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This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Coversheet: **Taxing financial services**

Discussion Paper for Session 11 of the Tax Working Group
June 2018

Purpose of discussion

This paper responds to the Group's request for advice on options for applying GST to financial services. The paper outlines the current GST treatment of financial services, the problems created by the current treatment and considers options for applying GST to financial services and the respective costs and benefits of these options.

Key points for discussion

- The Secretariat's view is that the options for applying GST to financial services are risky. The benefits of applying these options are unlikely to outweigh the costs. Does the Group agree with the Secretariat's assessment?

- Any changes will require further work and consultation to determine feasibility and impacts. This additional work will require significant policy resource and will not be feasible to complete within the Tax Working Group's timeframes.

- How does the Group wish to deal with this issue in the Interim Report? Options for the Interim Report include:

  - directional recommendations regarding the outcomes that the Government should seek to achieve;
  - a broad indication of options that could be subject to further analysis and consultation; or
  - do not cover in the Interim Report.

Recommended actions

We recommend that you:

a **Note** the Secretariat's view that options for applying GST to financial services are risky and the benefits are unlikely to outweigh the costs.

b **Indicate** how the Group wishes to deal with this issue in the Interim Report:

i. high-level directional recommendations;
ii. broad range of policy options; or
iii. do not include in the Interim Report.

Taxing financial services

Discussion Paper for Session 11
of the Tax Working Group

June 2018

Prepared by the Inland Revenue Department and the Treasury

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Executive Summary

The Group has requested advice on options for applying GST to financial services, including a financial activities tax as proposed by the International Monetary Fund.

Financial services are the services financial institutions such as banks provide in assisting borrowers, depositors and other customers to undertake financial transactions. In principle, these services should be subject to GST under our broad-base low-rate GST framework as they are services consumed in New Zealand.

Under our current GST rules however, these services are exempt from GST. This is due to the difficulty in valuing financial services when the majority of financial institutions charge for the services through interest rate margins (i.e. they pay depositors less interest than they charge borrowers). The current exempt treatment has costs. It results in under-taxing financial services provided to consumers. This has associated fairness as well as efficiency costs.

The key issue for financial services is whether there is a feasible method for applying GST to financial services where the costs of the option do not outweigh the benefits. This paper considers four options:

1. ***Cash flow method:*** GST registered businesses (including financial institutions) charge GST on all cash they receive for financial services, and claim input credits for all cash they pay out for financial services. The cash flows that are subject to GST include the interest payments as well as principle and repayments of principle.
2. ***Margin methods:*** GST registered businesses (including financial institutions) calculate the financial margin for every financial transaction and then apply GST to this margin.
3. ***Financial activities tax:*** Financial institutions are taxed on the sum of their cash flow profit and wages. This is intended to be a proxy for applying GST to financial services.
4. ***Apportioned financial activities tax:*** Financial institutions are taxed on the sum of their cash flow profit and wages; however, this is apportioned so that only the profit and wages attributable to consumer services are taxed. This is intended to be a proxy for applying GST to financial services.

All of these methods have trade-offs. The financial activities tax is relatively simple. However, it comes with significant costs as it creates tax cascades. These tax cascades are not consistent with horizontal equity and have significant costs for efficiency and productivity. Due to these costs, we would not recommend the financial activities tax.

The remaining three options avoid tax cascades. However, they are complex and come with potentially high compliance and administration costs as well as transitional issues. They also create risks that the tax will be avoided through obtaining financial services overseas. Internationally no country applies these methods and there are considerable risks if New Zealand is the first to adopt these.

As a result, if the Group wishes to include this issue in the Interim Report, the Secretariat would recommend the Group focus on high-level directional recommendations.

If the Group wishes to recommend potential changes, the Secretariat would suggest the Group recommend that the Government undertake further work and consultation on these options. Developing these options further would require significant policy resource and will not be feasible to complete within the Tax Working Group's timeframes.

1. Introduction

1.1 Purpose

1. This paper responds to the Group's request for advice on options for applying GST to financial services including consideration of the International Monetary Fund's proposal in 2010 to introduce a Financial Activities Tax (FAT) as a proxy for GST on financial services (International Monetary Fund, 2010).

2. This paper considers the application of a FAT solely as a mechanism to address under-taxation of financial services under our GST system. The International Monetary Fund also outlined a FAT that taxed economic rent in the financial sector as well as bank levies to fund the cost of financial sector bailouts. These are not considered in this paper.

3. The Secretariat has prepared a separate paper that considers financial transaction taxes.

1.2 Content and scope

4. Part 2 outlines the current GST treatment of financial services and its rationale, and considers the problems created by the current treatment.

5. Part 3 provides a summary of the options for applying GST to financial services.

6. The Appendix provides more detail on how the options would apply.

7. This paper considers GST on financial services at a relatively high level and uses simple example scenarios which focus on deposits and loans for banking institutions. Financial services encompass a wide range of other transactions such as derivatives or share transactions which are not focused on in this paper.

2. Background

2.1 Background

8. GST is a broad-based tax that is intended to apply to all consumption of goods and services in New Zealand. Under our broad-base low-rate GST framework, financial services should, in principle, be subject to GST[1].

9. Financial institutions such as banks provide their customers with a return on their savings and a range of other services. For example, in the case of banks when a depositor places money in a bank they do so partly because a bank provides a safe place to store their money and a convenient means to access and spend the money. When a person borrows money from a bank, the bank provides a service by connecting the borrower to the holders of capital. As a result, financial services are services consumed in New Zealand and in principle should be subject to GST the same as all other services consumed in New Zealand.

