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In Confidence

Office of the Minister of Revenue

Chair, Cabinet Economic Development Committee

GST ON FEES CHARGED TO MANAGED FUNDS

Proposal

1. This paper seeks the Cabinet Economic Development Committee's agreement to proposed changes to the Goods and Services Tax ("GST") treatment of fund manager and investment manager fees charged to managed funds and retirement scheme funds, including KiwiSaver schemes.

Relation to Government Priorities

2. The Government's Tax Policy Work Programme allocates policy resource to maintaining the tax system to ensure that the Taxation Acts are updated to reflect changes in technology, business practices, jurisprudence or other factors. This supports the health and integrity of the tax system by ensuring that laws work as intended. This proposal is required for these reasons.

Executive Summary

3. Goods and Services Tax is a 15% consumption tax on the supply of goods and services supplied to consumers in New Zealand. However, there are certain types of goods and services that are 'exempt' from GST. That is, GST is not imposed on these supplies. One form of exempt supply is financial services (such as the services managed funds supply to their investors).

4. The current GST treatment of management services supplied to KiwiSaver funds and other managed funds is complex and inconsistent. The GST treatment (that impacts the total price paid) of the services supplied by a fund manager or investment manager to managed funds can range from being 100% GST exempt to 100% subject to 15% GST.

5. These issues have resulted in an uneven playing field which may be distorting competition, leading to higher compliance costs and less GST revenue collected. As well, due to the complexity of the existing law, the various GST practices are not consistent with current GST laws.

6. Submissions received on the February 2020 *GST Policy Issues paper* were mixed, with most favouring their particular existing GST treatment for the whole industry. Some submitters suggested their current industry practice of applying a mix of 90% exempt / 10% taxable (effectively imposing a 1.5% tax on managers' fees) should be retained and legislated for across the industry. Other submitters preferred their current

approach of 100% of the fees being subject to 15% GST being retained and legislated for across the industry.

7. In recent months, my officials have met with key stakeholders such as managed funds (broadly split between larger funds and boutique funds) that will be impacted by any change and private sector GST advisors to discuss potential reform options, including retaining the current industry practices.

8. I am recommending all fund managers and investment managers fees charged to managed funds, including KiwiSaver funds, should be subject to 15% GST. This will provide simplicity and consistency across the industry and ensure there is a fair marketplace that is not distorted by the GST rules.

9. Because the recommended rules will impose GST on fund manager and investment manager fees, and the funds cannot claim back this GST cost as a GST input deduction, it is anticipated that much of this GST cost will 'flow-through' to fund investors in the form of higher fund fees.

10. The recommended rules will adversely impact investors, including KiwiSaver members. For many investors that are investing in managed funds for their retirement, including KiwiSaver members, the result of the recommended rules is they will earn smaller after-fee returns on their investments and, therefore, reduced amounts that are reinvested back into the managed fund to generate future returns and ultimately, diminished future retirement savings. However, the extent to which GST will lead to higher fees for retail investors is uncertain, as the market for manager services is viewed as relatively uncompetitive and managers may decide to absorb some of the cost of GST.

11. The proposed rules will result in approximately $37 million in additional tax revenue in the 2025/26 fiscal year, increasing to $247 million in the 2026/27 fiscal year. Projected to over ten years, the additional GST collected in the 2031/32 fiscal year is approximately $400 million, with the revenue impact of the change growing steadily over the forecast outyears

12. I agree with stakeholders that for most fund managers and investment managers, the proposed rules will impose significant transition costs. I am also mindful that these financial institutions have been asked to implement other regulatory changes in the short-to -medium term. In light of this, I am recommending a 36-month transition period before the new GST rules will apply.

Background

13. Goods and Services Tax is a 15% consumption tax on most goods and services supplied to New Zealand consumers by registered person (such as businesses). To ensure GST is not a cost on business production, businesses can claim GST input tax deductions on purchases of goods and services they use in their business.

