Financial Services and the GST —

A Discussion Paper

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The Gist of GST
A report, already published, which provides background information and a discussion of policy issues concerning the GST.

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A theoretical and empirical examination of the economic incidence of sales

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Financial Services and the GST
A discussion paper which considers different options for bringing financial services under the GST regime, and evaluates them from a technical viewpoint.

The Role of Excises in the Indirect Tax System
This paper will look at specific taxes, such as those on alcohol, tobacco, motor fuels, etc, and considers their role in the indirect tax system.

The Administrative and Compliance Costs of the GST
A canvassing of administrative and compliance issues surrounding the introduction of GST, drawing on the experiences of other countries.

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A paper which discusses the role of direct and indirect taxes in the total tax system, including the consideration of excise taxes and the use of different tax bases.

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1 Introduction

The Government has announced that it will introduce a Goods and Services Tax (GST) on 1 April 1986, as part of a set of measures to reform the tax system. Details of how the GST will operate are contained in the White Paper published in March 1985. The tax will apply to all goods and services supplied in New Zealand by registered GST taxpayers carrying out a business activity on a regular basis. Exports of goods will be zero rated.

In its booklet 'GST: The Key to Lower Income Tax', the Government explains the rationale for its tax policies, and the Institute of Policy Studies publication 'The Gist of GST' gives a general briefing on the main issues surrounding the proposal.

The White Paper contained no suggestions as to how financial services might be included in the tax. Instead, it acknowledged the need for further investigation, and announced that the present discussion paper would be released in April. The purpose of this paper, prepared under the auspices of the Institute of Policy Studies, is to discuss the nature of financial services and the problems of taxing them under a GST. It does not consider any wider social issues. As a discussion document, the paper will be the basis for continuing consultation with providers of financial services.

The institutions and groups likely to be affected by the tax proposals discussed in this paper include the Reserve Bank, trading banks, savings banks, merchant banks, finance companies, building societies, credit unions, life offices, superannuation funds, sharebrokers, foreign exchange and futures dealers, investment companies, solicitors, the Housing Corporation, the Rural Banking & Finance Corporation, stock and station agents, fire and general insurance companies, retailers and any businesses advancing credit, as well as other companies and individuals engaged in financial activity.

Thirty overseas countries already operate a GST-type of tax, but in none of them have financial services been fully integrated into the tax system. The problems of taxing these services are complex and centre on defining what a financial service is, how its taxable component might be measured and to whom the tax might apply.

Chapter 2 of the paper examines the special nature of financial services and the principles of taxation that should be applied to them. Financial services are divided into four broad groups: financial intermediation (borrowing and on-lending), trading in financial assets (foreign exchange, government stock, etc), fee and commission activity, and insurance services. In Chapter 3, the problems of how to measure financial services and how to assess their tax base are discussed.

The six tax options that may be applied to the various types of financial services are outlined in Chapter 4. These are:

- full invoicing (as in the general application of GST);
- separate tax rates;
- zero rating/exemption with credit;
- exemption;
- the additive approach; and
- net operating income.

In evaluating these options in Chapter 5, the authors take into account efficiency in the financial sector, the costs of operating the tax, the effects the tax might have on New Zealand's international competitiveness, and the Government's revenue requirements. Chapter 6 comments on the problems of implementing a new and unfamiliar tax, and Chapter 7 assesses its implications for exports and imports of financial services. Chapter 8 surveys overseas practice.

The authors make no recommendations. Their intention is to present the different ways of taxing financial services in order to make the Government and the business community aware of the implications of each option.

If the GST is to be in force by 1 April 1986, legislation must be passed this year to allow time to register taxpayers and to develop office and accounting systems. The Government has indicated that a final decision on how to treat financial services will be made in June.

2 The Special Nature Of Financial Services

2.1 GENERAL PRINCIPLES OF THE GST

The GST is designed to tax the goods and services consumed by households. In its final effect on consumers it should in theory be similar to a comprehensive retail sales tax (RST) on the same range of goods and services.

The following criteria influenced the choice of a comprehensive, single-rate, invoice-based GST as a form of indirect taxation:

a. a GST avoids any hidden tax or tax-on-tax effect because it can be identified at each stage of the production and distribution chain, and tax paid at earlier stages is rebated to registered GST taxpayers;
b. comprehensive taxation minimises the scope for evasion;
c. because the tax is clearly identified, imports can be treated in a comparable manner to domestically produced goods, and all GST relieved on exports; and
d. a single rate of tax across all goods and services will simplify tax administration.

In the treatment of financial services under the GST, the method of levying tax should be as visible, efficient and neutral in its effects as the general application of the GST.

2.2 HOW FINANCIAL SERVICES SHOULD BE TAXED

The following principles should be observed in taxing financial services:

a. the tax system adopted should be integrated as far as possible with the GST structure. This would require that taxes on inputs are able to be rebated and that the tax on outputs is identifiable, so that business users can claim rebates at the next stage of production.
b. the tax system should preserve neutrality of treatment between:
   (i) consumption of financial services and other goods and services;
   (ii) financial institutions themselves;
   (iii) financial institutions and other businesses providing financial services as part of their total taxable activities; and

(iv) domestic and offshore providers of financial services.

The method of tax should ensure that the tax is proportional to the value of the service element in each transaction, and can be separately identified.

c. the operating costs of the tax, which includes both the Inland Revenue Department's administrative costs, and the compliance costs of registered traders, should not be excessive. All registered persons will need to alter office and accounting systems to comply with the GST, which is likely to cause significant one-off costs. These should not be confused with the ongoing costs an institution will incur in complying with whatever system is required. This total operating cost should not be disproportionate to the expected revenue.

d. the consumption of financial services should form part of the tax base, in order that the Government's revenue and tax policy objectives may be met.

A distinction needs to be drawn between gross and net revenue. Much of the output of the financial services industry is sold direct to other businesses, and any tax levied would be rebated to those businesses. There is no net revenue gain in taxing financial services supplied to business. The tax is effectively paid by the user of those services, rather than the supplier.

For example, a bank providing cash handling services to a supermarket might charge transaction fees totalling $100. GST at a 10 per cent rate would raise the cost of the service to $110. The supermarket, registered under GST, can offset the $10 GST charge against the tax liability on its sales. If the $10 tax was not charged, it would not be available for offset. In this case, the payment of the tax would merely be deferred until the transaction charges were incorporated in the supermarket's sale prices.

The important point is that it is only the tax on the value of financial services supplied to final consumers which constitutes a net increase in the Government's total revenue from GST.

The GST is a tax on the consumption of goods and services by final consumers, that is, households and individuals. It is not a tax on the production of goods and services, and the tax treatment chosen for financial services should reflect this. Although financial services are supplied to businesses which are registered persons, they should not be regarded as final consumption for GST purposes.

2.3 TYPES OF FINANCIAL SERVICES

A financial service is made up of one or more financial transactions. Nearly all types of financial transactions are covered by this paper. They include:

a. *Financial intermediation* — borrowing and lending money; payment and receipt of interest, dividends, royalties and copyright fees.

b. *Trading in financial assets* — buying or selling any financial security, including fixed interest securities, bills, certificates of deposit, stocks and shares, foreign exchange, options or contracts for future supply of any financial asset.

c. *Fee and commission activity* — providing financial services for explicit fees, including commissions, application fees, transaction charges, etc.

d. *Insurance services* — providing life or fire and general insurance services.

The essential difference between financial transactions and other commercial transactions is that the payments to and from a financial institution do not accurately reflect the monetary value of the service provided. The problem is one of measurement. The service element in a financial service is frequently not a separate, identifiable charge made to a client.

On a typical borrowing or lending transaction, the cost of the service is spread across numerous transactions and is usually embedded in the interest charged. Only part of this may be a service fee to the client. The remaining part is an income payment to the depositor in the form of interest paid.

A home mortgage repayment, for example, is normally made up of three elements: a return of principal, the cost of funds and the margin earned by the financial institution involved. A $30,000, 30 year, 18 percent table mortgage would require a monthly repayment of $452. Only the interest margin, say 4 percent, is the service component. Over the life of the loan this is equal to roughly $97 per month. The price of the service is but part of the total transaction value.

In trading financial assets and providing life insurance, the price of the service is embedded in the costs incurred by the institution and in the pretax profits it earns in carrying out the service.

The type of business that comes closest to financial asset transactions is trading in second-hand goods, such as used motor vehicles, where the value of the service is also hard to calculate. Under a GST, the dealers will have bought cars, the prices of which will include non-rebateable tax incurred when the cars were first bought by the consumer.

To tax the full sale price as a new good would overstate the real value added by the business, and could lead to multiple taxation. To avoid this distortion, the White Paper (para 107) proposes a special arrangement for second-hand goods which allows an implicit GST on the purchase of goods to be claimed against the gross liability. Land sales are another area where it is difficult to identify the service charge, and the White Paper proposes that they should be exempted.