10. As GST is a consumption tax it should not apply to savings. Savings represent deferred consumption, and taxing them would involve taxing consumption twice. Instead, it is the financial margin that financial institutions earn that should be subject to GST. The difficulty with taxing these are that the savings and financial margin are often bundled making it difficult to isolate the financial margin.

Example – what is the financial margin we should be applying GST to?

Take a simple scenario in which a person borrows $100 from a bank at an interest rate of 15%. The bank borrows money at a rate of 5% to provide this lending.

When the person pays $15 of interest in the following year, $5 of this represents the cost of funds for the bank (or the interest paid to the depositor), while $10 represents the service the bank provided (excluding any risk premiums).

In principle, GST should apply to the $10 of services the bank provided.

11. Due to these difficulties, under current rules the financial services are 'exempt' from GST. Applying GST on financial services would be a relatively simple task if fees were charged for all financial services. However, it is difficult to apply GST when the charge for financial services forms part of the interest rate margins

[1] Some academics such as (Grubert & Mackie, 2001) and (Jack, 2000) have argued a contrary position to this. The argument raised is that financial services act solely as a means to facilitate a change in when a consumer undertakes consumption. This they argue is not consumption, should not be subject to GST, and taxing it would result in distortions. However, this view has been challenged and is not considered the prevailing view (KPMG, 2011), (Auerbach & Gordon, 2002) (Mirrless, et al., 2011). These authors note that financial services need to be considered separate to the savings they facilitate and that these services provide value add which GST should apply to.

2.2 How the current rules work

What is a financial service?

12. The following are considered financial services in New Zealand's GST rules.

- paying or collecting any amount of interest;
- mortgages and other loans;
- bank fees;
- securities such as stocks and shares;
- providing credit under a credit contract;
- exchanging currency
- arranging or agreeing to do any of the above (for example, mortgage broking);
- financial options;
- provision or transfer of ownership of a financial option;
- life insurance;
- deliverable future contracts; and
- non-deliverable contracts.

13. For the purposes of this paper, any reference to financial services is a reference to these services.

Exemption and zero rating of financial services

14. The current rules are as follows:

- Financial services to *consumers* are exempt from GST (i.e. they are input taxed). This means that financial institutions cannot claim GST back on inputs attributable to services to consumers (such as rent, advertising, computers or contractors).

- Financial services to *businesses* are zero rated (i.e. they are GST free).

- The zero rating of financial services to businesses is intended to ensure that GST does not become a cost to business. Input taxing financial services to businesses could otherwise result in tax cascades where GST applied multiple times during the production process. However, there is no empirical evidence on whether the benefits of zero rating are fully passed through to businesses. It is possible that the benefit is spread across business and non-business customers.

15. When an input is used for services to both consumers and businesses the financial institutions must undertake an apportionment exercise. The methodology for this apportionment is complex, and looks at the net margins earned for revenues from services to businesses compared with consumers[2].

[2] The apportionment methodology only looks at the respective revenue from interest paid and the financial services provided to borrowers. As a result, the financial service provided to depositors will not be considered in the methodology and therefore the apportionment methodology has some inaccuracies.

2.3 Problem caused by the exemption

16. The exemption for financial services reduces efficiency, revenue, and horizontal equity. It also increases compliance costs. These impacts are considered in greater detail below.

Revenue impact

17. The exemption reduces tax revenue. Australia estimates that their GST exemption for financial services results in a loss of revenue of $3.2 billion for the 2016-17 financial year. This is approximately 5.1% of Australia's GST revenue. The Secretariat is currently preparing a high-level estimate of the revenue foregone in New Zealand by exemption, and is working to provide this to the Group before its next meeting.

Fairness

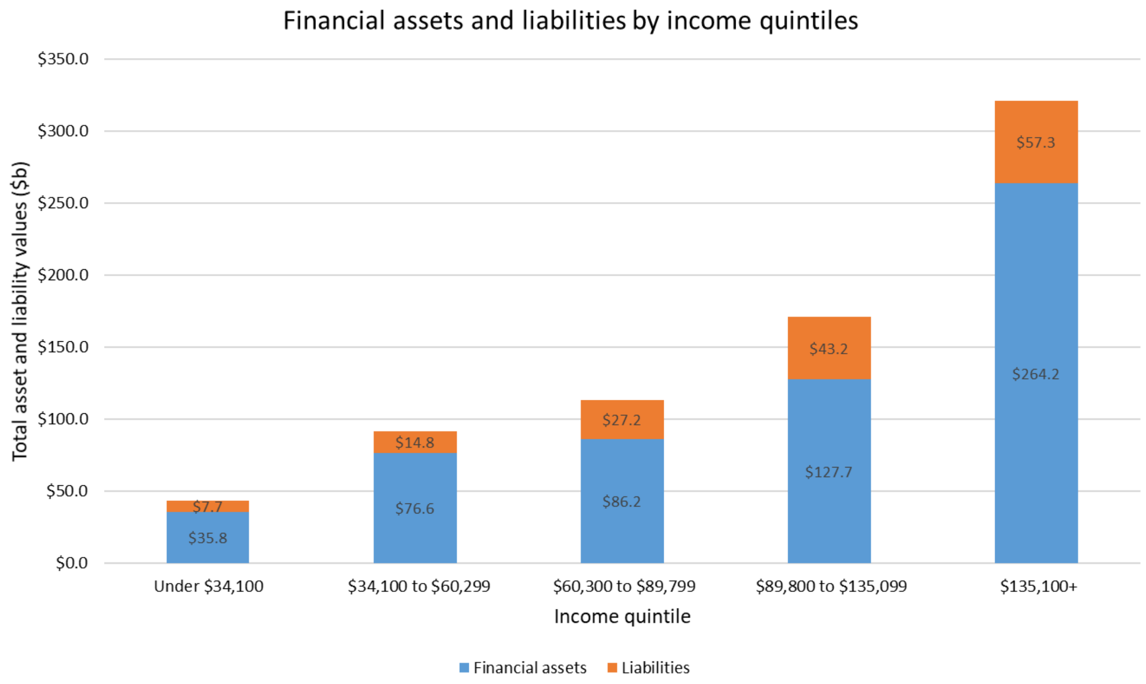
18. The exemption does not follow the principal of horizontal equity as financial services are under-taxed relative to other services.

