POLICY AND REGULATORY STEWARDSHIP

Tax policy report: Cabinet paper – GST on fees charged to managed funds

Date:	26 May 2022	**Priority:**	Medium
Security level:	In Confidence	**Report number:**	IR2022/240 T2022/1190

Action sought

	Action sought	**Deadline**
Minister of Finance	**Agree** to recommendations	1 June 2022
Minister of Revenue	**Agree** to recommendations **Authorise** the lodgement of the attached Cabinet paper	1 June 2022 By 10:00 a.m., Thursday 16 June 2022

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
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26 May 2022

Minister of Finance
Minister of Revenue

Cabinet paper – GST on fees charged to managed funds

Executive summary

1. This report seeks final policy decisions on a suitable transition period before the agreed policy changes to the GST treatment of manager fees charged to managed funds (including KiwiSaver schemes) takes effect. Attached to this report is a draft Cabinet paper and Regulatory Impact Statement for the policy changes.

2. This report follows on from your decision in April to impose GST on fund manager and investment manager fees charged to managed funds (IR 2022/152, T2022/848 refers). The policy changes will apply a consistent GST treatment of 15% GST on fund manager and investment manager fees charged to managed funds.

3. The key outstanding decision is regarding when the policy changes should take effect (the application date). This report provides advice on either a 1 April 2025 (24-month) or 1 April 2026 (36-month) application date after enactment, likely to be before 1 April 2023.

4. As noted in the earlier report, for many fund managers and investment managers, adopting the new rules will impose significant transition costs on them, at a time where they are already facing transition costs for other high priority regulatory changes.

5. The fiscal impacts of the decision on application date depends on the chosen transitional period. Assuming a two-year transition period, the likely increase in revenue from this change would be approximately $34 million in 2024/25 and $225 million in 2025/26, with the revenue impact growing by approximately 10% per annum going forward. With a three-year implementation period, the revenue impact has a similar size and profile, but is delayed by a year. Rather than immediately recognising the impact on Budget allowances, we recommend providing further advice on this as part of the development of the Budget Policy Statement later this year.

6. If you agree with the recommended option of 1 April 2026 following enactment, we recommend you approve the attached Cabinet paper and lodge it with the Cabinet Office by 10am Thursday 16 June 2022 for consideration at the Cabinet Economic Development Committee (DEV Committee) meeting on Wednesday 22 June 2022. If you agree to an application date of 1 April 2025, we will provide your office with a revised draft Cabinet paper as soon as possible.

7. Once Cabinet approval has been obtained, the legislative amendments would be included in the next available omnibus taxation bill currently scheduled for introduction in August 2022.

Background

8. On 12 April 2022, we reported to you on the issue of how GST should apply to fund manager and investment manager services provided to KiwiSaver schemes and other managed funds (IR2022/152, T2022/848 refers).

9. The report outlined the problem that the current GST treatment of these manager services can vary, with some being inconsistent with current GST laws and potentially distorting market competition.

10. The report provided advice on two different policy options:

    10.1 **Retain the status quo** and legislate to allow for the current practices to continue (100% exempt, 90% exempt/10% taxable, or 100% taxable treatment). The Financial Services Council (who represents large fund managers) preferred this option.

    10.2 **Making these services subject to 15% GST**. A group of boutique fund managers preferred this option.

11. We recommended the option to subject the fees to 15% GST, as it would reduce compliance costs, improve integrity, and ensure consistency across the industry. However, the option would lead to higher fees for savers, such as KiwiSaver members, and would impose significant transitional costs.

12. You agreed to subject these fees to 15% GST and agreed in principle to an adequate transitional period (such as 24-36 months after enactment) to mitigate the transitional costs.

Key concerns raised by stakeholders

13. As explained in the earlier report, the decision to impose 15% GST on fund manager and investment manager fees charged to managed funds will have several adverse impacts.

14. We expect that charging more GST to managed funds will increase the fees charged to retail investors, including KiwiSaver members. To the extent the fees increase, this will reduce after-fee returns and therefore the total amounts that are reinvested and, ultimately, future retirement balances[1].

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

16. 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 to reinvest a managed fund into an overseas fund, we believe it is unlikely a significant number of managed funds will relocate outside New Zealand in the short-to -medium term.

Application date

17. As noted in the earlier report (IR2022/152, T2022/848 refers), the decision to impose 15% GST would impose significant transition costs for affected[2] fund managers and investment managers. For many of these financial institutions, they are already being required to implement many other regulatory changes, such as the climate reporting disclosures, introduction of the Conduct of Financial Institutions regime, and proposed changes to anti-money laundering rules.

[1] Management fees are set as a percentage of the fund member's total balance.

[2] Those fund managers and investment managers that are required to transition from a 100% exempt or 90% exempt/10% taxable, to 100% taxable and applying 15% GST to all fees.

