

GST guidelines for working with the new zero-rating rules for financial services

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Prepared by the Policy Advice Division of the Inland Revenue Department

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Introduction

The new rules

1. The Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003 amended the Goods & Services Tax Act 1985 (the GST Act) to allow supplies of financial services by a GST-registered person to another GST-registered person to be zero-rated. The changes integrate the supply of financial services more fully into the GST system by taxing such supplies at the rate of 0% and allowing financial services providers to deduct input tax in respect of those supplies.¹ This is in contrast to the “exempt” treatment of financial services, whereby GST is not charged and financial services providers cannot deduct input tax for GST paid on goods and services used in supplying financial services.

2. From 1 January 2005 the zero-rating rules² allow providers to elect to zero-rate supplies of financial services to customers who:

- are registered for GST if the level of taxable supplies³ made by the customer in a given 12-month period (including the taxable period in which the supply is made) is equal to or exceeds 75 percent of their total supplies for the period;
- may not meet the 75 percent threshold but are part of a group that does meet the threshold in a given 12-month period (including the taxable period in which the supply is made) – for example, the treasury or finance function of a group of companies who receives financial services.

Note: The treatment of financial services supplied to unregistered persons remains unchanged. Supplies to final consumers in New Zealand are still exempt supplies and cannot be zero-rated under these guidelines.

3. From 1 January 2005 the GST Act also provides an additional deduction from output tax for supplies of financial services made to another financial services provider, which in turn makes supplies to businesses that would qualify to receive zero-rated financial services.⁴ The amount that can be deducted will be determined by the ratio of taxable to non-taxable supplies made by the recipient financial services provider.⁵ The formula for calculating the value of the deduction is set out in these guidelines, but is generally based on the recipients’ relative proportions of business and non-business customers.

¹ See *Tax Information Bulletin* Vol. 16 No. 1 February 2004 pp 23 to 31 for a discussion on the legislative amendments contained in the Taxation (GST, Trans-Tasman Imputation and Miscellaneous Provisions) Act 2003.

² See sections 11A(1)(q) and (r).

³ Excluding supplies of financial services zero-rated under sections 11A(1)(q) and/or (r).

⁴ See section 20(3)(h).

⁵ See section 20C.

4. These guidelines set out Inland Revenue's generally approved method for zero-rating supplies of financial services.⁶

5. They also set out the application of the various deductions allowed for financial services providers as input tax under the GST Act.⁷

What is a “financial service”?

6. Although many activities may be thought of as a “financial service”, for the purposes of the GST Act, the term “financial services” generally applies to the following types of transaction:⁸

- dealings with money;
- certain dealings with securities;
- the provision of credit and loans;
- the provision of life insurance (including superannuation);
- the provision of non-deliverable futures contracts and financial options;
- the payment and collection of interest, principal, dividends and amounts relating to transactions involving securities; and
- intermediation and brokerage services relating to the supply of debt, equity and life insurance.

7. Services that are not treated as financial services include debt collection, equipment leasing, credit control, sales ledger and accounting services, investment guidance, fire and general insurance and the provision of advice.

Examples of financial services include:

- paying or collecting any amount of interest;
- providing or brokering mortgages and other loans;
- issuing securities such as stocks and shares;
- providing credit under a credit contract;
- exchanging currency (for example, changing US\$ into NZ\$).

⁶ The authority for these guidelines is provided in section 20E.

⁷ See section 20(3).

⁸ See section 3.

Scope and purpose of the guidelines

8. These guidelines apply to financial services providers that are GST-registered, or liable to be registered for GST, who supply financial intermediation services. Financial intermediation services are those that bring together suppliers and consumers of financial services. Examples include deposit-taking intermediation, which involves bringing together suppliers and users of financial capital, and brokerage services involving the buying and selling of financial instruments and currencies.