19. International research indicates that taxes such as bank levies or taxes on financial margins are fully or partially passed on to customers. For example (Huang & Liu, 2009) finds that the introduction of GST (and input taxation of financial services) in Australia resulted in an increase in mortgage rates of 52.4 basis points (0.524%). This indicates that some of the cost of GST is likely to be passed on to customers of financial institutions[3].

20. The rate of pass through will depend on the respective market structures and elasticities for financial services. (Kogler, 2016)

21. The exemption benefits households, who consume financial services, but the incidence of the benefits is not straightforward to determine and so the impact on vertical equity is unclear. Financial assets and liabilities are mostly held by high-income households (see chart below), but financial institutions may earn higher margins on financial services to lower income households. Consequently, it is difficult to ascertain whether the exemption primarily benefits higher- or lower-income households.

[3] Other evidence of the pass through of taxes on bank include research on a tax on large Tokyo banks based on their financial margins. This research indicated that the tax resulted in significant increases in interest charged and reductions in deposit rates for the banks affected (Banerji, Chronopoulos, Sobiech, & Wilson, 2016). The pass-through was higher for customers dependent on bank financing (Imai & Hull, 2012). Bank levies imposed in Europe have been shown to have passed through to consumers, with the amount of pass through being variable (Kogler, 2016) and modelling of VAT in Europe using bank-level data indicates that VAT in Europe has, to some extent, been passed on to bank customers (Chiorazzo & Milani, 2011).



(Statistics New Zealand, 2016)

Efficiency

22. The current exemption creates 3 main distortions:

- The exemption creates 'in-source bias.' This distortion arises because financial service providers are charged unrecoverable GST on services provided by third parties. The provider will not bear this GST cost if it carries out those services itself, so there is an incentive for financial institutions to in-source production[4].

- The in-source bias creates an incentive for financial institutions to vertically integrate, and become larger than they would otherwise be without the exemption.

- The exemption subsidises financial services. Consumers have an incentive to utilise financial services over other goods and services. The extent of the subsidy depends on the degree of pass through of the GST exemption.

[4] We are not aware of any empirical evidence of the degree of this distortion.

Example – in-source bias

A financial institution needs IT support services. They have two options for obtaining these services:

- they can hire an external agency to provide the service at a cost of $1m plus $150k GST; or
- they can hire employees to undertake the services at a cost of $1.1m in wages.

In the absence of GST, the financial institution would choose to hire the external agency to provide these services.

When GST is applied, and assuming all of the GST is not recoverable, the financial institution will choose to hire employees to undertake the services instead. As a result the application of GST and the exempt treatment of financial services results in an incentive to in-source production.

Compliance and administration costs

23. The boundary between exempt and non-exempt services is complex. The apportionment of inputs is resource-intensive for both financial institutions and Inland Revenue.

24. However, the options for applying GST to financial services considered in this paper are also complex. As a result, the status quo potentially has lower compliance and administration costs when compared with the options outlined in this paper.

Savings rates

25. The current exemption from GST subsidises services that help consumers to save as well as to borrow and invest. As a result, it likely increases the amount of private savings in New Zealand overall. However, the extent of this impact is unclear and would depend on the incidence of the exemption as well as the behavioural impact a subsidy would have.

Public submissions

26. Four submitters supported the application of GST to financial services. These submitters noted that financial services are currently under-taxed and considered that there were feasible options for applying GST to financial services such as a financial activities tax *(Association of Salaried Medical Professionals, Dr Simon Chapple, New Zealand Council of Trade Unions, Public Services Association).*

27. Four submitters opposed the application of GST to financial services. These submitters considered that doing so would be technically complex, would create a number of difficulties and would negatively affect retirement savings *(BNZ, EY, KPMG, Mercer)*. One submitter considered that a financial activities tax would involve an element of estimation or speculation and as a result would be unfair *(KPMG).*

3. Options

3.1 Options

28. The key question for analysis is not whether GST *should* apply to financial services, but rather whether there is a *feasible option* for achieving this that do not create costs greater than the benefits.

29. There are four main options:

    1. ***Cash flow method:*** GST registered businesses (including financial institutions) charge GST on all cash they receive for financial services, and claim input credits for all cash they pay out for financial services. The cash flows that are subject to GST include the interest payments as well as principle and repayments of principle.
    2. ***Margin methods:*** GST registered businesses (including financial institutions) calculate the financial margin for every financial transaction and then apply GST to this margin.
    3. ***Financial activities tax:*** Financial institutions are taxed on the sum of their cash flow profit and wages. This is intended to be a proxy for applying GST to the financial service.
    4. ***Apportioned financial activities tax:*** Financial institutions are taxed on the sum of their cash flow profit and wages; however, this is apportioned so that only the profit and wages attributable to consumer services are taxed. This is intended to be a proxy for applying GST to the financial service.

30. Further detail of these is in Appendix 1.

31. All of the options help address the under-taxation of financial services. To different degrees they reduce the negative impact that the current GST exemption has on horizontal equity and remove the efficiency cost of the in-source bias and overconsumption of financial services.

