under the usual credit-invoice methodology.

This means that GST is not applied to the rate of interest advertised, or the rate paid on a loan or received on a deposit. Instead, the taxable margin is calculated as the difference between the actual amounts paid or received compared to what would have been paid and received according to the indexed rate of interest. Therefore the GST liability on financial services will decrease as the interest rate on a loan decreases and will increase as the interest rate paid on a deposit decreases.

The TCA records the details of transactions between the financial institution and the customer, including the principal amount of the deposit or loan, and applies the rate of GST on each entry. Although GST consequences arise on principal transactions, this is usually offset by corresponding GST debits and credits and net to zero. Therefore the TCA is in practice concerned with tracking the difference between actual interest rates (and corresponding interest payments or receipts) as compared to the indexed interest rate.

The TCA can therefore apply to loans and deposits in two ways: (i) the sum of the cash flows method; and (ii) the interest margin method.

- The sum of the cash flows method involves the calculation of the GST base for a period by: (i) debiting the TCA by the amount of all cash inflows associated with loans or deposits in the period; (ii) crediting the TCA by the amount of all cash outflows associated with a loan or deposit in the period; (iii) multiplying the net debit or credit balance by the indexing rate, which results in a debit or credit entry in the TCA for the period; and (iv) reducing the TCA balance at the end of the period by the loan or deposit balance, which becomes the opening balance for the next period. This approach does not require a distinction between interest and principal cash flows, since the closing balance reduction ensures that no net GST is paid or credited on the relevant principal amount.
- The interest margin method involves the calculation of the GST base for a period by: (i) determining the difference between the contracted interest in the period on a loan or deposit and the indexing adjustment; (ii) applying the indexing adjustment to the margin for the period; and (iii) multiplying the TCA balance by the GST rate for the period. This approach requires a distinction between interest and principal cash flows.

The model also includes a number of adjustments to reflect bad debts and discounts.

Securities transactions

The same methodology can, in principle, be applied to security transactions. Assuming that the mid-market price equals the mid-point between the dealer “bid” and “ask” prices (which converts to an explicit price), this fee can be allocated between purchasers and sellers of securities through a financial institution in the following way:

- The difference between the “bid” price paid by a financial institution for the purchase of a security as a principal and the mid-market price would be deemed to be a brokerage fee charged to the seller.

- The difference between the “ask” price received by a financial institution for the sale of a security as a principal and the mid-market price is deemed to be a brokerage fee charged to the purchaser.

The total amount paid or received by customers is deemed to include GST on the deemed brokerage fee.

Any gains and losses that arise on security inventories of financial institutions are recognised for GST purposes, either by recording the cash flows or using the TCA method.

If the cash flows are taxed: (i) all cash outflows from purchases are treated as purchases that are eligible for GST refunds; (ii) all cash inflows from sales are treated as taxable sales that are subject to GST; and (iii) all cash inflows from the receipt of dividends or interest are treated as taxable sales that are subject to GST.

The TCA account, on the other hand, is calculated in the same manner to that for deposit-taking intermediation: (i) all cash inflows are debited to the account; (ii) all cash outflows are credited to the account; (iii) the net balance in the TCA for a period is multiplied by the indexing rate and is credited to the TCA; (iv) the closing value of a security on hand is debited to the account to offset the credit associated with its purchase; (iv) GST is calculated on the closing balance; and (v) the closing value of a security becomes the opening value in the TCA for the subsequent period.

Under both methods, GST is calculated on the basis of cash flows associated with an entire security portfolio and is deemed to be derived from bearer securities without any counterparty, which means the burden of the GST falls on financial institutions.

Cash flows are deemed to be GST inclusive, but with the amount of gain or loss determined after excluding the deemed brokerage fee subject to GST: that is, the cost of a security is deemed to include the amount of the deemed brokerage fee, subject to GST, and the proceeds for a security are deemed to be reduced by the amount of the deemed brokerage fee, subject to GST.

Derivative transactions

In relation to derivative transactions, the TCA is not necessary as over-the-counter derivatives such as interest-rate swaps, forwards, equity swaps, commodity swaps and options can, in principle, be taxed according to the cash flows, provided that the price is grossed up to include GST.