Many financial transactions fall into the same category. In one sense, financial assets are very much another second-hand good, in that they are regularly traded to and from the household sector at prices which do not acurately reflect the service element. Taxing on the margin alone is not a satisfactory solution. If the goods or services are supplied to other registered persons, any tax applied at a prior stage can be lost if other registered persons are also taxed only on their margins. For example, if a financial institution had provided the mortgage described above to another, allied financial institution, which then provided it to a consumer, tax would be levied on the first sale on $97 a month, but would be fully rebateable for the second institution. Any final tax paid by a consumer would relate only to the margin of the second institution. For this reason, the tax treatment chosen for dealers in second-hand goods, while taxing only their margins, still imposes a final tax on the full value of the sale. If some form of marginal taxation is to be used, credits cannot be allowed for tax paid at earlier stages.

The four categories of financial services (and supporting transactions) are discussed below.

a. Financial Intermediation

The borrowing and on-lending of money, known as financial intermediation, is the major activity of most financial institutions. However, the interest payments and receipts flowing out of these transactions do not have the same function as the price of a service. This makes measurement difficult.

An interest rate has two components:

(i) a true interest rate, however defined, and

(ii) a margin for the risk management, information and other services provided by the financial institution.

A bank raising funds at an average cost of, say, 14 percent and on-lending at a rate of 18 percent has maintained a margin of 4 percent to cover its costs and contribute to profits. The margin is really borne in part by the borrower of the funds in a higher lending interest rate, and in part by the depositor in the form of a reduced return on deposits. If the financial institution retained no margin on its interest rates, and charged borrowers (or even depositors) a fee for its services, identifying the service charge would not be difficult. A large amount of credit is advanced in New Zealand in this way, such as the participatory mortgages administered through solicitors' nominee companies.

Measuring the output of investment companies poses a similar problem. The net dividend income of a pure investment company may be regarded as a charge for administering the underlying investments, in the same way that the net interest margin of financial institutions is an implicit service charge.

In theory, the value of services provided by organisations with flows of interest and dividends is relatively easily defined. In practice, it is much more complicated. Financial institutions borrow for their own purposes (e.g. to purchase buildings, computers, etc) as well as for on-lending. Similarly, many trading companies advance credit, either from their own funds or from general borrowings. The implicit service charge in a loan financed out of capital is impossible to calculate accurately for tax purposes.

Measuring the service charge in advance is not possible in most organisations. Net interest margins are measurable only afterwards, and cannot be identified at the time of the transaction.

b. Trading in Financial Assets

Many financial institutions also trade in financial assets, such as government stock and foreign exchange. The capital gains from these may be regarded as part of the services supplied by the institution. For example, an institution which buys and sells foreign exchange for its customers and other institutions is clearly providing a service which is quantifiable by the net revenue it generates.

In the same way, an organisation which regularly trades in equities or fixed interest securities is providing a service through its market presence and the availability of its portfolio.

The existence of a service is most obvious when an institution has a continued presence on both sides of the market, i.e. both buying and selling. It is less clear that a long-term capital gain constitutes a financial service, although there is often a very narrow line between the two. For example, the sharebroker who deals in government stock, buying and selling on behalf of clients, is clearly providing a service. The institution buying a parcel of stock for investment purposes, however, and selling it several years later after a drop in interest rates, is less obviously providing a service equal to the capital gain involved.

c. Fee and Commission Activity

In addition to their net interest margin and profits from assets trading, financial institutions earn a significant amount of revenue from fee and commission activity — filing fees, transaction fees, brokers' commissions etc. These sources of income vary, but are relatively easy to deal with under a GST because they represent an explicit price for the service, provided that the charge reflects full cost recovery.

Many financial institutions, in particular trading and savings banks, have tended to underuse explicit fees for services. This is especially true of payments services which have been cross-subsidised by net interest margins, as when cheque accounts operate without charge, and the bank recovers its costs by not paying interest on the funds in those accounts.

Growing competition among financial institutions will make it more difficult for some groups to underprice one activity and overprice another. When this does happen, competition in the overpriced area will force a correction. It is unlikely that all cross-subsidisation will be eliminated, as in many cases the net interest margin will be the most efficient form of pricing. The proposed tax options should be examined to see what incentives they offer for accurate and explicit pricing.

d. Insurance Services

In life, fire and general insurance services, measuring the value of the services provided to policyholders is also difficult.

(i) Life insurance premiums are made up of three elements: savings (of the policyholder), indemnity, and a management charge. The value of the service is defined as the net return from providing life cover plus the proportion of the earnings of the fund used to meet management expenses and any pre-tax profit (operating surplus). In a mutual fund, there is no operating surplus as such. This measurement method focuses on expenses rather than income, although in order to derive the operating surplus the income of the company must be used. It is the same as the result obtained from a measurement of the outputs by the net operating income method, i.e. net premiums less claims plus investment income retained by the company.

(ii) For fire and general insurance companies, there is not the same savings element as in life insurance. The service is equal to the cost of providing the insurance services, including any pre-tax profits earned.

In both cases it is important to stress that the value of services is not the whole of the premium paid, but only that portion of the premium (and associated earnings) retained by the administering company.

3 Measuring Financial Services

3.1 VALUE OF FINANCIAL SERVICES SUPPLIED TO CONSUMERS

The central problem in taxing financial services is to establish the value of the services provided. This is particularly true of individual transactions, but applies as well to measuring them in aggregate. Quantifying financial services is also a problem for the Department of Statistics in compiling the national accounts (see Appendix A1).

There are several different ways to value total financial services supplied. Two broad approaches may be used to quantify them. Services supplied may be summed either on the basis of the institution which provides them, e.g. a bank or finance company; or by the value of the broad categories of financial services defined in the previous section. In view of this paper's emphasis on the nature of financial services, the following data is presented on a service and not on an institutional basis (although there is sufficient detail in Appendix A1 to derive institutional aggregates):

Total Value of Financial Services Supplied 1982/83

	$M
Financial intermediation	1021
Financial asset trading and fee and commission activity	496
Insurance services	638
	2155

Source: Department of Statistics, Census of Services 1982/83

Including financial services in GST will not increase the total tax revenue in proportion to the total value of the services supplied. Many of these services are supplied direct to other businesses, which will be able to have any tax paid rebated. In net terms it is only the value of financial services supplied direct to final consumers that increases the tax base.

Value of Financial Services Supplied to Consumers

	$M
Financial intermediation	465
Financial asset trading and fee and commission activity	32
Insurance services	426
	923

These numbers should be treated with considerable caution, as they use very rough approximations, based on the Department of Statistics data, of the split between the value of services supplied to consumers and to intermediate purchasers of financial services.

3.2 REVENUE EFFECTS

No revenue would be collected if financial services were zero rated — that is, if a zero rate of tax were applied to outputs, and full credit claimed for tax on inputs. Exempting all financial services from GST would lead to revenue being collected on the total inputs of financial institutions — a tax base of $651 million, plus about $130 million of capital expenditure, giving a total of $781 million. Applying tax in the normal manner on the value of services supplied to final consumers involves a tax base of some $923 million, or $92 million revenue at a 10 percent rate of GST.

3.3 SUBTRACTIVE AND ADDITIVE APPROACHES

The tax base for the GST may be derived in two different ways. In the general application of the tax, the base is assessed as total sales less any taxes already invoiced to the business on its intermediate inputs. This invoice-based collection method is sometimes referred to as the subtractive approach. It requires invoices to be collected as evidence of sales and of the tax paid on purchases of inputs. The other way of collecting tax is the additive approach, which uses a tax base comprising the sum of the items which make up the inputs.

How to calculate both of these is demonstrated in the table on page 15, which is a production account for a typical enterprise.

For the above firm the same revenue could have been achieved using the additive approach and the value added catogories directly (items 2 to 5 inclusive). These add up to $20,000, which would yield $2,000 at 10 percent.

This accounting identity is the reason why taxes similar to the GST in overseas countries are usually known as value added taxes (VATs). This is a misnomer, however, as the real base for the tax is the value of total output of goods and services sold to consumers.

Taxing a firm in the above way is described as the additive approach. It involves a different concept of tax liability from the subtractive approach.

CALCULATION OF GST TAX BASE BY BOTH SUBTRACTIVE AND ADDITIVE APPROACHES

Inputs			Output		
		$			$
1.	Purchase of goods and services (intermediate consumption/inputs)	10,000	6.	Total Sales (Output)	30,000
	Value Added				
2.	Wages, salaries, super, etc (compensation of employees)	10,000			
3.	Depreciation (consumption of fixed capital)	2,000			
4.	Excises, duties, etc (indirect taxes)	1,000			
5.	Profits before interest, tax and dividends (operating surplus)	7,000			
		30,000			30,000

Assuming a GST rate of 10 percent, the company's tax liability, calculated by the subtractive approach, would be establishing in the following manner:

	$
Tax due on total sales: $30,000 @ 10 percent	3,000
less:	
Tax paid on purchases: $10,000 @ 10 percent	1,000
Net amount due to Inland Revenue Department	2,000

Because the liability is not identified on the basis of outputs, the provider of the services initially pays the tax, which is then passed on in the form of higher prices. For any individual firm, the difference between the tax due by the subtractive approach and that due by the additive approach would depend on the amount of income from sources other than sales of goods and services — mainly interest and dividends.