32. The incidence of all of these options would be on financial institutions as well as consumers of financial services. As a result, the options would likely reduce private savings. As noted above it is difficult to determine the extent of this.

33. However, the design details of each option change the cost and benefits significantly. The main trade-off between each of the options is between simplicity and accuracy. These design details mean that the benefits of the options do not necessarily exceed the costs.

34. A summary of these costs and benefits is provided below.

International issues

35. In addition to these general trade-offs, there is a concern that the options could result in consumers acquiring financial services directly from overseas financial institutions

to avoid GST. This issue arises as it is probably only feasible for these options to be applied to domestic financial institutions.

36. This is similar to the challenges faced in applying GST to online services. However, the solution for GST and online services (and proposed for imported low-value goods) is probably not feasible for financial services. This is because applying GST to online services relies on the simplicity of applying GST to these, as well as the willingness of service providers to comply with the rules. This is less likely to be the case with the above options.

37. Most of New Zealand's major financial institutions are subsidiaries of Australian parents. This increases the risk that these businesses could potentially restructure to provide financial services to New Zealand customers from Australia if New Zealand's GST rules were reformed to tax financial services. Existing regulatory requirements for financial institutions in New Zealand could constrain the ability for financial institutions to undertake this restructuring exercise and mitigate this risk. However, the full impact of this would require further research.

38. Appendix 2 outlines the international methods of taxing financial services. Few countries tax financial services comprehensively. The countries that tax financial services either partially tax them, or use proxy methods similar to a financial activities tax.

39. Because no country taxes financial services comprehensively, this means there is significant risk in New Zealand being the first to adopt one of these measures. The measures are untested and the full impacts of them are unclear.

Option 1: Cash flow method

40. GST registered businesses (including financial institutions) charge GST on all cash they receive for financial services, and claim input credits for all cash they pay out for financial services. The cash flows that are subject to GST include the interest payments as well as principle and repayments of principle.

Benefits of cash flow method

41. The main benefit of the cash flow method is that it results in an accurate amount of GST being paid on a net present value basis. This means that it fully meets the horizontal equity objectives and removes the negative efficiency costs created by the current exemption.

42. In addition, GST can be applied on a transaction-by-transaction basis. This means it is able to be integrated into our current credit-invoice system for GST and avoids tax cascades.

Downsides of cash flow method

43. The option has three main downsides[5]. The first is compliance costs. This option would create a GST requirement for all domestic financial transactions and inbound GST transactions. This may put strain on financial institutions compliance mechanisms and require potentially complex IT system upgrades for all financial institutions. The wide nature of the option may also create strains for Inland Revenue to administer and enforce.

44. The second concern is transitional. The option results in the right amount of GST being paid if all cash inflows and outflows have GST applied to them. On introduction, this will not be the case, as GST will not have applied to transactions before the application date. This would lead to a windfall gain for those with savings and a windfall loss for those with liabilities on introduction. This could potentially be counteracted with a windfall tax; however, in practice this could be difficult.

45. The third is revenue risks. The option leads to large amounts of GST input credits being available for cash outflows. This raises the risk that some taxpayers may create arrangements to claim large amounts of input credits, and then not pay the corresponding output tax. Similar issues have arisen in the past with GST and land and the risks are potentially greater for financial services as financial transactions have lower transaction costs.

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[5] An additional concern is sometimes raised that the option would create cash flow difficulties for businesses as they need to raise an additional 15% of funding for loans to meet the GST cost. However, this is not likely to be a significant concern. For example, if a business borrows $1,000 (excluding GST) from a bank then they will have an immediate output tax liability of $150 which causes the raised cash flow concern. However, the bank should be willing to lend an additional $150 to fund this liability as they will be able to immediately claim a $150 input credit for the loan. As a result, this factor was discounted by (Mirrless, et al., 2011).

Option 2: Margin method

46. GST registered businesses (including financial institutions) calculate the financial margin for every financial transaction and then apply GST to this margin.

Benefits of margin method

47. The main benefit of the margin method is that it results in an accurate amount of GST being paid, so long as a correct method for determining the financial margin is used. If accurate, it will remove the distortions created by the current GST exemption and remove horizontal equity concerns. The option attributes financial services on a transaction-by-transaction basis and therefore is able to be integrated into a credit-invoice GST system.

48. An advantage of the margin method over the cash flow method is that it smooths out the payment of GST. This mitigates the transitional and revenue integrity issues with the cash flow method.

Downsides of margin method

49. The margin method has two downsides. The first is that it is complex and comes with high compliance and administration costs. The option requires calculating the financial margin for all financial transactions and applying GST to this amount. This faces similar concerns to the cash flow method but with greater complexity.

50. During 1995-1996 a version of the margin method called the tax calculation account method was tested at ten large financial institutions in six countries in Europe. Overall the system was found to be conceptually robust and the costs of on-going operation were considered modest. However, there were a number of concerns and apprehensions about the system. This included the time and effort to transition to the system and the time and effort for financial institutions modify their computer system and set up accounting and information systems necessary to deal with the option. In addition, there was apprehension from financial institutions about revealing their financial margins and there were concerns about the amount of effort required to explain the system for their customers. We would note that that this study looked at the costs for financial institutions, while the option would also create compliance costs for all GST registered businesses (Huizinga, 2002) (Chronopoulos, Lucia Sobiech, & Wilson, 2017).

51. The second downside is that the method relies on an accurate calculation of the financial margin. Calculating financial margins is complex. There is no uniform margin across financial products and customers, and determining the margin on a transaction-by-transaction basis is difficult. An incorrect calculation of the margin can result in over-or under-taxation. This over-or under-taxation creates efficiency and fairness costs. For example, if the cost of lending interest rate was set above the true

interest cost, it would overcharge borrowers and under-charge depositors. This would not be consistent with horizontal equity and could distort decisions[6].