14. However, there are certain types of goods and services that are deemed to be exempt from GST[1]. One form of exempt supply is financial services, such as those services KiwiSaver schemes and other managed funds supply to their investors.

15. The current GST treatment of management services supplied to KiwiSaver schemes and other managed funds is complex and inconsistent. The pricing of the management services supplied to managed funds can distort competition, lead to higher compliance costs, and less Crown revenue.

Complexity and inconsistency of the existing rules

16. KiwiSaver and other types of managed funds purchase three main types of services from third parties:

    16.1 Fund manager services. A fund manager has overall responsibility for managing the fund. This can include offering and issuing units in the fund to investors, managing the fund's investments, reporting to investors, and procuring services from an investment manager and various administration service providers.

    16.2 Investment manager services. An investment manager recommends which assets (such as shares, bonds, cash) or other funds the fund invests into. When reporting to investors, manager services and investment manager services are both reported as "management fees' which are set as a small percentage (typically between 0.2% and 2%) of the funds under management.

    16.3 Various administrative services. These include legal, accounting, ICT (information and communications technology) or reporting services.

17. Managed fund fees charged to investors can have a large impact on the financial wellbeing of investors as they directly contribute to the level of accumulated savings, including retirement savings from retirement schemes (such as KiwiSaver). Generally, fees should decrease over time through economies of scale as the amount of funds under management grow and the benefits are passed onto consumers. For this reason, the Government (through the KiwiSaver default provider appointment process) and the Financial Markets Authority have focused in recent years on ensuring fund investors (including KiwiSaver members) receive value for money.

18. Providers of these fund manager and investment manager services apply GST inconsistently, resulting in an uneven marketplace across the industry.[2]

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[1] Meaning GST is not charged on the good or service, but also the business cannot claim back GST charged on the costs incurred to supply that exempt good or service. These supplies are known as being 'input-taxed' because the GST charged on these purchases is collected and not claimed back.

[2] Unlike many other industries, any GST applied to these services represent a real cost for managed funds. This is because under New Zealand's GST rules managed funds are 'exempt' from GST. They cannot claim back GST charged to them, and do not apply GST to the fees they charge to investors.

19. The industry applies the following GST practices:

    19.1 For retirement schemes, an existing **GST exemption** applies for management services provided directly to a retirement scheme. However, this exemption is limited.[3]

20. For other types of manged funds, the GST treatment is usually by either:

    20.1 The largest fund managers and investment managers typically treat 10 percent of their services as being subject to 15% GST and the remaining **90 percent as GST exempt**. This is because they consider their services are mostly "arranging" the buying and selling of investment products and so most of their service should qualify for the GST exemption for financial services. Because their fee is effectively only subject to 1.5% GST, this approach may allow them to charge lower fees to the wholesale managed funds.

    20.2 A group of boutique fund managers and investment managers apply **15% GST to all of their services**. This is because they consider their services are providing investment advice and other types of services that are typically subject to 15% GST. This approach means the managers can claim GST deductions on their purchases. This may be because they have fewer 'in-house' resources, compared to the larger fund managers and investment managers.

21. Many of the industry's current GST practices, such as 90% exempt, are not consistent with existing GST law. However, up until 2014 these positions were accepted by Inland Revenue as part of an industry agreement. However, in 2017, Inland Revenue formally considered how the GST should apply to these fees under existing law, with the draft conclusions further complicating the issue. This means that even retaining the status quo industry practices would require amendments to the GST Act.

22. The problem and several potential policy solutions have been subject to ongoing consultation with the industry, including the issue being subject to public consultation in *GST Policy Issues: an officials' issues paper* released in February 2020. Overall, submitters' views were mixed on what the preferred solution should be, largely depending on their current approach to GST.

23. Following public consultation, my officials continued to engage with industry representatives. The Financial Services Council (which represents most of the large managed funds managers) raised a new preference to effectively legislate the status quo. This approach would involve a fund manager or investment manager choosing their preferred GST treatment, based on one of three available options. It would allow the current, inconsistent GST practices of all three GST treatments to continue. However, the option would avoid any transition costs or other costs which could otherwise require managed funds to charge higher fees to investors, such as KiwiSaver members.