If the TCA were used, the “inception profit” (associated with the writing of a derivative) would be used as the equivalent of an explicit intermediation fee subject to GST. The “inception profit” equals the present value of the anticipated margin associated with the writing of a derivative and is determined as the difference between the price specified under the instrument and the mid-market price for the same position in the same instrument. The inception profit is then treated as a loan to the counterparty, in respect of which the TCA is established to compute GST on the financial margin over the term of the derivative. Subsequent cash flows under a derivative instrument are treated as debits or credits to the TCA.

Life insurance

Life insurers can be taxed either by reference to cash flows or using the TCA method. Either method measures both the risk intermediation margin and the net investment margin of insurers.

Taxing life insurance by reference to cash flow requires the application of GST to all cash inflows of an insurer from premiums and investments, with the provision of input tax credits for all amounts that are paid as claims and are credited as interest to policy reserves. Amounts paid as claims to registered businesses are treated as taxable sales by such businesses and are subject to GST.

The application of the TCA method to insurance policies involves: (i) the debiting of the amount of cash inflows (premiums) associated with a particular policy for the relevant period; (ii) the crediting of the amount of cash outflows (claims, bonuses and policy surrenders) associated with a particular policy for the relevant period; (iii) a debiting or crediting equal to the net debit or credit balance for the period multiplied by the indexing rate; (iv) a reduction equal to the amount of the reserve balance associated with a particular policy at the end of the period; and (v) the remittance or refund of amounts equal to the TCA balance at the end of the period multiplied by the GST rate. The closing TCA balance for a period becomes the opening TCA balance for the following period.

Several adjustments to the general methodology are required to ensure that re-insurance is treated as a zero-rated supply and that, where TCAs are used, policy reserves are allocated to particular policies for the purposes of the TCA on a per transaction/per customer basis. Separate TCAs are also required for insurance policies and for investment activities. The indexing adjustment then serves to allocate the total insurance margin between insurance policies (the risk intermediation margin) and investments (the investment intermediation margin).

ANNEX C

NUMERICAL EXAMPLE COMPARING THE TREATMENT OF TAXABLE SUPPLIES AND EXEMPT SUPPLIES UNDER CURRENT LEGISLATION WITH THE PROPOSED ZERO- RATING ENVIRONMENT³⁹

This annex illustrates how the proposal to zero-rate domestic business-to-business supplies of financial services is aimed at removing tax cascades and creating parity with taxable supplies of non-financial goods and services. It assumes that the tax is able to be fully shifted forward by the supplier to the customer.

Current treatment: Supply of taxable goods and services by Business B

Business A	Purchase	1,000
	GST at 12.5 percent	125
	Credit for GST paid	(125)
	Cost of purchase	1,000
	Mark-up at 20 percent	200
	Price before GST	1,200
	GST at 12.5 percent	150
	Selling price	1,350
<hr/>		
Business B	Purchase	1,350
	Credit for GST paid	(150)
	Cost of purchase	1,200
	Mark-up at 5 percent	60
	Price before GST	1,260
	GST at 12.5 percent	157.50
	Selling price	1,417.50
	<hr/>	
Business C	Purchase	1,417.50
	Credit for GST paid	(157.50)
	Cost of purchase	1,260
	Mark-up at 2 percent	25.20
	Price before GST	1,285.20
	GST at 12.5 percent	160.65
	Selling price	1,445.85
	<hr/>	
Final Consumer	Purchase	1,445.85

³⁹ As per figure 3 on page 22.

**Current treatment:
Supply of financial services by financial intermediary**

Business A	Purchase	1,000
	GST at 12.5 percent	125
	Credit for GST paid	(125)
	Cost of purchase	1,000
	Mark-up at 20 percent	200
	Price before GST	1,200
	GST at 12.5 percent	150
	Selling price	1,350
Financial intermediary	Purchase	1,350
	Credit for GST paid	0
	Cost of purchase	1,350
	Mark-up at 5 percent	67.50
	Price before GST	1,417.50
	GST at 12.5 percent	0
	Selling price of services	1,417.50
Business C	Purchase	1,417.50
	Credit for GST paid	0
	Cost of purchase	1,417.50
	Mark-up at 2 percent	28.35
	Price before GST	1,445.85
	GST at 12.5 percent	180.73
Selling price	1,626.58	
Final consumer	Purchase	1,626.58