[6] It could also have fiscal implications. For example, if there are relatively higher numbers of businesses borrowers and consumer depositors, then overcharging services to borrowers would reduce the amount of revenue generated.

Option 3: Financial activities tax

52. Financial institutions are taxed on the sum of their cash flow profit and wages. This is intended to be a proxy for applying GST to the financial service.

Benefits of financial activities tax

53. The financial activities tax is the simplest of all the options. Financial activities taxes have been implemented overseas, although we are not aware of any evaluations of these. This option would help address the under-taxation of financial services and would help address the in-source bias created by exemption.

Downsides of financial activities tax

54. The main downside of this option is that it charges unrecoverable GST on services provided to businesses and therefore creates tax cascades. This is because a FAT taxes financial services provided to businesses. These businesses are not able to obtain credit for this tax paid and so it creates a cascade[7]. These cascades have significant negative effects.

55. Tax cascades do not align with horizontal equity. A tax cascade for financial services would result in effective tax rates being higher for goods and services provided by businesses which use financial services.

56. The IMF proposed to address this by having a lower FAT rate (for example a 7.5% rate rather than a 15% rate). However, this lower rate creates additional horizontal equity concerns. With a lower FAT rate consumer services will face under-taxation as the effective tax rate is lower than the GST rate. Services to businesses will continue to be overtaxed with a lower FAT rate. A lower FAT rate does not remove the issues with tax cascades; instead it just reduces the overall impact of a FAT, including both positive and negative impacts.

57. Tax cascades also have significant efficiency impacts. They result in discouraging businesses from acquiring financial services. This would discourage businesses from making what could otherwise be the most efficient business decisions.

58. Of potentially greater concern is that because an FAT applies to services provided to businesses it would increase the cost of borrowing for these businesses. Increasing the cost of borrowing will increase the effective interest rate for these businesses and this would likely decrease business investment and the capital intensity of New Zealand.

59. Decreasing capital intensity has negative implications for productivity and wage growth, in particular as New Zealand is relatively capital shallow. As a result, an FAT would have negative implications for productivity, growth and wages. (Conway, 2016) (Conway, Meehan, & Parham, 2015)

[7] This is explained further in Appendix 1.

Option 4: Apportioned FAT

60. Financial institutions are taxed on the sum of their cash flow profit and wages; however, this is apportioned so that only the profit and wages attributable to consumer services are taxed. This is intended to be a proxy for applying GST to the financial service.

Benefits of apportioned FAT

61. The apportioned FAT appears to be relatively simple as it can be done using information and systems that financial institutions already have in place. So long as the apportionment is correct, this option leads to the right amount of GST being paid and so can be considered reasonably accurate with the associated fairness and efficiency benefits.

Downsides of apportioned financial activities tax

62. The largest downside of this option is that the accuracy of it relies on the apportionment exercise accurately apportioning the financial margin between consumer and business services. Getting the apportionment wrong can result in under- or over-taxation of depositors and borrowers, leading to efficiency and fairness costs. There are some areas where it may be considered that the current methodology could be inaccurate[8].

63. In addition, Inland Revenue has noted that the current apportionment is a complex resource intensive task for financial institutions. Some financial institutions have historically taken conservative positions on this, due to them not having enough information to more precisely determine their apportionment. However, the accuracy has improved in more recent years.

64. One final consideration is whether the cost of the tax would be spread to all customers of financial institutions and therefore create an effective tax cascade. This would defeat the purpose of apportionment that would create the same fairness and efficiency costs as outlined in option 3.

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[8] For example, the current apportionment can over or under-attribute financial services to borrowers rather than lenders, as they focus on the gross margins received from interest for banks. Further research would be required as to how large these issues are and whether they could be overcome.

Partial options

65. In addition to these full options for taxing financial services, three partial options have been applied overseas for addressing some of the issues with GST and financial services. These are:

A payroll tax on financial institutions

66. The payroll tax is intended to address some of the under-taxation and in-source bias for financial services. In this regard it can be considered a partial FAT which excludes the cash flow profit of financial institutions. This has similar advantages and disadvantages as a FAT. However, we would not recommend this option as the FAT and the apportioned FAT provide more comprehensive options for addressing these issues.

Zero-rating all financial services

67. Zero-rating all financial services addresses the in-source bias created by exemption as it removes the GST cost for outsourced services. It does, however, increase the under-taxation of financial services with associated fiscal impacts and costs for fairness and efficiency. One submission to the Tax Working Group recommended that this option be considered further.

Applying GST on explicit fees for financial services

68. Applying GST on explicit fees for financial services ensures that GST is appropriately applied to these services. However, doing so creates a distortion between financial services paid for through fees and those paid for through margins. As a result, it is likely to lead to financial institutions avoiding charging explicit fees and instead charging through margins. This would likely advantage saving through banks and other providers that charge through margins over managed funds and other financial institutions that charge through explicit fees.

69. This means that applying GST on explicit fees is unlikely to result in a significant improvement over the status quo in the long-run. It is likely to lead to financial institutions restructuring to avoid charging explicit fees, and would disadvantage firms who do not have the capacity to undertake such restructuring. As a result, we do not consider that the benefits of this option would be significant and consider that the costs would likely be greater.

4. Conclusion

70. There is a strong in-principle case for applying GST to financial services. The current exemption creates a gap in the GST base, reduces tax revenues, is inconsistent with horizontal equity, and creates distortions.