If the additive approach of calculating tax liability had been chosen in New Zealand, the revenue raised would in theory be the same amount as from the subtractive, invoice-based approach proposed. The proper treatment of imports and exports could not have been achieved, however. A possible use of the additive approach is considered in Appendix A3.

4 Tax Options

Taxing financial services may be approached in three different ways. The choice between them is largely determined by how clearly the output from an activity or institution can be defined:

a. Where the output of individual services can be clearly identified, an invoice method may be used. Options include full invoicing of transactions, applying separate tax rates, and a zero rate of tax.
b. Where outputs are difficult to measure, calculation of the tax base cannot be achieved. The main option is exemption.
c. Where it is possible to use alternative methods to calculate the tax base, the additive and net operating income options may be considered.

4.1 FULL INVOICING

Full invoicing would require an invoice which identifies the full value of the transaction. This value may be either the actual cost of the transaction, as in fees or commissions, or the value of the nominal amount the transaction represents, as in deposits and withdrawals. Invoices would need to be attached to all deposits, withdrawals, credits, debits etc., associated with the transaction. Providers of financial services who were registered would be able to claim tax credits on inputs.

Full invoicing could be confined to services for which specific fees or charges are made. However, some other way of taxing non-fee services would have to be found in order to maintain tax revenue.

4.2 SEPARATE TAX RATES

Transactions involving interest payments could be based on either all or part of the interest paid. A GST of 10 per cent levied on the full interest payable on a $10,000 loan at 20 per cent interest, would amount to $200. This would significantly overstate the value of the service supplied. Using some partial measure of the interest as the basis for tax would lead to rates of tax which vary according to the proportion of interest on which they are based.

The rate of tax on a transaction could be adjusted to equal that proportion of the transaction which represents a service charge, when that charge can be estimated. Then in the case of the $10,000 bank loan, the value added or service element is the amount of a margin above the cost of borrowing the funds. At a lending rate of 20 per cent and a cost of funds of 16 per cent, the margin is 4 per cent, or one-fifth of the total interest rate. A GST of one-fifth of the full rate could then be applied.

4.3 ZERO RATING

When goods or services are zero rated no tax is paid on outputs, and a full credit of tax paid on inputs may be claimed. Exports of goods will be zero rated under the general GST, and will therefore contain no tax element in their final price. All tax on the domestic inputs of these products will be either credited (against any other GST owed) or repaid to the exporter.

In order to apply a zero rating, an output value generally needs to be established. This is difficult for many financial services, but the same effect can be achieved by exemption with credit.

4.4 EXEMPTION

Transactions exempted from GST are not liable to output tax and no credit can be claimed for tax paid on inputs. As a result, no tax can be identified in a sale to a registered person even though there is a tax element in the price. This puts suppliers of exempted goods or services at a disadvantage, compared to zero or even positive rating, as they cannot recover tax paid on inputs or identify tax on outputs. When some of an institution's activities are exempt and the rest taxable, apportioning the cost of inputs between various activities can be very difficult to achieve and opens the tax system to evasion. Inputs such as a computer may be used in both taxable and exempt areas, but credits for input tax are allowable only to the extent that these items are used in taxable activity.

The difference between zero rating and exemption is important. Tax paid on inputs used in exempt activities cannot be claimed for a refund, even when other activities of the business are taxable, and other inputs credited.

Exemption with credit is used when no output value on goods or a service can be established and zero rating applied. It allows a full claim to be made for taxes on inputs, and no tax is passed on in the prices of outputs. In many European countries, exports of financial services are exempted with credit under value added taxes. For the rest of this paper the term zero rating will be used to cover both these options.

4.5 ADDITIVE APPROACH

This is essentially a different way of arriving at the tax base and gives an aggregate tax liability not directly related to the outputs of the taxed activity. It may be calculated as the sum of the items which make up value added in a transaction (see section 3.3) instead of by the subtractive approach applied to other GST traders. These items are salaries and wages, other labour expenses, rates, levies, all other indirect taxes, and net operating surplus less depreciation (the latter item being equivalent to the sum of dividends, retained earnings, and income tax). This gives a tax base which excludes the cost of inputs purchased from outside the firm. To be consistent, and ensure that tax on inputs is not lost, no credit would be allowed for GST on inputs. Another additive tax base may be calculated by summing all non-capital inputs, and including depreciation in the taxable total. This way, tax credits can be allowed for all inputs, including capital purchases.

4.6 NET OPERATING INCOME

This approach may be applied from the standpoint of an institution or of an individual activity. Credits may be claimed for all tax on inputs, and tax liability is calculated on the basis of all 'net operating income'. For an institution, net operating income would consist of net interest, plus the margins and fees made on other activities of the institution, such as dealing in stock or foreign exchange. For a specific activity, net income (before deduction of other costs) from that particular activity would be used. Tax on this would be calculated at the tax-inclusive rate. The tax would not necessarily be attached to invoices, although any separately specified charges could be taxed separately and deducted from overall tax liability. Because the tax is based, in effect, on the margin retained by the institution there are difficulties in allowing such tax to be rebateable to other financial institutions.

5 Appraisal Of Tax Options

This chapter applies the six tax options to each of the four areas of financial services outlined in Chapter 3. These are financial intermediation, trading in financial assets, fee and commission activity, and insurance services. The criteria used for this appraisal are the principles of taxing financial services given in Section 2.2 that:

a. taxes should be identified and rebateable;
b. the regime should preserve competitive neutrality;
c. operating costs for a given revenue should be minimised; and
d. the amount of revenue raised by the tax should be consistent with the normal application of GST.

The alternative would have been to apply each tax option to an entire institution. However, the institutional framework was not found adequate to meet the first and second criteria, since the tax would be on an aggregate basis and not related to transactions. Almost all businesses are engaged in some type of financial activity, such as borrowing or depositing funds, but the hallmark of a financial institution is that such activities dominate its sources of income. An institutional basis, applied generally, also requires institutions to be arbitrarily categorised. The same financial activity might then be taxed in different ways in different institutions.

Although the areas of financial services are examined separately, any final method of levying GST should ensure compatibility between them. This requires that the administrative and compliance costs are not greatly increased by different tax treatments, and that no distortions exist in the amount of tax levied on each type of service. Should this happen, it would lead to changes in the form of services and transactions to minimise tax liability. The problems discussed in Section 2.3 for the non-rebateability of taxes imposed on a marginal basis sometimes apply to separate tax rate treatments, and to net operating income treatments where the tax is not specified.

5.1 FINANCIAL INTERMEDIATION

The main issue when considering borrowing and lending transactions is the extent to which interest and dividend flows should be included in the tax base.

At one extreme all interest flows, including those received by depositors, would bear tax. This is a version of the full invoice method. It would require savers to register in order to charge the tax to the financial institution, and presumably to claim back input taxes. In this scenario there is no final consumer of financial services, which defies commonsense. An alternative would be to tax lending interest rates alone, but this would overstate the value of the services provided.

An approach which better identifies the tax base would be to reduce the rate of tax on lending interest to a level which approximates the average net interest margin. This requires a consistent definition of interest. An examination of some possible ways of doing this is included in Appendix A2.

Royalties and copyrights could be treated as explicit fees for services, which would then allow them to fit with the general application of GST.

Detailed evaluation of each of the six tax options, as applied to this area, follows:

Full Invoicing

a. Depositors as well as lenders would need to register. Tax liability would be overstated.
b. Lending would shift outside institutions, e.g. to person-to-person transactions or some method other than charging an interest rate.
c. Operating costs extremely high, especially if all transactions (all deposits, withdrawals etc) were included.
d. Revenue collections would be too high.

Separate Tax Rates

a. Tax is identifiable and rebateable (to a registered person not being taxed on a marginal basis) although calculated on an arbitrary basis.
b. Neutrality can be seriously compromised by averaging, but most forms of lending could be included.
c. The range of methods would involve a range of operating costs. There is a trade-off between precise assessment and a position of high compliance costs on the one hand and simple, more arbitrary methods on the other.
d. Likely to provide the correct amount of revenue.

Zero Rating

a. No tax charged.
b. An incentive would exist to direct into this area other forms of financial activity subject to tax. Should be limited to exports of services to be consistent with treatment of other services.

c. Operating costs would be relatively low unless apportionment of outputs or inputs was required.
d. Nil revenue.

Exemption

a. Input tax would cascade on services supplied to registered persons, as it is not identified.
b. Competitive problems would arise, especially vis-a-vis offshore lenders.
c. Operational costs could be high if inputs need to be apportioned between exempt and taxable activities.
d. Revenue would be collected only on intermediate inputs. Some incentive for organisations supplying exempt services to produce intermediate goods and services themselves (e.g. establishing their own printing operation). Net revenue will exceed correct assessment in some cases.

Additive Approach

a. Tax would cascade as it is not identified and cannot be rebated. May be useful for pure investment companies where services are supplied to (or on behalf of) owners.
b. Competitive problems would arise from both offshore and domestic producers who can provide equivalent services and/or identify tax.
c. Operating costs are unlikely to be high.
d. Net revenue collected would be too high as a result of tax cascades.