9. The guidelines do not apply to persons that do not supply financial services as part of their normal business activity – for example, one-off or isolated transactions that do not constitute a wider activity involving supplies to another person for a consideration, activities that involve only holding securities belonging to another entity, and the issue of capital in a company or trust. These activities are generally not considered on their own to constitute a taxable or exempt activity for GST purposes.⁹ However, whether or not a particular financial service constitutes such an activity needs to be determined on a case-by-case basis. Any questions regarding whether or not a financial activity is a taxable or exempt activity should be directed to Inland Revenue or a tax advisor.

10. The application of the zero-rating rules requires providers to know, at a minimum, whether their customer is registered for GST and the ratio of taxable supplies to total supplies made by the customer. Under the GST Act, these tests must, in the first instance, be applied on a transaction-by-transaction basis. However, to recognise the costs that could arise in meeting these requirements, the GST Act allows providers to apply an alternative method approved by Inland Revenue, either generally or by specific agreement.

Alternative approaches

11. Providers may seek approval from Inland Revenue to use a different method from that specified in the guidelines for zero-rating supplies of financial services, provided it produces as fair and reasonable a result as identifying eligible customers on a transaction-by-transaction basis would.¹⁰ Otherwise, providers may either apply these guidelines or zero-rate supplies of financial services on a transaction-by-transaction basis, as required by the GST Act.

12. Inland Revenue may also agree to an alternative method for determining the extent to which goods and services are applied for making taxable and non-taxable supplies for the purpose of adjusting deductions of input tax. Approval will always be dependent on the alternative producing a fair and reasonable result.¹¹

⁹ See section 6 and also see *Taupo Iki Nui Body Corporate v Commissioner of Inland Revenue* (1997) 18 NZTC 13,147 and *Polysar Investments Netherlands BV v Inspecteur der Invoerrechten en Accijnzen* 1993 (Case C-60/90).

¹⁰ See section 20E.

¹¹ See section 21A.

Summary of guideline options

13. Providers have the following choices if they elect to use the zero-rating rules and deduct input tax for GST paid on making zero-rated supplies of financial services.

Topic		Relevant sections in the GST Act	Options		
			Option 1 Use these guidelines	Option 2 Not use the guidelines	Option 3 Obtain a specific method
Zero-rating		Sections 3 and 11A(1)(q) and (r)	See paragraphs 22 to 52	Zero-rate on a transaction-by-transaction basis	Apply in writing to Inland Revenue to use an alternative method
Deductions from output tax	Principal purpose / change-in-use adjustments	Sections 20(3)(e) and 21 to 21G	See paragraphs 56 to 77	Use the principal purpose test or direct attribution to deduct input tax	Apply in writing to Inland Revenue to use an alternative method
	Deduction for supplies between financial services providers	Sections 20(3)(h) and 20C	See paragraphs 78 to 90		

References

14. Unless otherwise specified, all section references are to the Goods and Services Tax Act 1985.

Election into the new GST rules

15. The GST Act requires providers to give written notice to Inland Revenue if they wish to zero-rate supplies of financial services and/or be eligible to deduct input tax for supplies of financial services made to other financial services providers.

16. This means if the compliance costs of zero-rating outweigh the benefits, providers can choose not to elect into the new provisions.

17. Elections will take effect from the first day of the taxable period in which Inland Revenue receives the written notice.

18. An election will cease from the end of the taxable period:

- in which the provider ceases to carry on a taxable activity; or
- that is nominated by the provider in a written notice, if the date nominated is after the taxable period in which Inland Revenue receives notice; or
- in which Inland Revenue receives written notice if the provider does not nominate a taxable period.

19. Elections should be addressed to:

Inland Revenue Corporates
Financial Sector
Private Bag 39984
Wellington

Fax (04) 802-6192

Who to contact

20. Any questions in relation to these guidelines should be directed to Inland Revenue on 0800 377 776. Financial services providers who are companies or groups of companies with an annual turnover in excess of \$100 million or whose industry is governed by specific tax legislation should call Inland Revenue on 0800 443 773.