18. Of the transitional costs incurred[3], the changes to the IT systems (often involving multiple layers of legacy IT systems) are likely to require the most time to prepare and implement the changes, especially for funds owned by banks. This issue is compounded because these financial institutions already have several new high priority regulatory programmes and regimes to implement in the short term[4].

19. To ensure it is viable for funds and service providers to implement the new GST rules, while minimising the transition costs (as these costs will likely be passed onto fund members, including KiwiSaver members), a reasonable transition period is required.

Stakeholder views

20. Stakeholders have mixed views on the time required to implement the new GST rules. The Financial Services Council have previously told us that impacted service providers and managed funds would require a three-to-five-year transition period, whereas other service providers and funds, who are largely unaffected by the changes, have told us they would expect it would require less time for the industry to implement the new rules.

21. Officials from both the Ministry of Business, Innovation and Employment (MBIE), and the Financial Markets Authority (FMA) have recommended a minimum 3-year transition period. They've told us the scope and pace of regulatory change is already being raised as a significant issue by the NZ financial service industry. We are unable to accurately determine whether the industry has excess capacity to absorb additional regulatory change, in the short-to -medium term.

22. MBIE and FMA note that for larger fund managers, they are facing a significant number of regulatory changes in several areas over the next few years, including banking and insurance regulations, financial advice and cash system changes. The nature of any regulatory change means their business-as-usual operations are disrupted, including their ability to invest and deliver their own product and service innovations that usually benefit their consumers.

23. Previous tax policy changes involving the banking and financial industries have generally had an implementation period of up to two years after enactment, however some projects have grandparented existing rules for up to five years. Each change and the transition period required have been considered on its merits.

24. Given both MBIE and FMA recommendations align with the industry's view that the new rules change would require minimum three years to implement, it does suggest that a shorter time period would place additional risk, pressure and cost on affected managers and funds to deliver the required changes.

Fiscal impact of transitional period options

25. Other than transition costs, the main trade-off between a two-year transition period and a three-year transition period is that a two-year transition period would start collecting additional GST revenue one year earlier. This results in more revenue falling within the forecast period if a shorter transition period is agreed.

26. The fiscal impact of these options should be considered in light of your wider fiscal and policy objectives.

[3] These transition costs include IT systems, appoint new service providers or renegotiate commercial contracts, update investor disclosure statements, prepare public communications, and responding to increased contacts from customers.
[4] Including climate reporting disclosures, changes to the anti-money laundering rules, and the introduction of the conduct of financial institutions regime (CoFI).

Recommendation

27. In light of this combination of factors, Inland Revenue recommends you approve an application date of 1 April 2026, providing an approximately three-year transition period after enactment (likely to before 1 April 2023).

28. Treasury also agrees that a three-year transition period is likely to minimise transition costs for industry on the basis of advice from MBIE and the FMA, but notes that doing so would reduce the revenue gained in the forecast period by around $220 million. It therefore considers it a more balanced judgement based on whether you weight minimising those transition costs or realising a near-term fiscal benefit more highly.

29. While a three-year transition period is longer than many other tax policy changes that impose implementation costs on affected stakeholders, there are precedents for transition costs involving the banking and financial sector to be considered on their individual merits. These include the 2021 unclaimed monies changes providing a two-year transition period (subject to Inland Revenue approval), 2018 BT investment income changes providing a two-year transition period and the 2010 life insurance reforms were subject to various transitional rules for up to five years.

Financial implications

30. Since our earlier report, we have further developed our fiscal forecast, including incorporating updated managed fund data and revised assumptions. Further advice is also provided on managing the fiscal impacts against forecasts and allowances.

31. Assuming a two-year transition period, the likely increase in revenue from this change is now $34 million in 2024/25 and $225 million in 2025/26, with the revenue impact growing by approximately 10% per annum going forward. With a three-year implementation period, the revenue impact has a similar size and profile, but is delayed by a year.

32. We will immediately recognise the impact on tax forecasts if Cabinet agrees to the policy change. However, we propose to advise on whether to recognise any allowance impacts as part of the process of setting Budget allowances through the Budget Policy Statement. That would allow the allowance impacts of this and other tax policy changes to be consider in aggregate, alongside other economic and fiscal considerations.

New data

33. We have updated our forecast model using recently published Financial Markets Authority managed fund data, for the quarter ending 31 December 2021.

Revised assumptions

34. Currently, some fund managers and investment managers can only claim a certain proportion of the GST incurred on their expenses because most of the fees charged are GST exempt. We believe the remaining unclaimed GST is instead being incurred as a business cost to the manager and consequently charged as higher fees to the managed fund.

35. Under the new rules, managers will be able to claim back all of their GST incurred on their expenses. These additional GST deductions will offset against the GST charged on the fees, resulting in less GST paid to the Crown. The forecast now includes an assumption that managers incur taxable inputs of 20% of the value of the fees they provide to the funds. This assumption was informed by financial

information contained in the 2021 annual report of the Guardians of New Zealand Superannuation.