**Proposed treatment:
Supply of financial services by financial intermediary**

Business A	Purchase	1,000
	GST at 12.5 percent	125
	Credit for GST paid	(125)
	Cost of purchase	1,000
	Mark-up at 20 percent	200
	Price before GST	1,200
	GST at 12.5 percent	150
	Selling price	1,350
Financial intermediary	Purchase	1,350
	Credit for GST paid	(150)
	Cost of purchase	1,200
	Mark-up at 5 percent	60
	Price before GST	1,260
	GST at 0 percent	0
	Selling price of services	1,260
Business C	Purchase	1,260
	Credit for GST paid	0
	Cost of purchase	1,260
	Mark-up at 2 percent	25.20
	Price before GST	1,285.20
	GST at 12.5 percent	160.65
Selling price	1,445.85	
Final consumer	Purchase	1,445.85

In this example, by zero-rating the supply of financial services, the tax cascade has been removed and parity is achieved with other (non-financial) supplies provided the transaction is for the purposes of making taxable supplies.

GLOSSARY OF TERMS USED IN THIS DOCUMENT

Brokerage services: In relation to financial services, the intermediary standing between buyers and sellers of commodities, currencies, debt and equity securities. The provision of brokerage services involves three distinct cash flows: (i) payment by a purchaser to the intermediary of the purchase price for a specified item; (ii) receipt by a seller through the intermediary of the sale price for a specified item; and (iii) the fee charged by the intermediary for the provision of the intermediation services.

Cash-flow taxation: A method of calculating the taxable value of financial services, based on treating cash inflows as taxable sales and cash outflows as taxable purchases.

Credit-invoice mechanism: The mechanism by which GST is collected and paid in New Zealand, which works by levying tax in instalments at each transaction in the production and distribution chain. A liability to charge tax arises every time a registered person makes a supply. Tax is also imposed on imports. Credits for tax paid on a registered person's purchases means that the tax rolls forward at each intermediate transaction until the point of sale to a final consumer.

Deposit-taking intermediation: This involves the making of deposits and debt investments with an intermediary who provides the relevant funds to users of capital in the form of loans. Deposit-taking intermediation involves five distinct cash flows: (i) the advance of a principal sum by the supplier of capital through the intermediary to the user of capital; (ii) the repayment of the principal sum by the user of capital through the intermediary to the supplier of capital; (iii) the pure time-value return or interest charge that compensates the supplier of capital for the use of its funds by the user of capital; (iv) the premium charged by the intermediary to compensate for the risk of default on payment obligations by users of capital; and (v) the fee charged by the intermediary for intermediation services.

Exempt activity: Any activity carried on by a registered person that makes exempt supplies.

Exempt supplies: A supply that is not subject to GST but for which the supplier is unable to claim an input tax credit. In the context of the reforms proposed in this discussion document, exempt supplies include supplies of financial services to final consumers (households), financial intermediaries and businesses that have more than an incidental activity of supplying financial services.

Exemption-without-credit: This is the technical description for the current treatment of financial services. Briefly, it means that a financial intermediary does not charge GST on the supply of a financial service described in section 3 of the GST Act. It also means that in supplying any financial services the provider is unable to claim an input tax credit for any GST incurred in producing that

service. This treatment is a proxy for taxing final consumption as it ensures that the intermediary expressly bears the tax cost.

Final consumers/households: GST is a tax on the supply of goods and services in New Zealand. The tax is ultimately borne by the last person in the production-distribution chain, who is often referred to as the final consumer. The tax is borne by final consumers as they are unable to claim an offsetting credit for the tax paid when acquiring the goods or services.

Financial intermediary: In its broadest sense, the term "intermediary" includes any person who serves to bring other persons together. Intermediation is the service provided by a person in bringing together suppliers and consumers of particular goods and services. Intermediaries therefore reduce transaction costs otherwise associated with matching suppliers and consumers. "Financial intermediation" can be divided in to four categories:

- intermediation between suppliers and users of financial capital;
- intermediation between persons with different exposures and/or tastes for risk;
- intermediation between persons with exposure to similar risks;
- intermediation between buyers and sellers of commodities, currencies, debt and equity securities.

In addition to these intermediation services, firms may also provide advisory and administrative services, such as record-keeping and cash management functions and credit and investment evaluation.