[3] This exemption does not apply where a retirement scheme invests into an underlying wholesale managed funds, as the managers and investment managers will be providing their services to the wholesale fund, rather than the retirement scheme.

24. A law change is required to resolve the legislative uncertainty that is impacting the managed funds industry.

Services supplied by fund managers and investment managers subject to 15% GST

25. I recommend that all fund manager and investment manager fees charged to managed funds should be subject to 15% GST. This includes fund manager and investment manager fees charged to retirement schemes.

26. This proposal is consistent with associated GST frameworks and principles, in particular the financial services exemption, which should generally be limited to cases where there are valuation issues.

27. This proposal will result in competitive neutrality across the managed funds industry with all fund manager and investment manager suppliers competing fairly in the marketplace. All their manager fees would be subject to 15% rather than some being treated as exempt or 90% exempt (effectively 1.5% GST). As well, general managed funds and retirement schemes that invest into underlying wholesale funds would no longer be disadvantaged when compared to retirement schemes that procure management services directly. The fund managers and investment managers that are currently charging 15% GST on their fees would not be impacted by the proposed changes.

28. By requiring the same GST treatment across the industry, fund managers and investment managers will have simplified GST compliance as they would be able to claim GST deductions for all the GST charged on their external costs. There will be less risk of errors or tax disputes on the GST treatment of services provided to managed funds.

29. Compared to the other options, this proposal is more sustainable in the long term, as there is likely to be less pressure for further exemptions or pressure on the legislative boundary and novel interpretations of the rules in an attempt to obtain a GST advantage over competitors.

Impact on retail fees charged to investors

30. The proposed rules seek to impose 15% GST on fund manager and investment manager fees charged to managed funds, however the managed funds remain subject to the financial services exemption and so cannot claim back this GST cost. Therefore, it is expected that the additional GST collected will flow through as an additional cost to a managed fund and therefore higher fees for its retail investors, such as KiwiSaver members. Officials from the Financial Market Authority are also of the view that the increased costs of GST will be passed onto KiwiSaver members in the form of increased fees. This increase is counter to recent years where KiwiSaver fees have fallen by 0.15% or 15 basis points over the past two years.

31. The extent to which GST will lead to higher fees for retail investors is uncertain. The economic literature[4] for other types of GST increases and decreases has found they

[4] IHS (2011), "The Effect of VAT on Price-Setting Behaviour" in IFS et al., A retrospective evaluation of elements of the EU VAT system, Report prepared for the European Commission, TAXUD/2010/DE/328.

are more likely to affect the prices paid by consumers (in this case, retail investors) in more competitive markets, or if the GST reform is broader.

32. New Zealand's managed fund fees are regarded as being less competitive (that is, we have higher fees) than other countries. This could suggest that some funds may be able to offset or absorb some of the additional GST cost pressures by changing their commercial practices, or reducing their profit margins, rather than raising their fees by the full amount of added GST. This is because in more competitive markets, businesses have lower profit margins so are less able to absorb cost increases as an alternative to increasing their retail prices.

33. Because management fees are set as a percentage of the member's total balance, retail investors (such as KiwiSaver members) with higher balances and those invested into higher fee funds would likely face larger increases in fees and therefore reductions in their future fund balances. We expect this change to have a greater direct impact as a share of retirement income on wealthier New Zealanders, who are more likely to have larger savings, including savings in managed funds. However, for some retail investors (such as KiwiSaver members) with low total savings, while the impact as a share of their total retirement income will be lower, the importance of these savings to meet future living costs during retirement means the impact of increased fees may have a disproportionate impact on their living standards in retirement. This is illustrated in the appendix.