Penalties and interest

21. Providers are responsible for complying with the various Inland Revenue Acts and may face penalties and interest if they do not meet the obligations set out in those Acts. Information about obligations, penalties and interest can be found in the Inland Revenue publication *Taxpayer obligations, interest and penalties (IR240)*, which is available on the Inland Revenue website www.ird.govt.nz.

Zero-rating

Paragraphs 22 to 52 set out Inland Revenue's approved method for applying the zero-rating rules in relation to supplies of financial services. Financial services providers who have elected to zero-rate supplies using the guidelines must comply with these paragraphs.

General application

22. The zero-rating rules allow providers to:

- Zero-rate supplies of financial services to customers who are registered for GST if the level of taxable supplies made by the customer¹² in a given 12-month period (including the taxable period in which the supply is made) is equal to or exceeds 75 percent of their total supplies for the period.
- Zero-rate supplies of financial services to customers who may not meet the 75 percent threshold but are part of a group that does meet the threshold in a given

¹² Excluding supplies of financial services zero-rated under sections 11A(1)(q) and/or (r).

12-month period (including the taxable period in which the supply is made) – for example, the treasury or finance function of a group of companies that receives financial services.

23. Supplies of financial services cannot be zero-rated if:
- they are supplied to businesses whose activity of making exempt supplies of financial services and other non-financial exempt supplies is more than 25 percent of their total supplies; or
 - they are supplied to unregistered persons (or final consumers).
24. When making a decision on whether or not a supply of financial services should be zero-rated, all necessary steps must be undertaken to ensure that the decision is correct.

Evidential requirements

25. It is important to keep adequate books and records to substantiate any decisions to zero-rate financial services to customers, undertake regular reviews of any systems and procedures used to categorise customers and generally comply with the tax law. It is also necessary to have a process that enables those decisions to zero-rate services to be reviewed each year. The review process need not be comprehensive but it is expected that a reasonable sample of data of at least 10 percent in total across all customer, industry and business groups will be selected and tested. If a material level of inconsistency is detected, Inland Revenue expects that the provider will undertake a more rigorous review and corrective programme.

26. If the financial services provider is aware that a customer is no longer eligible to receive zero-rated supplies, zero-rating should cease. For one-off transactions a review will not necessarily be required – see paragraph 38.