71. The key question is whether there is a feasible option for applying GST to financial services where the benefits of the option outweigh the costs. This paper has considered four options. Our judgement is that it is unlikely that the benefits of any of the options outweigh the costs and that introduction of them would come with considerable risk for New Zealand.

72. All of these methods come with trade-offs. The FAT is relatively simple and has international precedent. However, it comes with significant costs as it creates tax cascades. Tax cascades are inefficient and are not consistent with horizontal equity. An FAT would likely increase the cost of capital for business and therefore be harmful for productivity and wages. As a result, we would not recommend a FAT.

73. The remaining three options avoid the tax cascades created by a FAT. However, all of these options are complex and none has been implemented internationally. As a result, the options come with risks and it is not clear whether the benefits of these options would outweigh the costs. There is likely to be considerable risk in New Zealand being the first to adopt any of these.

74. In addition, for all the options there are risks that the tax is avoided through New Zealander consumers obtaining financial services directly from overseas financial institutions. As New Zealand's main financial institutions are foreign owned, this may make this risk greater.

75. As a result, if the Group wishes to include this issue in the Interim Report, the Secretariat would recommend the Group focus on high-level directional recommendations.

76. If the Group wishes to recommend potential changes, the Secretariat would suggest the Group recommend that the Government undertake further work and consultation on these options. Developing these options further would require significant policy resource and will not be feasible to complete within the Tax Working Group's timeframes.

Appendix 1: Further detail on options

77. The Appendix provides more detail on the four options for applying GST to financial services. The treatment of financial services is complex. For the purposes of analysis, the examples in the Appendix are highly stylised. The policy options presented here would need further consideration and analysis in light of the range of technical complexities, for example the treatment of derivatives or risk premiums.

Option 1: Cash flow method

78. This method requires GST registered business to charge GST on all cash they receive related to financial services. GST registered businesses may then claim input credits on all cash they pay out relating to financial services. The cash that GST applies to includes the interest for loans and deposits as well as the full principal and repayments for loans and deposits.

79. This method has been shown to result in the right amount of GST being paid on a net present value basis (EY, 1996).

Example – cash flow method with household depositor and borrower

A household deposits $1,000 into a bank. The interest rate for the deposit is 5% and the depositor withdraws the money after one year.

In respect of the deposit received from the household the bank has the following GST position:

	Cash (excluding GST)	***GST***
Year 1	$1,000 inflow	Pay GST of $150
Year 2	$1050 outflow ($1,000 withdrawal and $50 interest)	Claim GST of $157.50

The bank lends the money to another household. The interest rate for this lending is 15% and is repayable in one year.

In respect of the loan the bank has the following GST position:

	Cash (excluding GST)	***GST***
Year 1	$1,000 outflow	Claim GST of $150
Year 2	$1,150 inflow ($1,000 principal and $150 interest)	Pay GST of $172.50

On net the bank has charged $100 (excluding GST) for their financial service and paid $15 in GST. As a result, this method results in the correct amount of GST being paid.

Example – cash flow method with household depositor and business lender

A household deposits $1,000 into a bank. The interest rate for the deposit is 5% and the depositor withdraws the money after one year.

In respect of the deposit, the bank has the following GST position:

	Cash (excluding GST)	***GST***
Year 1	$1,000 inflow	Pay GST of $150
Year 2	$1050 outflow ($1,000 withdrawal and $50 interest)	Claim GST of $157.50

The bank lends the money to a GST registered business. The bank charges the business 15% interest and the loan is repayable after one year.

In respect of the loan, the bank has the following GST position:

	Cash (excluding GST)	***GST***
Year 1	$1,000 outflow	Claim GST of $150
Year 2	$1,150 inflow ($1,000 principal repayment and $150 interest)	Pay GST of $172.50

For the business, they have the following GST position:

	Cash (excluding GST)	***GST***
Year 1	$1,000 inflow	Pay GST of $150
Year 2	$1150 outflow ($1,000 principal repayment and $150 interest)	Claim GST of $172.50

For the loan to the business any GST charged is refunded and so there is no net GST liability for transactions between the bank and business.

For the deposit from the consumer, in year 1 $150 of GST is paid. In year 2, a GST refund of $157.50 is received. On a net-present value basis (with a 10% discount rate), this is equivalent to charging GST on the $50 of financial services in year 2.

Why GST would need to apply to all cash flows under this method

80. For this method to work, GST needs to apply to all cash flows for financial transactions, including payments of principle as well as interest. Applying GST to the gross interest would not lead to the right amount of GST being paid as it would overcharge borrowers, and provide a subsidy to depositors. If the majority of depositors are consumers and the majority of borrowers are businesses then this could also lead to a revenue loss.

Example – what would happen if we applied GST to just the interest?

A household deposits $1,000 into a bank. The interest rate for the deposit is 5% and the depositor withdraws the money after one year.

In respect of the deposit the bank has the following GST position:

	Interest (excluding GST)	***GST***
Year 1	$0	$0
Year 2	$50 paid	Claim GST of $7.50

The bank lends the money to a GST registered business. The bank charges the business 15% interest and the loan is repayable after one year.

In respect of the loan, the bank has the following GST position:

	Interest (excluding GST)	***GST***
Year 1	$0	$0
Year 2	$150 received	Pay GST of $22.50

For the business, they have the following GST position

	Cash (excluding GST)	***GST***
Year 1	$0	$0
Year 2	$150 paid	Claim GST of $22.50

This results in a net GST refund of $7.50 in year 2.

Option 2: Margin methods

81. This option involves trying to calculate the value of the financial margin for each financial transaction. GST is then applied to the value of the margin.