34. Stakeholders have mixed views on the level of fee increase as a result of the GST change. The large managed fund providers (that are currently 90% exempt / 10% taxable) represented by the Financial Services Council believe the full GST cost will be passed through to retail investors, whereas the boutique funds believe the additional GST cost may have little impact fees charged to retail investors due to increasing pressure to compete on investor fees.

Stakeholder views on the proposal

35. While stakeholder views have been mixed, they can be broadly be regarded as:

    35.1 The large managed funds, represented by the Financial Services Council, consider the proposal to be their least preferred option, as it would require them to shift from a fully exempt or 90% exempt treatment to 15% GST applying to all fees. Their most preferred option is legislating the status quo. They believe this option imposes the least transition costs and on-going costs on managed funds and consequently, their fund investors.

    35.2 The boutique managed funds (which are much smaller in comparison), consider the proposal to be their most preferred option, as it provides a level marketplace with their competitors, while imposing no transition costs or on-going costs on themselves.

36. Alongside this, stakeholders have suggested the proposed changes may encourage a behavioural change in some managed funds, in that they may relocate their funds offshore to avoid incurring GST on the fund manager and investment manager fees charged. This is because GST is not collected on services supplied to offshore domiciled funds, which a New Zealand based fund can then invest into.

37. While it is difficult to measure the behavioural impact, the effect of this would be less GST collected over time. Given the likely transition costs of establishing and domiciling an existing New Zealand managed fund in another country, or reinvest a managed fund into an overseas fund, it is not anticipated that a significant number of funds will relocate in the short to medium term.

Transitional costs

38. The proposal to charge 15% GST on all fund manager and investment manager fees would consequently impose significant transition costs for fund manager and investment managers that are not already applying 15% GST.

39. The Financial Services Council advise that the proposed rules will impose significant transition costs and have submitted that they would require a three-to-five-year transition period. There are currently over 1,000 funds[5] offered to retail investors. Nearly all of these funds will need to amend their IT systems, appoint new service providers, or renegotiate commercial contracts, update investor disclosure statements, prepare investor communications, and staff training to respond to increased investor contacts.

40. In particular, the changes to the IT systems are likely to require the most time to prepare and implement (especially for funds managed by banks). This is because these financial institutions have much of their IT resources pre-committed to other projects. This includes implementing other required regulatory changes, such as climate reporting disclosures, changes to the anti-money laundering rules and the introduction of the new regulatory regime covering the conduct of financial institutions (CoFI).

41. To ensure funds and their service providers have sufficient time to implement the proposed new rules, I recommend providing a transition period between enactment of the law change and the application of the new rules. I recommend 36 months is provided for this.

Revenue collection

42. The proposed rules will result in approximately $37 million in additional tax revenue in the 2025/26 fiscal year, increasing to $247 million in the 2026/27 fiscal year. Projected to over ten years, the additional GST collected in the 2031/32 fiscal year is approximately $400 million, with the revenue impact of the change growing steadily over the forecast outyears.

43. The forecast is based on December 2021 data published by the Financial Markets Authority about the manager's basic fee for each KiwiSaver and non-KiwiSaver fund. There are several key assumptions underlying the revenue forecast. These include:

    43.1 That all, or nearly all of the additional GST will ultimately be passed on to fund investors, including KiwiSaver members.

    43.2 Management fees charged to fund investors will continue to grow at 5% for 2022 and 10% per annum thereafter. This assumption is based on the dollar value of

[5] 331 KiwiSaver funds (operated by 39 KiwiSaver schemes) and 758 non-KiwiSaver managed funds.

basic manager's fees on KiwiSaver and Non-KiwiSaver managed funds growing by an annualised average of 20.6% for the three years between 31 December 2018 and 31 December 2021. A more conservative assumption of 5% for 2022 and 10% per annum for later years was used to account for recent investment returns which have been historically high, while the first four months of 2022 had negative investment returns, and that future contributions to KiwiSaver and other retirement schemes may be less as more investors reach retirement age.