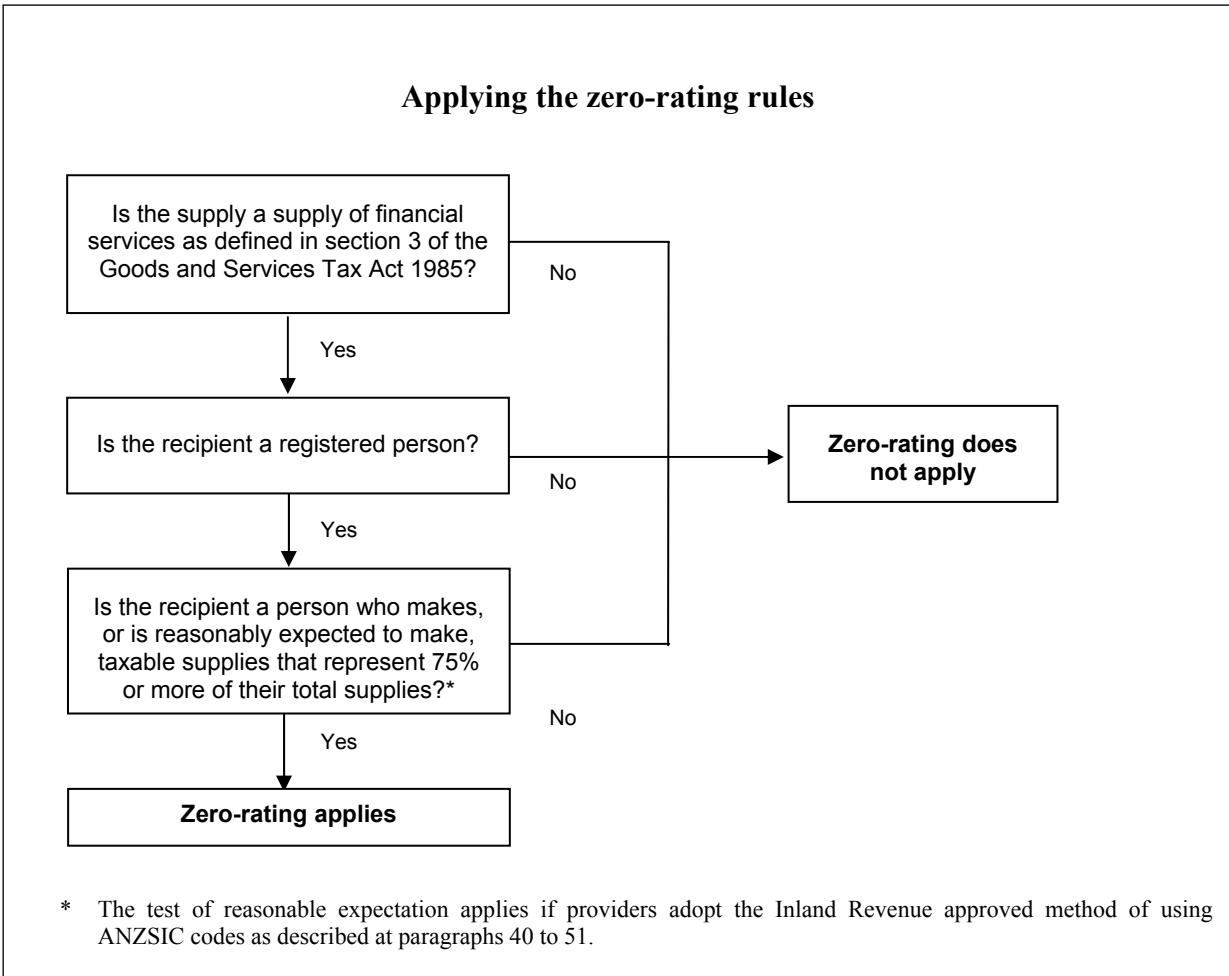
27. Records that Inland Revenue expects to be maintained in relation to this part of the guidelines include communications with customers with regard to their registration status and the 75 percent threshold.

Identifying eligible customers

28. Unlike the usual GST rules, the zero-rating rules impose a requirement that providers obtain information about their customers. This is intended to ensure that the deductions of input tax that result from applying the zero-rating rules relate only to supplies made to qualifying businesses. Supplies to unregistered customers remain treated as exempt supplies. Input tax cannot be recovered in respect of supplies to these customers.

29. It is expected that the determination of the taxable status of a customer will be made by the provider supplying the financial services. The reason for this is that the difference between the supply of zero-rated financial services and exempt financial services is the respective ability or inability to deduct input tax in respect of those supplies. The deduction of input tax is therefore a matter for the provider – not the recipient to determine.

30. The questions that should be considered when determining whether a supply of financial services should be zero-rated are illustrated below.



Zero-rating supplies of financial services

31. The zero-rating rules therefore require that providers consider two questions in relation to their customers’ activities:

- **The registration test:** Is the customer registered for GST?
- **The 75 percent test:** Has the customer made, or is likely to make, in the relevant taxable period supplies of goods and services that are taxable supplies that represent 75 percent or more of total supplies?

Note: When establishing whether or not a customer qualifies under the 75 percent test, all taxable supplies made by the customer should be considered, except for supplies of financial services that are zero-rated under the new rules. Imported services that are treated as supplies for the purpose of the “reverse charge”¹³ should also be excluded for the purposes of this test.

32. Assessing whether the customer qualifies under both limbs must occur in the taxable period in which the supply of financial services is made.

33. If the customer is part of a group, the tests may be applied by reference to the group of which the customer is a member.¹⁴

General requirements

34. Two options may be adopted in relation to the application of the new zero-rating rules – a transaction-based approach or a customer account approach. The option selected should best suit the customer and the type of financial service supplied.