Net Operating Income

The effect of this approach depends on how it is applied. If identified on transactions it is similar to separate tax rates, if not, comments on the additive approach apply.

5.2 TRADING IN FINANCIAL ASSETS

These financial markets are very competitive, and it is difficult to design an efficient but equitable treatment for them under a GST. Although trading in financial assets, particularly fixed interest securities, is primarily a business activity, distinguishing between individuals trading for personal as distinct from business purposes is not easy. An individual's capital gain from share trading after normal commissions have been paid, for instance, should not be included in the tax base. Some business test or threshold may be required.

The absence of a tax on financial assets trading could encourage growth in this market as a way of avoiding tax. For example, when routed through a broker, the service element of transactions in fixed interest securities and equities is normally included in the broker's commission. If the broker had instead bought the securities on his own account and then sold them, his service element would effectively have been built into the price of the asset being traded. Similar problems arise in treating any costs of holding such assets, as they can be relatively easily shifted between the fixed interest area and the area of borrowing and lending, so as to impact on net interest margins.

Foreign exchange dealing presents similar problems to fixed interest securities trading. Prices quoted by traders include a margin which covers the cost of providing the service. Sales to and purchases from households clearly constitute a service, although the service element in any one transaction is hidden.

Foreign exchange also raises the issue of international trade in services, where precise and appropriate treatment of the service element is critical so as not to penalise exporters or unduly advantage importers. Even when the service is being provided in New Zealand, it may be a close substitute for a service provided offshore. Taxing the service may disadvantage New Zealand- based operators, depending on the tax regimes applying overseas, and encourage them to operate from offshore.

On the other hand, a favourable treatment could lead to erosion of the tax base if external foreign exchange transactions could not be clearly separated from internal transactions. For example, a registered person could use a foreign currency account for both export-related services and the settlement of some domestic liabilities.

Full Invoicing

a. Tax liability would be overstated. Many individuals would need to register and be eligible for rebates.
b. The tax on assets would be overstated and direct borrowing and offshore trading be encouraged.
c. High compliance costs as all sales require invoices.
d. The revenue base would be overstated.

Separate Tax Rates

a. Tax could be identified and rebated (to registered persons not taxed on a marginal basis).
b. Tax would not relate to the value of the service provided. Competitive problems would arise for some classes of transactions.
c. Compliance costs would depend on the method adopted. Simpler systems might be arranged which traded off some efficiency.
d. The method chosen could be adjusted to collect a target revenue. The tax base might be eroded if activities were easily substituted by a lower taxed or imported alternative.

Zero Rating

a. All tax would be rebated.

b. No problem with offshore operators, but there would be domestic pressure to shift activity into this non-taxed area.
c. Operating costs would be low.
d. Nil revenue.

Exemption

a. Tax paid on inputs to these activities would not be rebateable, leading to tax cascades.
b. Non-identifiability of the tax would lead to competitive disadvantages vis-a-vis services supplied offshore and any substitute forms of activity supplied direct to consumers (e.g. equity capital rather than debt).
c. Apportioning input credits between taxable and non-taxable activities would raise operating costs.
d. Revenue would be collected on intermediate inputs, and again, as the tax cascaded.

Additive Approach and Net Operating Income

a. An aggregate tax liability could be established but it would be impossible to accurately identify the tax element in any one transaction, and tax cascades would develop.
b. Non-identifiability of the tax on individual sales would put New Zealand-based financial intermediaries at a disadvantage.
c. Operating costs are unlikely to be high.
d. Net revenue would be too high as a result of tax cascades.

5.3 FEE AND COMMISSION ACTIVITY

Where identifiable fees and commissions are charged for financial transactions the tax base would appear to be clearly defined.

Problems do arise if substitution of fees and commissions takes place when other activities are attracting a lower tax. For example, financial institutions commonly cross-subsidise transaction fees and lending interest margins. An uneven tax treatment may encourage sharebrokers to place less emphasis on commission income and more on selling shares at a profit.

The costs of compliance must be examined carefully. Many of the existing fees (e.g. transaction fees on cheque accounts) are very small, and the compliance costs may be disproportionate to the revenue generated.

Consideration follows of the application to fee and commission activity of the six tax options:

Full Invoicing

a. Fees and commissions represent clearly defined charges on which tax can be levied.

b. Competitive effects depend largely on how other financial services are treated.
c. Operating costs would be kept relatively low if the Commissioner of Inland Revenue accepted current (or similar) forms of charging as alternative forms of invoices. Some degree of aggregation of transactions on one invoice may also be required.
d. Full revenue would be collected if the charges represented full cost recovery for the service.

Separate Tax Rates

a. No particular alternative method has been considered. Possibilities would be transaction-based taxes (e.g. the current credit card and cheque duties).
b. Any method in this area is likely to be arbitrary, impinging more heavily on some types of transactions than others. This would create incentives for changes in forms of financial activity to minimise tax liabilities.
c. Operating costs are impossible to assess.
d. The collection of revenue would depend entirely on the approach adopted.

Zero Rating

a. All input tax would be rebated.
b. Competitive problems would arise insofar as activities in this area were more lightly taxed than other financial services.
c. Operating costs would be minimal.
d. Revenue would be nil.

Exemption

a. Tax cascades would be created.
b. Offshore-based operators would be given an advantage. There could also be effects on domestic competition if substitute forms of activity were possible under an alternative tax treatment.
c. Operating costs would be raised if apportioning inputs was required.
d. Revenue would be greater than under zero rating. Net revenue could be too high, depending on the proportion of services supplied to other businesses.

Additive Approach and Net Operating Income

a. Unless there was a way of identifying tax on individual transactions, this approach would lead to cascades.
b. Because tax was not identified, both offshore and domestic competitive problems would develop.
c. Operating costs would be very high if the approach was applied to these financial transactions alone.

d. The tax base would accurately reflect the value of financial services, but the inability to identify tax on transactions would lead to cascading.

5.4 INSURANCE SERVICES

Appropriate ways of treating insurance services are difficult to achieve. They should be looked at in two separate contexts:

a. Life Insurance

Life insurance services are different from other financial services in that they are nearly all provided direct to households, and the boundary problems usually involved in defining institutions do not exist. This meets some of the requirements for an efficient application of an additive type approach.

In the case of life insurance funds, particularly mutual life insurance funds, the institution and the policyholders are the same for the purposes of the GST. That is, a tax which reduces the earnings of the life insurance fund is borne by the policyholders through a lower rate of reversionary bonuses. Although the allocation of such a tax among policyholders would be random, and might not bear any relationship to the value added in the particular product they have purchased, an additive approach may be more appropriate here than in any other financial sector.

Equity should be maintained between the various forms of investment, so that superannuation funds, life insurance companies, and investment management companies faced similar tax regimes.

A more detailed discussion of how an additive approach might work for life insurance companies is outlined in Appendix A3.

b. Fire and General Insurance

Fire and general insurance is more complicated. Much of this type of insurance is business to business, as in financial intermediation generally. There is also the problem that offshore insurance services may be substituted for New Zealand-based services, in order to avoid tax. With the internationalisation of insurance markets, a New Zealand company can take out offshore insurance relatively easily.

Reinsurance is an important part of the risk-spreading mechanism. Any tax which could not be clearly identified at the point of purchase, and rebated at the point of export, would tend to make the reinsurance business less efficient.

The tax options outlined in Chapter 4 are reviewed below for insurance services:

Full Invoicing

a. Tax imposed on the full value of premiums would overstate the value of services provided, but could be explicitly stated and input tax credits claimed.
b. Direct importing of insurance services would become highly desirable, leaving domestic operators at a considerable disadvantage. This is more of a problem for fire and general insurers, as businesses are more likely to import the service.
c. Operating costs would be relatively low.
d. The revenue base would be overstated, although there would be a drain of revenue as overseas companies took market share.

Separate Tax Rates

a. A possible method, particularly for fire and general insurance, would be to establish a service charge for the industry as a whole. This could be used to set a lower rate of tax applicable to the full value of all premiums. The tax would then be identified and rebateable (on services sold to registered persons not taxed on a marginal basis).
b. Competitive problems would not be severe for sales to business.
c. Operating costs would be relatively low.
d. Any given level of revenue could be achieved through the setting of the separate tax rate.

Zero Rating

a. No tax would be passed on in sales.
b. Problems would only arise through inclusion of otherwise taxable activities in the zero rated area. It should, however, be possible to delineate this area relatively clearly to avoid erosion of the tax base.
c. Operating costs would be relatively low.
d. Revenue would be lost on insurance services sold to households.

Exemption

a. Some cascades would arise, particularly for fire and general policies sold to registered persons.
b. Some competitive disadvantages would arise vis-à-vis offshore insurers.
c. If all the services of an insurer were exempt, apportioning inputs would be no problem. If mixed with taxable activites, apportionment would cause some operating costs.
d. Revenue would be collected from intermediate inputs, and a small amount would arise from the cascade effect caused when businesses purchased fire and general insurance.