43.3 That a manager currently incurs taxable inputs of 20% of the value of the management services they provide. In the future, a manager could claim the additional GST input deductions on their expenses and offset these deductions against the GST charged on their fees, resulting in less GST paid to the Crown.

43.4 The forecast does not consider any other second-order effects.

Implementation

44. The proposed rules do not create any material implementation costs to Inland Revenue.

45. The proposed rules will impose transition costs on affected fund managers and investment managers. These are outlined above.

Financial Implications

46. The proposed rules will result in approximately $37 million of additional tax revenue in the 2025/26 fiscal year, increasing to $247 million in the 2026/27 fiscal year. Projected to over ten years, the additional GST collected in the 2031/32 fiscal year is approximately $400 million, with the revenue impact of the change growing steadily over the forecast outyears.

47. The additional GST revenue collected will not be directly recognised on allowances and instead will ‘flow-through’ to future tax revenue forecasts. The Treasury will advise Ministers on the impact of this additional tax revenue alongside other economic and fiscal considerations when setting future allowances.

Legislative Implications

48. Implementing these proposals requires changes to the Goods and Services Tax Act 1985.

49. If approved, I propose including the legislative changes resulting from these recommendations in the upcoming omnibus taxation bill, scheduled for introduction in August 2022.

Impact Analysis

Regulatory Impact Assessment

50. The Quality Assurance reviewer at Inland Revenue has reviewed the regulatory impact assessment prepared by Inland Revenue and associated supporting material, and:

50.1 The Quality Assurance reviewer at Inland Revenue has reviewed the *GST on management services supplied to managed funds* Impact Summary and considers that the information and analysis summarised in it meets the quality criteria of the Regulatory Impact Analysis framework.

50.2 This issue has been subjected to wide consultation, including through a public issues paper. As identified in the Key Limitations or Constraints on Analysis section, a difficulty with assessing the revenue implications of the various options has been establishing the managed funds' likely responses/behavioural changes to GST changes, and the extent to which deductions are currently being claimed on the various input costs associated with providing management services to the managed funds.

Climate Implications of Policy Assessment

51. The Climate Implications of Policy Assessment (CIPA) team has been consulted and confirms that the CIPA requirements do not apply to this proposal as the threshold for significance is not met.

Population Implications

52. There are no population implications arising from these proposals.

Human Rights

53. The proposal does not give rise to any human rights implications.

Consultation

54. The initial problem definition and proposed rules were consulted on as part of the release of the *GST Policy Issues: an officials' issues paper* in February 2020. Officials received 11 written submissions on the proposals. Stakeholder views were mixed

55. The large managed funds (represented by the Financial Services Council) view the proposal as their least preferred option, as it would apply 15% GST to the fund manager and investment manager fees charged to their managed funds. Their preferred option is legislating the status quo, as this will impose no material transition costs and no additional cost on their fund investors.

56. However, the boutique managed funds (which are much smaller in comparison) prefer the proposed rules, as they believe these rules will provides a level marketplace with their competitors.

57. The Treasury, the Ministry of Business, Innovation and Employment, and the Financial Markets Authority were consulted throughout the policy development process and in preparation of this paper.

58. The Ministry of Business, Innovation and Employment considers the proposal will have a significant impact on the fees paid by retail investors in managed funds and therefore investment savings outcomes over time, notably in KiwiSaver. Investment fund fees in KiwiSaver are highly relevant when research shows there are issues around retirement savings adequacy for many New Zealanders. While MBIE acknowledges some

inconsistency and complexity with the status quo, the impacts of these are not clear and should be weighed carefully against the likely significant costs of the proposal.

59. The Financial Markets Authority notes that value for money in the fund management sector has been a significant area of its focus in recent years. Overall, fees for KiwiSaver schemes have fallen by 0.15% or 15 basis points over the past two years. The Financial Market Authority's view is that the increased costs of GST will be passed onto members in the form of increased fees.