82. The value of the financial margin can be calculated by a number of methods. For example, EY and the Mirlees Review considered that the Government bond rate could be considered the cost of capital for financial institutions[9]. Following this, any interest charged above that rate is the financial margin for loans, and the difference between the rate and the amount paid to depositors would be the financial margin for depositors. (Mirrless, et al., 2011) (EY, 1996).

83. A version of this called the “Tax Calculation Account” method was considered by the European Union as a feasible option for applying GST to financial services; however proposals for it did not proceed. Another method by a more recent paper considered that the financial margin could be calculated on a firm-by-firm basis, through looking at their total interest rate margins across the business and applying this ratio to every financial transaction (Lopez-Laborda & Pena, 2018)[10].

[9] As New Zealand banks receive funding from international sources, there is a risk that this may not accurately reflect banks’ cost of capital.

[10] We note that although the method proposed by Lopez-Laborda and Pena would potentially be simpler, it does come with some accuracy downsides. In particular, the method appears to attribute greater amounts of the financial service to borrowers rather

84. This margin method is similar to the cash flow method. The key difference is that it avoids the large amounts of GST being paid and subsequently refunded and instead smooths these out.

Example – margin method using a tax calculation account

A household deposits $1,000 into a bank. The interest rate for the deposit is 5% and the depositor withdraws the money after one year. The Government bond rate is 10%.

In respect of the deposit received from the household the bank has the following GST position:

	Interest (excluding GST)	***Financial margin***	***GST***
Year 1	$0	$0	$0
Year 2	$50	$50 (10%-5%) x $1,000	$7.50

The bank lends the money to another household. The interest rate for this lending is 15% and is repayable in one year.

In respect of the loan provided to the household, the bank has the following GST position:

	Interest (excluding GST)	***Financial margin***	***GST***
Year 1	$0	$0	$0
Year 2	$150	$50 (15%-10%) x $1,000	$7.50

On net the bank has charged $100 (excluding GST) for their financial service and paid $15 in GST. As a result, this method results in the correct amount of GST being paid.

Option 3: Financial activities tax

85. This method involves charging GST to financial institutions based on the sum of their cash flow profit[11] and wages. This was proposed by the International Monetary Fund as a means of addressing under-taxation of financial services in VAT systems (International Monetary Fund, 2010).

86. The rationale for this method can be understood if our GST is considered to be effectively a tax on cash flow profits and wages. In our GST system businesses pay output tax on supplies they make on a cash flow basis and get input credits for all non-wage expenses on a cash flow basis. As a result, GST is the same as taxing their cash flow profit, once wages and other equity transactions are added back in.

87. A simplified example below of a bakery is used to illustrate this; however the logic is applicable to financial institutions.

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than depositors. For example, if the respective interest rates are 15% and 5%, then the method would attribute a financial margin of 7.5% to the borrower and 2.5% to the depositor.

[11] This is a modified cash flow profit which excludes equity transactions such as dividends or sales of shares.

Example – FAT for a bakery

Take a bakery where they:

- acquire ingredients from a wholesaler at a cost of $100 plus $15 in GST;
- pay staff wages of $200; and
- sell the bread for $500 plus $75 in GST

Their net GST bill is $60 ($75 output tax, minus $15 input credits).

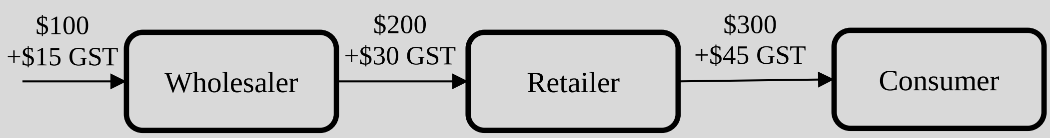
If GST were replaced with a tax on cash flow profit and wages, this would result in the same amount of tax being paid. Their cash flow profit is $200 and wages are $200, with a tax rate of 15% this results in $60 of tax.

88. As a result, an FAT, if applied to all businesses is in principle the same as a GST system[12].

89. However, the key difficulty with a FAT is that it would apply solely to one business in a production chain (the financial institution) and is not able to be integrated within the GST credit-invoice system. In particular, where financial services are provided to both business and consumers, a FAT at the GST rate will effectively charge unrecoverable GST for financial services provided to businesses. This will result in overcharging GST.

90. Below is a simplified example of this to illustrate, for a wholesaler and retailer.

Example – financial activities tax for wholesaler and retailer



Take a situation where

- a wholesaler acquires goods for $100 +$15 GST;
- they sell the goods to a retailer for $200 + $30 GST; and
- the retailer sells the goods to a consumer for $300 + $45 GST.

In this situation, in our current GST rules, the wholesaler will have the $15 of GST refunded and the retailer will have the $30 of GST charged to them refunded. This results in GST only applying once when the goods are sold to the consumer.

If, however, the wholesaler had GST replaced with a tax on cash flow profit and wages, and the retailer continued to have GST apply under the credit-invoice system, then GST will apply multiple times. The wholesaler will pay $15 GST in acquiring their goods, will pay $15 from

[12] Another method of achieving this could be to charge GST on the sum of financial institutions wages and any economic rents earned by them. This is because a tax on cash flow profit is equivalent to a tax on economic rents (Mirrless, et al., 2011). However, a tax on cash flow profit is likely to be the simpler approach and so is the one we are considering further.

the tax on their cash flow profit and wages and then the consumer will pay $45 of GST. This will result in $75 of GST being paid on $300 of goods. This is an effective GST rate of 25%.[13]

91. The issues raised in this simplified example are also applicable to financial services provided by financial institutions. If a FAT applied to financial institutions this would effectively result in unrecoverable GST being charged for services to businesses and therefore create tax cascades.