Additive Approach and Net Operating Income

a. An aggregate tax liability could be established fairly easily, but identifying the tax element in individual transations would be difficult. For life insurance, where almost all business is with consumers, this is not a serious problem.

b. Competitive problems for life insurance are relatively small, except where an offshore operator could sell directly to New Zealand consumers. The prospect of offshore competition is more significant for fire and general insurance.

c. Some operating costs would be involved e.g. calculation of a separate GST base with appropriate treatment of depreciation. They would be relatively minor, however.

d. Net revenue would be overstated if any cascades occurred.

6 Implementation And Transitional Problems

Timetable

The GST is scheduled to operate from 1 April 1986. From the time the legislation is passed in September, organisations will have about six months to put in place systems for measuring and collecting the tax. Many retailers already have much of the information required on the tax. Other types of business face more severe problems. If the Government's decisions are not made early, efficient implementation will be jeopardised.

Invoicing Requirements

The GST is an invoice-based tax system which requires organisations selling goods and services to issue a particular form of invoice, as set out in the White Paper. But many financial charges are small, and do not lend themselves to this type of invoicing.

For example, transaction fees paid to the banks are normally straightforward debits through the Databank system. If a full GST invoice was required for each debit, the paperwork would be considerable. The very small clearance fees charged on over-the-counter lodgements (around 10 cents) are another example. It could be extremely expensive for institutions to have to issue a form of invoice for each transaction. The cost of stationery alone could easily exceed the revenue generated.

In order that the financial sector might be properly integrated into the GST framework, the Government needs to allow other ways of complying with the tax. These could include, for instance, acceptance of non-standard types of invoice for GST purposes.

Existing Contracts

If lending interest were taxed by any of the methods suggested, serious transitional problems would arise. These revolve around contracts entered into before the date the tax comes into force - 1 April 1986. It is difficult both in principle and practice to apply a tax to an existing arrangement.

The question of principle will need to be addressed more fully at the political level. In practice, the problems are quite serious. If all interest paid or payable after 1 April 1986 were deemed liable for tax, institutions would have to review every outstanding loan and revise the repayment schedule to cover the tax payable. Apart from difficulties for the borrower of the funds who might be unable to meet the increased payment, the compliance cost would be significant.

The White Paper makes provision for the general GST to apply to existing contracts for supplies of goods or services. To that extent it would be inequitable to allow pre-existing financial contracts to run on free of tax. On the other hand, consumers who have undertaken binding contracts may consider it inequitable to have tax imposed part way through the life of the contract. It may also prove difficult to further reschedule mortgages.

Existing Taxes

The Government intends to use part of the revenue from GST to offset revenue lost from abolishing most wholesale sales taxes and some other indirect taxes. If a workable tax treatment is found for the financial sector, it would be appropriate for cheque, credit card and instrument duty to be abolished.

Operating Costs

The magnitude of operating costs (both administrative and compliance) will depend on the final tax treatment(s) chosen, and should influence that choice. Given the present uncertainty over possible tax treatments, it is too early to estimate the costs likely to be incurred by businesses in meeting their legal requirements, or by the Inland Revenue in administering the regime. These costs would rise principally for the following reasons:

a. the need to provide an acceptable invoice for tax purposes, as discussed above;
b. the need to maintain an adequate system of collecting and recording tax on outputs, and recording tax paid on inputs; and
c. the degree to which apportioning input taxes across activities is required.

At the same time, the GST will give a benefit to registered persons in the form of additional cash flow. Tax collected on sales is not proposed to be passed on to Inland Revenue until a month after the end of a two-monthly period. Provided that the firm is not in a net refund position, this time lag will confer potentially substantial cash flow benefits to registered persons.

General Issues

A number of general issues emerge in using some of the subsitute methods discussed in this paper. They include:

a. the difficulty of choosing a method which fits different institutional circumstances;

b. the need for any method to withstand financial manipulation/creative accounting;
c. the need to maintain certainty for consumers of these finanical services; and
d. the trade-off which typically occurs between operating costs and precise application.

7 Exports And Imports Of Financial Services

It is quite appropriate for exports of financial services to be effectively zero rated under the GST regime. This will ensure that New Zealanders providing services are not disadvantaged in the international market. A similar treatment is envisaged for exports of non-financial services. As a result, any tax system which is introduced for financial services will need to allow for zero rating or exemption with credit on services provided to non-residents. Definition will be difficult, as in many cases the service will have been provided in New Zealand to the non- resident, or offshore to a New Zealand resident.

Equally important is the need to ensure that imports of services are taxed in the same way as those provided domestically. For example, an individual borrowing funds offshore to finance a New Zealand purchase should in theory pay the same tax as if the loan had been raised in New Zealand. It is most unlikely that such flows could be detected, let alone taxed appropriately.

In the EEC financial services are generally exempted with credit only where it can be shown that the service was provided to a person outside the EEC. The internal consistency in the EEC means there is no need for special treatment for trade among its members.

In evaluating how tax changes will affect New Zealand's financial services, the tax treatment of overseas operators also has to be assessed. If major competitors faced similar taxes in their own countries, special treatment would not be required.

The proposed treatment of exports of goods conforms to the principle of taxing in country of destination. The alternative, taxing in country of origin, would be valid only if all countries had similar tax systems.

In New Zealand's case the major offshore financial centres in competition with domestic operators (Singapore, Sydney, Hong Kong) have indirect taxes on international transactions. Australia also has some domestic transactions taxes. It is important, if the strength of the local market is to be preserved and enhanced, that the GST treatment of financial services, particularly in the foreign exchange area, does not unduly disadvantage New Zealand-based operators.

8 Overseas Tax Practice

OVERVIEW

In nearly all value added tax systems most financial services have been exempted, and exports exempted with credit or zero-rated. Details are listed below of the methods used in European VATs.

The definition of financial services in a country is important, as in many cases certain activities such as stockbroking and safety deposit box rentals are taxable. On the whole, services with clearly defined fees capable of being separated from any institution's general services, remain taxable. The United Kingdom tax system illustrates this.

United Kingdom

Most financial services in the UK are exempt. These include dealings in foreign exchange, the transfer of money, the operation of all savings or deposit accounts, and any fee-based activity where the total consideration does not exceed £10. Exports of financial services — which in the British context means services provided to non-residents of the EEC — are a difficult area. Where such transactions can be identified as having been provided to non-residents, they are zero rated.

Taxable activities include underwriting, executor and trustee services, stockbroking, and advisory and registrar services. The problem then arises of how to allocate inputs in order to establish whether an input tax should be credited or not credited. In general, the ratio of input taxes allowed as offsets depends on the ratio of taxable or zero rated activities to total income.

Other EEC

Most EEC countries adopt a similar approach to that of the UK, although the legislation varies widely. In many countries, more services are zero rated. The allocation of input taxes generally depends on a turnover test by which the ratio of taxable and zero rated turnover to total turnover is measured. But if an input can be clearly identified as having been used in the production of taxable or zero rated services, it can be excluded from apportionment.

In general, banks seek to maximise their ability to claim back taxes on inputs by:

a. increasing the volume of taxable services they provide;
b. re-routing certain loans through non-EEC-based associates of companies to which they lend; and
c. ensuring that they do not incur input taxes on transfers of items within their own group.

United States

The United States does not have a federal VAT- or GST-type tax, although many states impose a retail sales tax. Under this system financial services are not taxed, nor are a number of other services. As part of the current Administration's efforts to reform the US tax system, the US Treasury has released a study on the feasibility of implementing a federal VAT.

This report looked at taxing interest in full, with certain exceptions. Most of the exceptions related to sectors of the economy where it was felt that imposing a VAT would be inappropriate, such as housing loans.

From a practical point of view the US Treasury work is not particularly useful. Problems of defining interest were not addressed, and the implicit over-taxation which comes from taxing full interest was not recognised. Nevertheless, the work was useful in establishing that interest includes a service element which is rightly taxable. The service element supplied to depositors, as well as to borrowers, was not mentioned, however.

Israel

When the Israeli Government introduced a VAT it decided to adopt an additive approach to taxing financial institutions.

This made institutions liable for the tax, as well as responsible for finding ways of passing on the tax burden to the consumers of their services. Opposition to the cascade effect of this unidentified tax element led the Government to remove the tax. In its place, an equivalent tax has apparently been levied on payroll and operating surplus. It is understood that this is a non-rebateable, indirect tax which has the same effect as the additive VAT, but it is not deemed a part of the value added tax system.

Other Financial Taxes

Many countries have forms of taxation on bank services which are not VAT- or GST-type taxes. In some cases they are a proxy for the fact that bank services are not being appropriately taxed, and as such they may be of interest to New Zealand authorities designing their own tax regime. These taxes usually take the form of transaction duties like cheque and credit card duties, or an annual tax on some financial aggregate. Australia has two tiers of taxes, one each at the Commonwealth and state level. Transaction taxes are levied only on that portion of the value of financial services relating to the payments system. This area currently provides a significant amount of the fee income of the major financial institutions. Where these duties and taxes exist in any country alongside VAT systems, they are not usually treated as rebateable input taxes.

More common in Europe is some form of annual tax levied on a financial aggregate, for example the French tax on the credit liabilities of banks and certain other financial institutions. In many cases these taxes are revenue-raising measures designed to compensate for non-inclusion of financial services in the value added tax.