35. Both options will generally require providers to enquire directly whether or not the customer is registered for GST. Financial services providers may approach Inland Revenue with the view to using an alternative method to determine whether or not a customer is registered for GST.¹⁵ Approval of an alternative method will depend on the level of existing information that the financial services provider holds on its customers and whether the alternative method provides a fair and reasonable result – see paragraph 11.

36. Again, for both options, whether the customer meets the 75 percent test must be determined either on the basis of information held by the provider on the customer or by using the Australian and New Zealand Standard Industrial Classification codes (ANZSIC codes). A full list of ANZSIC codes may be found on the Statistics New Zealand website.¹⁶

¹³ See section 5B and see *GST guidelines for recipients of imported services* and *Tax Information Bulletin* Vol. 16 No. 1 February 2004 pp 32 to 45 for a discussion on the reverse charge.

¹⁴ In section 11A(1)(r) the term “group” is defined by reference to section IG 1 of the Income Tax Act 1994. A group is defined as two or more persons that have an aggregate common voting interest greater than or equal to 66 percent.

¹⁵ For example, Inland Revenue may, depending on the integrity of information held by a provider’s internal systems, accept a determination on a customer’s registration status on the basis of whether the customer has elected to be covered by the protections and provisions provided for under the Credit Contracts and Consumer Finance Act 2003. A customer that elects to be covered by that Act must be treated as an unregistered person.

¹⁶See:

<http://www.stats.govt.nz/domino/external/web/carsweb.nsf/94772cd5918085044c2567e6007eec2c/5b3e1b99a0d86615cc256cec007e6b14?OpenDocument>

Determining eligibility per transaction

37. If the supply is in relation to a hire-purchase, finance lease or transaction for which the terms and conditions of the financial service are unlikely to change, the assessment of whether the customer qualifies to receive zero-rated financial services should be established at the time agreement is reached on the contractual terms of the financial service. As GST is a tax on transactions involving the supply of goods and services, any capital or principal arising from the contract should be ignored.¹⁷ Instead, attention should be given to the interest/income margin arising from the transaction because it approximates the value of the intermediation services provided.

38. If the duration of the arrangement is short term – no more than three years – and the terms and conditions of the financial service cannot be altered over that period, providers may exclude these arrangements from any annual review provided that adequate care is taken in determining the eligibility of the customer at the time the arrangement was established. Any arrangement that has an indefinite duration or a duration of more than three years may be required to be periodically reviewed – see paragraph 25.

Example – loan to a bakery

A local bakery approaches a finance company to assist with the acquisition of new equipment. The finance company offers the bakery a two-year table loan and asks the bakery to confirm whether or not it is registered for GST, in case the bakery defaults on the loan and the finance company is required to sell the equipment to recover the debt. As the transaction is largely a one-off arrangement and the cash flows are fixed over the period of the loan (which is short-term), the finance company is not required to include the arrangement in any future internal review. The finance company, having made the assessment that the bakery also meets the 75 percent taxable supply test, may zero-rate the table loan.

Determining eligibility per customer account

39. If a number of financial services are likely to be supplied to the same customer and/or the cash flows arising under a financial transaction are uncertain – for example, because of a revolving credit facility or regular transactions involving financial instruments/assets, applying the zero-rating rules on a transaction-by-transaction basis is likely to be difficult. To deal with this, the customer's initial eligibility to receive zero-rated financial services must be established at the time the account is created and may be used going forward, provided that the customer's eligibility is reviewed periodically. Again, rather than considering the capital or principal cash flows to and from the account facility, the provider should take account of the interest/income margin arising from the transaction because it approximates the value of the intermediation services provided.

¹⁷ An exception applies to finance lease contracts. See "GST and finance leases – classification, method of accounting and treatment of residual value clause", *Tax Information Bulletin*, Volume Eight, No. 1 July 1996.