Goods and services: "Goods" is defined in section 2 of the GST Act as all kinds of real or personal property other than choses in action⁴⁰ or money. "Services" is defined as anything which is not goods or money. Therefore money is not part of the GST base, and choses in action are treated as services.

Input tax credits: Registered persons are entitled to an offsetting credit for GST paid on purchases of goods and services acquired for the principal purpose of making taxable supplies. The term "input tax" is defined in section 3A of the GST Act.

Insurance: This involves the pooling of funds to spread exposure to risk among a number of persons or a number of different investments. Insurance involves three distinct cash flows: (i) payment by the insured of premiums (or savings in the case of diversification) to an intermediary for coverage in respect of a specified risk; (ii) payment by the intermediary to the insured of proceeds in respect of the occurrence of the specified risk (or the return on

⁴⁰ For example, leases of land, use of patent rights, an interest in a partnership, company shares, trademarks and copyrights.

an interest in a diversified savings portfolio); and (iii) the fee charged by the intermediary for intermediation services.

Reduced input tax credits (RITCs): A concession to allow registered persons to claim a percentage of input tax credits that would not otherwise be allowed for tax paid on their purchases. The purpose of the credit is to remove the bias financial intermediaries have to provide activities from within their own resources and thereby reduce the impact of GST. In Australia, where the RITC is used, the rate of input tax recovery is set at 75% of the GST paid on certain prescribed taxable supplies of goods and services.

Registered person: A “registered person” is a person who is required to charge GST on the supply of goods and services made by them. Registration is required if the person has a taxable activity and makes supplies in New Zealand that total more than \$40,000 in a 12-month period. Persons may also voluntarily register if they have a taxable activity and their turnover is less than \$40,000.

Risk intermediation: This involves the acceptance by the intermediary of exposure to a specified risk that the transferor is unwilling to bear, and the transfer by the intermediary of that exposure to another person willing to accept it. Risk intermediation involves three distinct cash flows: (i) the payment by the losing counterparty to a bet of the amount of that losing position to the intermediary; (ii) the payment by the intermediary of the amount of the losing bet to the winning counterparty; and (iii) the fee charged by the intermediary for intermediation services. The first two cash flows are channelled through the intermediary, who does not bear the risk associated with either side of the bet. The only risk assumed by the intermediary is, in fact, the credit risk associated with the chance that a losing party to a bet might default on its payment obligations, leaving the intermediary to make good on those obligations. A portion of the intermediation charge compensates for the assumption of this default risk.

Self-supply: The term describes the behaviour of providing necessary goods and services “in-house”. In the case of financial intermediaries, the behaviour may arise from the inability to recover the GST paid on their purchases of goods and services. If the financial intermediary cannot pass on these costs, or faces tightening margins, it may elect to reduce the cost of supplies by replicating external supplies internally.

Self-supply tax: A tax that is imposed, in theory, to achieve parity between internally generated supplies and those that could otherwise be sourced from third parties. It is designed, therefore, to remove the bias faced by some registered persons to in-source supplies of goods and services owing to the inability to claim input tax credits. The rate of tax should be equal to the standard rate of VAT/GST. The application of a self-supply tax would involve the complex issue of how to value internally created supplies.

Tax cascade: Tax cascades can arise where a supplier of a financial service cannot recover the GST paid on the purchase of goods and services used to make those supplies. To compensate, the financial intermediary either raises the price of the services or absorbs the GST cost. If the irrecoverable GST cost is passed on to businesses through higher prices, this may increase the prices charged by businesses for their products.

Tax invoice: A document that complies with section 24(3) or (4) of the GST Act.

Taxable activity: The taxable activity test, as defined in section 6 of the GST Act, establishes the boundaries within which GST operates. It is similar to a business test but without the requirement that the activity be carried on for profit. The existence of a taxable activity depends on whether the activity is carried on continuously or regularly and whether it involves, or intends to involve supplies, other than exempt supplies, to another person for a consideration.

Taxable supply: Taxable supplies are supplies charged with GST under section 8 of the GST Act, either at the standard 12.5% or, in certain circumstances, at zero percent.

Zero-rating: Zero-rated supplies of goods and services are taxed at the rate of zero-percent. No tax is payable but input tax credits are allowed in respect of supplying the goods and services.