DETAILS OF EUROPEAN TREATMENTS

EEC 6th Directive

Article 13 specifies certain exemptions. Under the compulsory exemptions are insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents.

Further exemptions are allowable, including:

- granting, negotiation and management of credit;
- negotiation and management of credit guarantees or other security;
- transactions concerning deposit and current accounts;
- transactions concerning legal tender; and
- transactions in shares, debentures and other securities.

Germany

Exemption without credit is applied to a specified list of financial transactions. The list seems comprehensive and includes insurance.

Exemption with credit applies to most financial transactions, excluding insurance, if either the contractor is established outside the EEC or the transactions relate directly to goods for export outside the EEC.

Belgium

Taxable services are specified and include services carried out by banks or other financial institutions, except for the transfer of securities or money. Specified as exempt without credit are:

- the deposit and acceptance of funds;
- credit operations including guarantee, discount and rediscount of commercial paper; and
- transactions involving the payment and acceptance of funds on another person's account.

Banks may elect to be taxable on the third category, whereupon credit for input tax is available. Insurance transactions are not specified in the list of taxable transactions.

Exemption with credit applies to most financial transactions and insurance if either the contractor is established outside the EEC or the transactions relate directly to goods for export outside the EEC.

Denmark

Financial and insurance services are specified as exempt without credit.

France

While all banking and financial services are in principle subject to tax, the majority are in practice exempted. Insurance and reinsurance are exempt without credit. Credit is available for insurance transactions and certain financial services where these relate directly to the export of goods outside the EEC.

Ireland

Exempted services are specified in a schedule. They include most financial services and insurance transactions.

Italy

Certain financial services are exempt without credit:
- credit transactions and related services;
- management services with respect to mutual investment funds,
- activities related to foreign exchange;
- insurance, life insurance and reinsurance; and
- the activities related to shares and bonds.

Although it is not entirely clear from the information available, it would seem that other financial services are taxable.

Luxembourg

Exemption without credit is applied to a specified list of financial transactions. This list is comprehensive and includes insurance.

Exemption with credit applies to most financial transactions, including insurance, if either the contractor is established outside the EEC or the transactions relate directly to goods for export outside the EEC.

Netherlands

Exemption without credit is applied to a specified list of financial transactions. The list seems comprehensive and includes insurance.

United Kingdom

Exemption without credit is applied to a specified list of financial transactions. The lists are comprehensive and one group covers insurance.

Zero rating applies to most financial transactions, including insurance, where the transactions relate directly to goods for export outside the EEC.

Norway

Services are taxable only if specified. Financial services and insurance are not included and are exempt without credit.

Sweden

Services are taxable only if specified. Financial services and insurance are not included and are exempt without credit.

9 Conclusion

The problem of applying GST to financial services arises from the difficulty of separating the cost of the service from the gross value of the transactions. In overseas countries with similar tax systems, most financial transactions have been exempted or zero rated where exported. This has avoided having to measure the price of the service but has led to tax being levied on services whose price already includes an element of tax.

Financial services are made up of a wide variety of transactions, provided by a diverse range of businesses and individuals. It is difficult to separate the activities of financial institutions from similar transactions undertaken (to a lesser extent) by most other businesses and many individuals. Rather than focusing on financial institutions, this paper has discussed the issues surrounding the taxation of financial services under a GST. These services were divided into four broad categories:

a. financial intermediation;
b. financial asset trading;
c. fee and commission activity; and
d. insurance services.

Each area of activity was examined in terms of the impact of the six different tax options outlined in Chapter 4. The criteria used in the assessment of these options were that the tax should:

a. be identifiable and rebateable;
b. be neutral with respect to competitiveness;
c. not impose operating costs disproportionate to the expected revenue; and
d. raise revenue in proportion to the value of the services.

Most of the options examined involved a degree of compromise on one or more of these criteria. Generally, those treatments that best met the efficiency criteria (a and b) and the revenue requirements were those with the greatest complexity and highest compliance costs. The simplest solutions involved some loss either of efficiency or revenue.

In some cases, applying a tax on total output of services will involve considerable operating costs. It is possible to tax only part of the output, e.g.

services provided direct to final consumers, at a lower level of operating costs. This transforms the tax from a true GST to more of a retail sales tax. Such an approach weakens the general integrity of an invoice-based GST but involves no net loss in revenue, as any tax on sales direct to businesses which are registered persons would have been subsequently rebated.

It is also important to ensure that the combination of different tax treatments for different activities does not encourage businesses to change their pricing practices to avoid tax.

Nevertheless, some options have arisen which deserve closer examination before the Government makes its final decision:

a. Full taxation of interest flows grossly over-taxes them. An alternative is to set some lower rate of tax to reflect the fact that only the interest margin represents the cost of services supplied. Is it appropriate to set an arbitrary tax rate on interest based on an average assessment of interest margins? Alternatively, is a better method available? Can a similar method be used for fire and general insurance?
b. If a tax on interest is introduced, should existing loans be subject to the tax on the same basis as new loans?
c. It is difficult to tax the trading of financial assets in a way which fairly reflects the service element, but avoids taxing individuals' income flows. Can some form of taxation be found to avoid this problem?
d. Full invoicing of fees and charges seems possible, but there is a potential loss of revenue if such charges do not cover the full cost of the service. What tax treatments of other financial services would avoid this?
e. Taxation of life insurance activities by an additive approach appears feasible. This is largely because the services are supplied direct to households and there is less requirement for identification of the tax. Would such an approach to life offices unduly disadvantage life insurance vis-a-vis other forms of savings?

It is hoped that further discussion of these questions during the consultative process will clarify the issues involved. This should lead to a more considered final integration of financial services within the GST regime.

Appendix A1

Measuring the Size of Financial Services

The potential size of the various areas of financial activity is detailed below. The tables are based on data provided by the Department of Statistics (sourced mostly from the 1982/83 Census of Services), but a number of approximations have also been used, especially when trying to assess the proportion of services supplied to consumers. These are generally made explicit, and were arrived at through discussions within the finance industry. They should be used for indicative purposes only.

The tables are presented initially by sector of activity: Banking (Group 811), Financing other than Banking (Group 812), and Insurance (Group 82). The information on the potential tax bases is presented on an institutional base, an activity base, and finally an activity base adjusted to show only the value of services supplied to consumers.

This approach varies to some degree from that used by the Department of Statistics for the national accounts, which presents some problems as discussed below.

National Accounts

Interest in the national accounts is regarded as a transfer of property income, ie, not as a payment for goods or services but as a payment for transfer of ownership of some asset (even if for only a short time, as with bank deposits). As a result, interest income does not form part of a firm's output for national accounts purposes. In the same way, the payment for title to second-hand goods is not regarded as production, though any margin retained by the seller would be. Other income transfers, for example the payment of social welfare benefits, are likewise not included in the national accounts as they represent a transfer of income not associated with the production of goods and services. This suggests that the financial sector, where the major part of income is derived from a net interest margin, makes a negative contribution to GDP (it has little recorded income but incurs salary and wage costs and it purchases other intermediate inputs). To compensate for this, an arbitrary output figure is arrived at, known as the net interest margin.

Because this output must have been bought by somebody, the Department of Statistics currently allocates it across all other production groups. A more accurate allocation would require separating out that part of the margin which constitutes final consumption by households.

Banking Sector

NZSIC Code: 81120 — Central and Trading Banking
81130 — Savings Banks

BANKING

	81120 $M	81130 $M	811 $M
Expenditure			
Salaries and wages	232	118	350
Commissions			0
ACC levies	35	4	39
Depreciation	15	8	23
Bad debts etc	13		13
Interest	903	399	1302
Rates, land tax etc	4	1	5
Other costs	174	101	275
Total costs	1376	631	2007
Income			
Income from final services	358		358
Dividends	8		8
Donations, royalties etc	12		12
Interest	1228	667	1895
Rent	5	2	7
Net extraordinary	18	0	18
Total income	1617	681	2298
Profit	241	50	291
Gross capital expenditure	40 (estimated split)	24	64

BANKING

	81120 $M	81130 $M	811 $M
Tax Base: Institution			
Zero rated	0	0	0
Exemption	214	125	339
Net operating income	714	282	996
Additive approach	739	298	1037
Tax Base: Activity			
Net interest and dividends	333	268	601
Asset trading & fees and commissions	358	0	358
Insurance services	0	0	0
Tax Base: Activity, adjusted for proportion of consumer transactions			
Net interest and dividends	133	188	321
Proportion assumed	40%	70%	
Asset trading & fees and commissions	18	0	18
Proportion assumed	5%	100%	
Insurance services	0	0	0
Total services supplied to consumers	151	188	339

Financing Other Than Banking

NZSIC Code: 81210 — Building Society Operation
81220 — Credit Union Operation
81230 — Co-operative Savings Association Operation
81240 — Money Market Dealing
81270 — Franchise and Royalty Operation
81290 — Other Financing not included elsewhere