Example – overdraft facility provided to a new bridal store

A finance company provides an overdraft facility to a new bridal store that is just starting up. As the owner is still outfitting new premises and has yet to maintain a stable income flow, the business requires a flexible source of financing to meet its day-to-day expenses. On the application form for the overdraft the finance company asks whether or not the bridal shop is registered for GST and the purpose of the overdraft. If, in reviewing the terms and conditions under which the advance is given, the finance company becomes aware that the bridal store's eligibility to receive zero-rated supplies has altered, zero-rating should cease.

Zero-rating using ANZSIC codes

40. Acknowledging the difficulties that may arise when seeking information from customers in relation to their level of taxable supplies, Inland Revenue will accept the use of ANZSIC codes as complying with the second limb (the 75 percent test) of the zero-rating rules. This means that it is not generally necessary to seek information from customers directly in respect of their level of taxable supplies, but providers are still generally expected to enquire as to whether their customers are registered for GST.

41. For the purposes of the 75 percent test, customers that can be allocated an ANZSIC code, other than those listed in tables A and B,¹⁸ may be treated as making taxable supplies that exceed the threshold. Providers are not required to enquire directly from their customers as to their ANZSIC code but can make their own judgement as to what ANZSIC code best applies. If, for whatever reason, a customer cannot readily be allocated an ANZSIC code providers can either seek information from the customer directly or treat any supplies of financial services to that customer as an exempt supply.

42. If the customer is part of a group, the ANZSIC code applied should be representative of the predominant activity undertaken by the group of which the customer is a member.

43. Any system or procedure used to allocate an ANZSIC code must provide the necessary accuracy and be subject to yearly internal audit and review – see paragraph 25.

Note: Providers that have reliable information concerning the actual activity of a customer must use this information instead of relying on ANZSIC codes.

¹⁸ See paragraph 50.

ANZSIC codes – an explanation

44. ANZSIC codes are used in New Zealand and Australia for the production and analysis of industry statistics. The objective of the codes is to identify groupings of businesses that carry out similar economic activities. Each code defines an industry and the similar economic activities which characterise the businesses involved in that industry by reference to the primary activity undertaken. In principle, any individual business can be assigned an appropriate industry category on the basis of its predominant activity.

45. When applying the ANZSIC codes for the purposes of the zero-rating rules, the term “business” includes companies, partnerships, trusts, non-profit organisations and government departments.

46. ANZSIC codes are structured according to divisions (the broadest level), subdivisions, groups and classes (the finest level). At the division level there are 17 divisions that are identified by an alphabetical character.

A	Agriculture, forestry and fishing
B	Mining
C	Manufacturing
D	Electricity, gas and water supply
E	Construction
F	Wholesale trade
G	Retail trade
H	Accommodation, cafes and restaurants
I	Transport and storage
J	Communication services
K	Finance and insurance
L	Property and business services
M	Government administration and defence
N	Education
O	Health and community services
P	Cultural and recreational services
Q	Personal and other services

47. The subdivision, group and class levels provide increasingly detailed classification of the broad categories. For example, in the case of fire and general insurance, any business that is primarily involved in this activity would be allocated ANZSIC code K7422, which is derived from the following:

<i>Division</i>	K
<i>Subdivision</i>	74
<i>Group</i>	742
<i>Class</i>	7422

Using ANZSIC codes

48. When using ANZSIC codes to determine whether a customer meets the 75 percent test, providers should refer to the class level, represented by a four-digit code, that is relevant to the customer’s predominant activity. Some class codes may have more than four digits – if this occurs, refer only to the first four. The codes will also sometimes appear with or without the alphabetical character. For the purposes of these guidelines, the class code should be read as including the alphabetical character.

49. If a customer’s activity is represented by a code that appears on either tables A or B (subject to paragraph 50) providers will not be able to zero-rate supplies of financial services to that customer. For conciseness, certain activities listed on tables A and B are referred to only by the first two or three digits (representing the subdivision or group classification). Any customer that is allocated a code that starts with those digits cannot receive zero-rated financial services.