60. Modelling by the Financial Markets Authority shows that the proposed approach will lead to KiwiSaver fund balances being reduced by $103 billion by 2070 (KiwiSaver balances of $2,196.9 billion), while fund balances for non-KiwiSaver managed funds would be lower by $83 billion (fund balances of $1,757.05 billion).

Communications

61. I will make an announcement on the contents of the Bill, including this proposal, when the bill is introduced. A commentary on the Bill will also be released at this time. Inland Revenue will include details of the new legislation in a *Tax Information Bulletin* after the Bill is enacted.

62. Some managed funds, as well as their fund managers and investment managers will oppose the proposed rules as the additional GST cost charged to them will be an increased cost to their business (because this GST cost cannot be claimed back). This will likely result in a mix of the fund manager and investment manager absorbing a portion of the GST cost due to commercial pressure, and a portion of the additional GST cost flowing through for retail investors, such as KiwiSaver members, in the form of higher fees.

Proactive Release

63. I propose to delay the proactive release of this Cabinet paper, associated minutes, and key advice papers with appropriate redactions until the introduction of the bill. The expected introduction date for this Bill is August 2022.

Recommendations

The Minister of Revenue recommends that the Cabinet Economic Development Committee:

1. note that the current rules are creating complexity and inconsistency across the managed funds industry.

2. agree to provide consistency by requiring fund manager and investment manager fees to be subject to 15% GST.

3. agree that the recommendation apply from 1 April 2026 (approximately 36 months after enactment).

4. note the recommended changes will adversely impact KiwiSaver members by reducing their retirement savings in both KiwiSaver schemes and non-KiwiSaver funds, which investors may have invested in to save for their retirement.

5. note the recommended changes has the following estimated fiscal impact within the forecast period, with a corresponding impact on the operating balance and net debt:

	$m – increase/(decrease)				
Vote Revenue **Minister of Revenue**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**2026/27 & outyears**
Tax Revenue	**-**	**-**	**-**	**37.000**	**247.000**
Total Operating	**-**	**-**	**-**	**(37.000)**	**(247.000)**

6. agree not to directly recognise any impact on allowances at this time as a result of this change.

7. note that officials will report back when developing the Budget Policy Statement with further advice on managing the aggregate effect of recent tax policy changes.

8. agree the legislative amendments to the Goods and Services Tax Act 1985 required to give effect to the recommended changes in this paper be included in the next omnibus tax bill currently scheduled for introduction in August 2022.

9. authorise the Minister of Revenue, in consultation with the Minister of Finance, to make final policy decisions, in line with these recommendations.

Authorised for lodgement

Hon David Parker
Minister of Revenue

Appendix 1 - Illustrative examples of potential upper-limit impacts on fees and future balances

Assume the fund is purchasing management services which are currently treated as being 90% exempt, 10% subject to GST (GST is effectively 1.5% on management services) and that management fees comprise 90% of the fund's total fees (the other 10% are administration fees).

Also assume the retail investor's balance grows by 5% in 2022 and 10% each year thereafter (before fees) as they continue to regularly contribute funds and reinvest returns.

Investor with $37,500 in a fund with a 0.8% annual fee

A retail investor with $37,500 invested in a fund that charged a 0.8% fee under the status quo (option 1) would currently pay a $300 annual fee. Under the proposed reform (option 2), and assuming the GST costs were fully passed through to the retail investor, their fee could increase by up to $29, to become $359 for the first year after the reform.

After 25 years of regular contributions and reinvesting, the investor would have had a $338,530 balance under the status quo and a $332,040 balance under the proposed reform, a reduction of $6,490.

Investor with $100,000 in a fund with a 1% annual fee

A retail investor with $100,000 invested in a fund that charges a 1% fee would pay a $1,000 annual fee under the status quo. Under the proposed reform, their annual fee could increase by up to $96, to become $1,194 for the first year after the reform.

After 25 years of regular contributions and reinvesting, the investor would have had a $862,308 balance under the status quo and a $841,128 balance under the proposed reform, a reduction of $21,179.