36. In addition, the original forecasts assumed a 10% per annum growth rate in the value of the affected management fees, which is conservative compared to the 20% per annum growth rate observed between 2018 and 2021. However, the new forecast now assumes a lower 5% growth rate for 2022 to reflect the fact that managed funds have generally experienced strongly negative investment returns for the first four months of 2022.[5] After 2022, a 10% per annum growth rate for fees is assumed.

37. The result of these new assumptions is the additional GST revenues that the proposal would collect have been revised downward, compared to our earlier advice.

Application date

38. As explained above, we are recommending an application date of 1 April 2026 (36-month transition period). If you agree to this application date, the additional GST will be collected from 1 April 2026 (2025/26). However, if you decide to proceed with an application date of 1 April 2025 (24-month transition period), then the additional GST collected will begin from 1 April 2025 (2024/25).

39. With a 1 April 2026 application date (Inland Revenue, Financial Markets Authority and MBIE recommendation), our current best estimate of the fiscal impact of the changes are the revenue gains shown in the following table:

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**2026/27**
Tax Revenue	-	-	-	37.0	247.0
Total operating	-	-	-	(37.0)	(247.0)

40. As noted above, the revenue impact in outyears would likely grow by approximately $30 million each year.

41. However, if you decide to proceed with a 1 April 2025 application date, our current best estimate of the fiscal impact of the changes are the revenue gains shown in the following table:

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**2026/27**
Tax Revenue	-	-	34.0	225.0	247.0
Total operating	-	-	(34.0)	(225.0)	(247.0)

42. The same assumptions about the likely growth in the revenue impact would apply regardless of the application date. Projected 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 beyond this period.

[5] The total value of funds under management is still expected grow during 2022 and future years because of regular contributions to the managed funds exceed withdrawals.

Managing against forecasts and allowances

43. There are various options for managing the fiscal impact of these changes, regardless of the application date chosen.

44. Officials recommend not immediately recognising any impact on Budget allowances as a result of this change. Additional tax revenue could allow Ministers to increase spending, pay down debt, or reduce taxes in other areas. We propose to advise on these broader choices as part of development of the Budget Policy Statement later this year, and will incorporate the fiscal impacts of this and other tax policy changes into that advice. This approach is consistent with how fiscally significant tax policy changes have been treated previously.

45. s 9(2)(f)(iv)

46.

Consultation

47. The Ministry of Business, Innovation and Employment and the Financial Markets Authority were consulted on the Cabinet paper and Regulatory Impact Statement, including the impacts on investors and the proposed transitional period.

Next steps

48. We have attached a draft Cabinet paper and Regulatory Impact Statement that reflects the recommendations in this and the April 2022 reports.

49. If you agree to the recommendations in this report, we recommend you approve and lodge the attached Cabinet paper with the Cabinet Office by 10am, Thursday 16 June 2022, for consideration at Cabinet Economic Development Committee's meeting on Wednesday 22 June 2022. If you agree to an application date of 1 April 2025, we will provide your office with a revised draft Cabinet paper as soon as possible.

50. If Cabinet agree to the policy changes, amendments to the Goods and Services Act 1985 could be included in the upcoming omnibus tax bill which is scheduled for introduction in August 2022.

Recommended action

We recommend that you:

1. **agree** to adopt one of these two options in respect of the application date:

   EITHER:

   Option 1: a delayed application date of 1 April 2026 (**approximately 36 months after enactment**) to provide time for affected providers to transition to the new rules. (*Inland Revenue's preferred option*);

   Agreed/Not agreed Agreed/Not agreed

   OR:

   Option 2: a delayed application date of 1 April 2025 (**approximately 24 months after enactment**) to provide time for affected providers to transition to the new rules.

   Agreed/Not agreed Agreed/Not agreed

2. **note** that Option 1 above 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	-	-	-	37.0	247.0
Total operating	-	-	-	(37.0)	(247.0)

   Noted Noted

3. **note** that Option 2 above 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	-	-	34.0	225.0	247.0
Total operating	-	-	(34.0)	(225.0)	(247.0)

   Noted Noted

4. **agree** to one of these two options in respect of managing the fiscal impact of the change:

   EITHER:

   Option 1: not to directly recognise any impact on allowances at this time as a result of this change and defer these choices to further advice on the Budget Policy Statement later this year (*The Treasury's preferred option*);

   Agreed/Not agreed Agreed/Not agreed

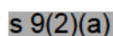
   OR:

   s 9(2)(f)(iv)

   Agreed/Not agreed Agreed/Not agreed

5. **authorise** and **lodge** the attached Cabinet paper with the Cabinet Office by 10am Thursday 16 June 2022, for consideration by the Cabinet Economic Development Committee.

Authorised and lodged



s 9(2)(a)

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