Option 4: Apportioned financial activities tax

92. This method uses the same methodology as the financial activities tax outlined above however the amount of the tax is apportioned so that it is only charged on the proportion of services that are attributable to financial services provided to consumers.

93. New Zealand has an existing method for financial institutions to determine the value of services provided to consumers. This is done in the business to business zero rating rules (outlined in section 2.2 above).

94. The goal of the apportionment is to ensure that the financial activities tax solely applies to the value add provided to consumers. This helps to address the tax cascade issues outlined above.

Example – apportioned financial activities tax

A financial service provider receives $100m in interest income in a year. $50m of this is from consumer loans and $50m is from loans to businesses.

The financial service provider pays interest income of $50m in the year. $25m of this is to consumer and $25m is to businesses.

The financial institution pays wages of $10m for the year.

The sum of cash flow profits and wages for the institution is $50m. 50% of this is attributable to consumer services. The FAT base is $25m and FAT payable would be $3.75m. This is the same amount as if GST was applied to the financial margin for the loans to consumers ($25m x 15%)

[13] If this occurred in practice, it is likely that the relative prices for all the goods would change to reflect the embedded costs of the tax. For simplicity, we are keeping the prices for these example static.

Appendix 2: Methods of Taxing Financial Services Applied in International Practice

	Method	Countries	Explanation
Exemption or zero rating	***Zero-Rating services to businesses, exempting services to consumers***	New Zealand, Quebec (up to 2013)	Applies a zero rate to financial services provided to GST registered businesses, while allowing a full crediting of GST on inputs for those services. Supplies to consumers are exempt, with no input credit allowed in relation to those services.
	Exemption with Input Credits	Australia, Singapore, Malaysia	Allows crediting of a proportion of input GST. No GST is applied to the supply of financial services.
Tax explicit fees and commissions	***Taxation of Explicit Fees and Commissions***	Australia, Singapore, South Africa, Malaysia, the Philippines, India, China, Korea, Belgium, Slovenia, Andorra, Ghana, Mexico, Thailand, Taiwan	Imposes GST on fees and commissions, as the value of these fees are easy to identify. Financial margins are still exempt under this method.
Transactions tax	***Taxation of Gross Interest***	Argentina Proxy taxes China, the Philippines, Taiwan, Thailand, Korea	Imposes GST on the gross amount of interest on loans. This taxes more than just the implicit fee proportion of the interest. The implicit fee on other services, such as deposits, are not taxed.

Financial activities tax and similar proxy methods[14]	***Subtraction Method***	Italy	Tax is imposed on the value added, which is the difference between revenues and deductible purchases.
	Net Operating Income	Mexico	Tax is imposed on the sum of net interest plus margins, explicit fees and commissions.
	Addition Methods	Quebec, France, Israel, Denmark, Norway	Tax is imposed on the sum of wages, cost of capital and profits. This method does not allow the claiming of input credit.
	Financial Activities Tax	Iceland, Norway (KPMG, 2017) and Denmark (Sorensen, 2011) (only on remuneration)	A tax imposed on remuneration and profits in the financial sector.
Optional methods	***Option to Tax***	*Tax only fees* Belgium, Lithuania, France *Tax fees and margin* Austria, Estonia, Germany	Gives financial institutions the choice of applying GST to financial services and receiving and input credit, or to treat the services as exempt and not receive a credit.

(Lopez-Laborda & Pena, 2018)

[14] The subtraction, addition and net operating income methods are similar to a financial activities tax in that they attempt to address the under-taxation of GST through a tax on the gross receipts and expenses for the business. The key difference is that they utilise different calculations for determining the 'value add'.

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Glossary

Derivative. A financial security with a value that is reliant upon or derived from an underlying asset or group of assets.

Economic incidence. The individual or entity which bears the final burden of a tax (or receives the benefit of a transfer), after response effects, such as price and wage changes, are taken into account. This is distinct from the legal incidence of the tax or transfer.

Efficiency cost of taxation. Cost to society due to individuals, households, and firms making consumption and production choices in order to pay less tax, in the case where the tax is not intended to change behaviour deliberately (i.e. is not a *Pigouvian tax).*

Financial institution. A business engaged in the business of dealing with monetary transactions, such as deposits, loans, investments and currency exchange.

Financial margin. The difference between revenue and expenses for financial institutions.

Goods and services tax (GST). A broad-based value-added tax on consumption in New Zealand.

GST exemption. Where GST is not charged on a good or service and the provider of the good or service is not able to claim back any GST charged to them on inputs they acquire in the production process. In New Zealand residential accommodation and financial services are the main areas with GST exemptions.

Horizontal equity. Horizontal equity refers to people in similar circumstances being treated in a similar way. For instance, by paying a similar amount of tax in the context of the tax system, or receiving a similar level of benefit in the transfer system.\

Legal incidence. The individual or entity legally liable to pay a tax or receive a transfer bears the legal incidence of the tax or transfer. The legal incidence often differs from the economic incidence.

Tax cascade. A tax that is applied at multiple points in the supply chain without any deduction for the tax paid at earlier stages.

Value-added tax (VAT). A VAT is a type of transaction-based consumption tax that is levied at each stage where value is added in the production process and at the point of sale. New Zealand’s GST is a form of VAT.

Vertical equity. Vertical equity is the principle that people with low means should receive greater assistance than those with higher means, and that those with greater economic capacity should have a higher tax burden.

Zero rating. Where GST is not charged on a good or service and the provider of the good or service is able to claim back any GST charged to them on inputs they acquire in the production process. In New Zealand exports is the main area with zero rating.