FINANCING OTHER THAN BANKING

	81210 $M	81220 $M	81230 $M	81240 $M	81270 $M	81290 $M	812 $M
Expenditure							
Salaries and wages	18	5	5	16	0	76	119
Commissions	0	0	0	2	1	1	2
ACC levies	1	0	0	1	0	5	6
Depreciation	4	0	1	1	0	8	15
Bad debts etc	0	0	0	6	0	12	18
Interest	76	0	6	246	0	744	1075
Rates, land tax etc	0	0	0	0	0	0	0
Other costs	25	2	5	23	0	133	188
Total costs	124	7	17	293	2	979	1424
Income							
Income from final services	6	0	6	43	1	81	138
Dividends	0	0	0	3	0	63	66
Donations, royalties, etc	0	0	0	0	4	0	4
Interest	158	5	12	286	1	966	1429
Rent	3	0	0	0	0	19	22
Net extraordinary	0	0	0	3	0	3	6
Total income	167	5	18	335	6	1132	1665
Profit	43	−2	1	42	4	153	241
Gross capital expenditure	9	0	04	4	16	33	

FINANCING OTHER THAN BANKING

	81210 $M	81220 $M	81230 $M	81240 $M	81270 $M	81290 $M	812 $M
Tax Base: Institution							
Zero rated	0	0	0	0	0	0	0
Exemption	34	2	5	27	4	149	221
Net operating income	91	5	12	89	6	388	590
Additive approach	96	5	11	92	10	396	608
Tax Base: Activity							
Net interest and dividends	82	5	6	43	1	285	420
Asset trading & fees and commissions	6	0	6	43	1	81	138
Insurance services	0	0	0	0	0	0	0
Tax base: Activity based, adjusted for proportion of consumer transactions							
Net interest and dividends	66	5	6	9	1	57	144
Proportion assumed	80%	100%	100%	20%	100%	20%	
Asset trading & fees and commissions	1	0	1	4	0	8	14
Proportion assumed	10%	10%	10%	10%	10%	10%	
Insurance services	0	0	0	0	0	0	0
Total services supplied to consumers	67	5	7	13	1	65	158

Insurance

NZSIC Code: 82110 — Life Insurance
82120 — Medical Insurance
82130 — Fire and General Insurance
82210 — Superannuation and Pension Funds
82301 — Services to Insurance and Superannuation

INSURANCE

	82110 $M	82120 $M	82130 $M	82210 $M	82301 $M	82 $M
Expenditure						
Salaries and wages	66	3	93	1	23	186
Commissions	90	2	56	0	5	153
Depreciation	21	0	6	2	1	30
Interest	1	0	2	40	1	44
Rates, land tax etc	9	0	29	0	038	
Other costs	94	3	58	9	24	188
Claims, pensions etc	404	38	374	433	0	1249
Total Costs	685	46	618	485	54	1888
Income						
Net premium income	654	49	565	662	0	1930
Management fees	10	0	7	0	3	20
Dividends	57	1	32	66	0	156
Interest	345	7	35	321	7	715
Rent	84	0	8	26	1	119
Commissions	0	0	18	0	53	71
Extraordinary and others	68	0	3	72	12	155
Total Income	1218	57	688	1147	76	3166
Balance of income over operating expenses for the year	533	11	50	662	22	1278
Operating surplus	3	0	18	0	22	43
Gross capital expenditure	?	?	?	?	?	?

INSURANCE

	82110 $M	82120 $M	82130 $M	82210 $M	82301 $M	82 $M
Salaries and wages	66	3	93	1	23	186
Depreciation	21	0	6	2	1	30
Rates, land tax	9	0	29	0	0	38
Intermediate consumption						
Other costs	94	3	58	9	24	188
Commissions	90	2	56	0	5	153
Transfer to proprietors of any gross expense profit	3	0	18	0	22	43
For this calculation, all medical insurance and superannuation companies are assumed to be mutuals						
Total	283	8	260	12	75	638
Proportion supplied to consumer	95%	100%	50%	100%	10%	
Services supplied to consumers	269	8	130	12	8	426

Appendix A2

Separate Tax Rates

This appendix outlines one way in which a separate rate of tax for lending interest rates could be calculated. The proposal has a number of variations, some of which are discussed under the section headed 'Appraisal'.

Proposal

A reduced rate of tax could be worked out to ensure that only the value added in lending transactions (the net interest margin) was being taxed. The formula for calculating this lower rate would be:

$$\text{Tax Rate} = \frac{\text{Net interest margin}}{\text{Interest rate}} \times \text{Standard GST Rate}$$

Assuming a net interest margin of 4 percent, a gross interest rate of 20 percent and a standard GST rate of 10 percent, the reduced rate of tax would be:

$$\text{Tax Rate} = \frac{4.0}{20.0} \times 10$$

$$= 2.0 \text{ percent}$$

It is important to note that this is 2.0 percent of the interest charged, not 2.0 percent of the principal. In the example, the tax is equal to 0.4 percent of the amount of the loan, which would raise the total price to the borrower from 20.0 to 20.4 percent per annum.

Different financial institutions have different net interest margins, which are both separate and unpredictable. A decision would need to be made as to whether each institution could calculate its own rate, or whether an industry average calculation should be applied to all lending.

Alternatively, the tax could be set as a fixed amount at the commencement of a loan. This would simplify administration, but weaken the link between the amount of tax and the value of the service being provided.

Definition of Interest

What constitutes interest is especially difficult to define in complex commercial transactions. For the purposes of GST, the finance rate calculation from the Credit Contracts Act could provide a consistent measure. This has an advantage in that it is already mandatory to disclose the finance rate in most forms of lending, although this may cause compliance costs as it is generally not the rate used to calculate interest payments.

The Credit Contracts Act does not cover all forms of lending, and definitional problems would remain for calculating interest on more complex transactions. Many of these involve securities trading, and the appropriateness of taxing them would depend on how the transactions themselves are treated under a GST.

Coverage

A tax on all lending would have some complications. At one extreme, any individual depositing funds at a bank could be defined for tax purposes as lending those funds. This would be impractical, as it would require all savers to become registered GST taxpayers. A turnover test, with taxable turnover adjusted to ensure that only the assessed net interest margin was counted, would be an improvement.

This approach would still include a large number of deposits by trusts, superannuation funds, other institutions, and individuals whose annual interest income was above the tax threshold.

The coverage could be further narrowed to apply only to forms of credit currently controlled under the Credit Contracts Act. This would exclude a large number of deposit and lending activities among companies and financial institutions, but would include most forms of lending to the consumer. The loss of the commercial lending is not important in net revenue terms.

Evaluation

The method outlined is very general and could be applied in several ways. Evaluating it against the criteria set out in Section 2.2 takes into account some of the alternative definitions and the extent of coverage.

The criteria used are:

a. the tax should be identified and rebateable;
b. competitive neutrality should be preserved;
c. operating costs should not be excessive; and
d. the tax should be based on the value of the services supplied.

Unless otherwise stated, the evaluation assumes that an average interest margin has been used to set a rate of tax on all lending by organisations and individuals with sufficient taxable turnover to pass the GST business test:

a. All the alternatives proposed allow the tax to be fully identified and rebates claimed where appropriate.
b. A single rate of tax across all lending would not necessarily be competitively neutral. The tax is meant to be on the net interest margin, which will vary widely. Some lenders will therefore have to charge an excessive tax, while others will benefit from charging a lower rate.
c. There would be significant compliance costs if all lending were taxed, as this would include inter-institutional transactions. Financial institutions receive deposits from both taxable and non-taxable sources. In high turnover markets, such as the wholesale call money market, the compliance costs of having to invoice all transactions would be excessive. These would be minimised if

the tax was limited to lending as defined in the Credit Contracts Act. This area requires further investigation.

d. All the alternatives apply a full rate of tax on the net interest margin of most lending to the household sector. This yields the full revenue contribution required. If some forms of lending (mainly inter-institutional transactions) were excluded, the net revenue loss would not be significant, as in most cases the tax would have been rebated.

Conclusion

The perfect form of a separate tax rate on lending interest would allow each lender to calculate his own margin, and apply the tax accordingly. The coverage would be total. But such a tax would have the highest compliance and administrative costs, and a plethora of tax rates.

To achieve a more simple application, some of the requirements for competitive neutrality must be sacrificed.

Appendix A3

Additive Approach

Background

The additive approach switches the focus from the price of the service to the elements which make up that price. In principle, this should generate the same amount of revenue as the general GST for any good or service. The main reason for moving to the additive method is where the price of the service cannot be clearly identified, as is the case in many financial transactions.

One form of the additive approach allows for rebating of tax on inputs of goods, and the other does not. The following example illustrates these alternatives:

XY Finance Company	**$000**
Income	250
Interest	10
Fees and commissions	10
Trading	50
Miscellaneous	5
Expenses	
Wages and salaries	50
Other inputs	30
Interest	180
Depreciation	25
Operating surplus	30
Capital purchases	25

Tax Base

Input credits disallowed		Input credits allowed	
	$000		$000
Wages and salaries	50	Wages and salaries	50
Operating surplus	30	Other inputs	30
		Operating surplus	30
Base	80	Depreciation	25
plus Input taxes:		Total output	135
Other inputs	30		
Capital purchases	25	less input credits:	
		Other inputs	30
		Capital	25
Total output	135		
		Tax Base	80

The tax base in the two cases is the same, because capital purchases are the same as depreciation. If capital purchases were higher (say $50,000) the total tax for the example in which input credits are disallowed would rise by $25,000, but in the second case they would stay the same.

In order to minimise any inequity in the treatment of capital, it would be preferable to allow inputs to be credited and to include depreciation in the tax base.

The disadvantages of additive approach relate to the difficulty of isolating the tax element in any particular transaction. This means that the tax cannot be rebated to the purchaser, which leads to tax cascades and lack of competitive neutrality.

Life Insurance

Life insurance is more suited to taxation by the additive approach for three reasons:

a. Because purchasers of the service are usually the beneficiaries of the fund's income, it is more appropriate for the tax to be borne by the life fund than loaded onto the premium.

b. The purchasers of life insurance policies are predominantly final consumers. This removes the problem of tax cascades.

c. The existence of regulatory controls makes it relatively easy to isolate the costs associated with the activity to be treated additively from the costs of other business activity.

The components of an additive tax base for life insurance companies would be:

— salaries, wages and other labour costs of those involved in the administration and management of the fund;

— depreciation (assuming that all GST on inputs, including capital, is rebateable);

— that part of any transfer to proprietors which represents gross expense profit (this would exclude income tax on policyholders' income from the tax base); and

— all items of intermediate consumption.

This treatment would integrate life office activities fully into the credit-offset mechanism, but would not identify tax on outputs.

If necessary, it could be possible to find some method which expressed average administrative costs as a percentage of the premium, and allowed the tax to be identified and rebated where appropriate.

Investment and other activities of the life office could be treated as outlined elsewhere. This would allow comparable tax treatment for activities such as lending, which are independent of the type of institution offering the loan. Consideration needs to be given to how existing contracts would be affected.

Depreciation of Operational Capital Items

Purchases of capital are effectively removed from the tax base by the offset mechanism, but re-enter the tax base as the capital is 'used up' (depreciated). To avoid complication, normal Inland Revenue depreciation rules could be applied. The actual rates of depreciation used are not very significant, although they would affect the timing of GST payments. When an asset is sold, an adjustment would be made to the GST liability of the fund:

- where a profit above its book value is made on sale of the asset, the GST liability for the period would be reduced (higher depreciation costs would have effectively made the fund's tax liability greater than it should have been); or
- where a loss is made, this would be added to the tax liability.

Transitional problems will need to be resolved regarding the value of assets at 1 April 1986. It seems likely that market valuation as at that date would be required.

Glossary of Terms

Additive Approach — A method of calculating the tax base by adding up all input items which make up value added, and excluding the cost of inputs purchased from outside the business. Value added inputs include wages and salaries, rates, levies, and gross margin less depreciation.

Capital Gains — Increase in the value of a capital asset after realisation.

Cascades — The process that occurs when prices of goods and services include some unrebated tax from an earlier stage of production or distribution. The tax applied on top of this unrebated tax increases the final sale price by more than the overall rate of tax imposed.

Close Substitution — Where one form of an activity can easily replace another, becoming a close substitute for it. Mostly occurs when there is an overseas substitute, as in insurance services.

Compliance Costs — Costs to taxpayers over and above the amount of tax they must pay. Includes the cost of accountants, the value of time spent becoming familiar with the tax, keeping records and filing returns.

Credit-Offset — A means of relieving tax on sales of taxable goods and services between businesses by offsetting tax paid on purchases against tax charged on sales.

Direct Taxes — Taxes on income, profits and wealth. Direct taxes imply that the person who is legally responsible for the tax bears the economic burden of the tax (see Incidence).

Distortion — In economic usage, distortion occurs when a tax method selectively affects the price of a particular good or service, sometimes because of the form or manner in which the good or service was produced. The product may therefore have an unfair advantage or disadvantage in the market.

Distribution System — Importers, wholesalers, retailers and the transport sector.

Exemption — Under a GST this means that at the relevant stage the trader does not have to levy tax on the goods or service. However, it may still be taxed at other stages. This contrasts with zero rating, which involves an exemption on sales with credits on purchases, so there is no tax component in prices.

Exemption with Credit — The taxpayer may claim a full refund of tax paid on the inputs of the good or service. No tax is passed on in the prices of output sales. This method is used when no output sale value can be established and zero rating applied. In practice, exemption with credit is the same as zero rating.

Fee and Commission Activity — Charges on financial services in the form of fees and commissions, levied by the providers of those services.

Financial Assets — Usually a certificate representing a sum of money or capital which may be bought and sold. The form of the asset is dictated by the financial market in which it is traded. Financial assets include debentures, stocks, shares, foreign exchange and futures contracts.

Financial Assets Trading — The buying and selling of financial assets (usually in the form of a certificate representing a sum of money or capital).

Financial Institution — Any organisation which derives its income predominantly from trading in financial assets e.g. banks, finance companies, investment companies, credit unions, building societies and life insurance offices.

Financial Intermediation — The financial services that take place between two sets of clients, as when a bank accepts deposits from firms and consumers and lends these funds on to other firms and consumers.

Financial Services — Services consisting of one or more financial transactions, offered by a financial institution, a firm or an individual to a consumer or household.

Financial Transaction — A transaction involving money that takes place between two parties. Financial transactions are of many kinds, ranging from a simple cheque payment to lending and borrowing funds, transferring money from one currency into another and buying Government stock.

Full Invoicing — A method of applying the Goods and Service Tax which would require an invoice based on the full value of every transaction. This value may be either the actual cost of the transaction, as in fees and commissions, or the value of the nominal amount the transaction represents, as in deposits and withdrawals.

Goods and Services Tax — An indirect tax on the value of goods and services sold in New Zealand, to be introduced on 1 April 1986.

GDP — Gross Domestic Product. The total value of goods and services produced by an economy in a year. Also equal to the total value added in an economy in a year.

Incidence — The incidence of a tax refers to how tax burdens are distributed among different groups and income classes. **Legal incidence** refers to the person who must bear the responsibility for paying the tax. **Economic incidence** recognises that the economic burden for paying the tax can be shifted onto others, in the form of changes in prices, wages, or profits. A tax is **progressive** if the (economic) tax burden, expressed as a percentage of income, *rises* as income rises. A tax is **regressive** if the tax burden expressed as a percentage of income, *falls* as income rises.

Indirect Taxes — Taxes on transactions, goods and services, where the person paying the tax is not the person who bears the economic burden of the tax.

Input Tax — The GST already paid on inputs purchased by a trader (for which she/he receives credit).

Inputs — Materials, services, wages, salaries and other labour costs, capital costs, depreciation, duties and excises which go into any stage of production or distribution.

Net Interest Margin — That part of an interest rate which represents the margin retained by the supplier of those services, above the cost of borrowing funds.

Net Operating Income — The net operating income of an institution consists of net interest, and the margins and fees charged on the institutions other financial activities, e.g. dealing in stock or foreign exchange. The net operating income of a specific activity would be the net revenue from that activity alone, without margins and fees. When net operating income is used to calculate tax liability, credits may be claimed for all tax paid on inputs.

Neutrality — This is achieved where the imposition of a tax does not result in any change in the way producers or consumers use their resources.

Output Tax — The GST owed on sales by taxable traders. GST tax liability is the difference between output tax and input tax (which equals the difference between tax on sales and tax credits from purchases of inputs).

Outputs — Goods and services resulting from a process of production; usually synonymous with the sale of those goods and services.

Registered Person — An individual, business or other organisation required to register and pay GST.

Retail Sales Tax (RST) — A single-stage indirect tax levied on goods and services at the final stage before consumption. Sales to businesses are exempted from tax. The potential tax base of the RST is the same as that of the GST.

Separate Tax Rates — Tax rates adjusted to equal the proportion of a transaction which represents a service charge. The rates therefore vary according to the size of the service charge.

Stage of Production — Manufacturing, importing, wholesaling and retailing are each a stage of production.

Subtractive Approach — The method of calculating the tax base used for the general Goods and Services Tax. It is all sales of an institution less the sum of all purchases of inputs.

Tax Avoidance — Legally arranging the affairs of a taxpayer to minimise taxes.

Tax Base — The base on which a tax is levied, e.g. income, expenditure (or consumption) on wealth. The GST has expenditure (consumption) as its base.

Tax-on-Tax — When taxes imposed at one stage of production are taxed at a subsequent stage without relief.

Value Added — In accounting terms, the difference between the price paid for an item and the price received for its sale. In economic terms, the contribution to GDP made by a sector or commodity.

Value Added Tax (VAT) — Also referred to as a Goods and Services Tax (GST). A sales tax levied on the difference between a firm's sales and its purchases. Because taxpayers are permitted to deduct the tax paid on an item at earlier stages from their tax liability, they effectively pay tax only on that proportion of the item's value (as reflected by its price) to which they have contributed.

Zero Rating — A nil rate of tax. When goods or services are zero rated no tax is paid on output sales, and a full credit of tax paid by previous suppliers of the good or service may be claimed on inputs. In effect, this is the same as exemption with credit.