50. Customers that are allocated a code that is listed on table A will be treated as not having an activity that complies with the 75 percent test. Customers that are allocated a code that is listed on table B will be treated as not having an activity that complies with the 75 percent test unless information is received from the customer that clearly demonstrates otherwise. If the customer provides written evidence of having an activity of making taxable supplies of goods and services exceeding the 75 percent threshold providers may zero-rate any supplies of financial services to that customer.

51. Codes that are not contained in tables A or B may be treated as complying with the 75 percent test.

**TABLE A:
Excluded ANZSIC codes – No zero-rating**

Excluded codes		Reason
<i>Codes beginning with</i>		
K73 or 73	<i>Finance</i>	<i>Financial services</i>
K7411 or 7411	<i>Life insurance</i>	<i>Financial services</i>
K7412 or 7412	<i>Superannuation</i>	<i>Financial services</i>
K75 or 75	<i>Services to finance and insurance</i>	<i>Financial services</i>
M813 or 813	<i>Foreign government representation</i>	<i>No taxable activity</i>
Q97 or 97	<i>Private households employing staff</i>	<i>No taxable activity</i>
R99 or 99	<i>No response/refusal</i>	<i>No information</i>
0000 or unknown	<i>Miscellaneous</i>	<i>No information</i>

TABLE B:
Excluded ANZSIC codes – No zero-rating unless activities suggest otherwise

Excluded codes		Reason
B1314 or 1314	<i>Gold ore mining</i>	<i>Fine metal</i>
B1317 or 1317	<i>Silver-lead-zinc ore mining</i>	<i>Fine metal</i>
C2723 or 2723	<i>Copper, silver, lead and zinc smelting, refining</i>	<i>Fine metal</i>
C2941 or 2941	<i>Jewellery and silverware manufacturing</i>	<i>Fine metal</i>
E4111 or 4111	<i>House construction</i>	<i>Residential accommodation/5-year rule</i>
E4112 or 4112	<i>Residential building construction</i>	<i>Residential accommodation/5-year rule</i>
F4792 or 4792	<i>Jewellery and watch wholesaling</i>	<i>Fine metal</i>
G5255 or 5255	<i>Jewellery and watch retailing</i>	<i>Fine metal</i>
H5710 or 5710	<i>Accommodation</i>	<i>Residential accommodation</i>
L7711 or 7711	<i>Residential property operators</i>	<i>Residential accommodation</i>
Q961 or 961	<i>Religious organisations</i>	<i>Donated goods and services</i>
Q9629 or 9629	<i>Interest groups</i>	<i>Donated goods and services</i>

Example of zero-rating supplies of financial services using ANZSIC codes

Allocating ANZSIC codes:

A finance company provides financial services to small businesses and households in the company's local community. The company conducts a review of its business clients that are involved in a number of activities and categorizes them as follows:

Client	Registered for GST?	ANZSIC code	Zero-rate?
Bakery	Y	G5124	Y
Builder	Y	E4111	?
Butcher	Y	G5121	Y
Café	Y	H5730	Y
Cash loan business	Y	K7330	N
Cattery	?	Q9529	?
Charity	Y	Q9629	?
Dairy	Y	G5110	Y
Florist	Y	G5254	Y
Fruiterer	Y	G5122	Y
Hairdresser	N	Q9526	N
Health food shop	Y	G5129	Y
Independent bookseller	Y	G5243	Y
Lawyer	Y	L7834	Y
Pharmacist	Y	G5251	Y
Second-hand goods dealer	Y	G5252	Y
Sports club	Y	P9319	Y
Toymaker	Y	C2329	Y
Watchmaker	Y	G5255 or G5269	?

Making further inquiries:

From the review, the finance company decides that it needs to gather more information from the cattery, charity and watchmaker in order to work out whether or not they can receive zero-rated supplies of financial services.

The cattery

The finance company has some doubt about whether or not the cattery is registered for GST. It telephones the cattery owner to establish whether it is registered for GST and the nature of the supplies made. She confirms that the business is registered for GST and has a taxable activity. The finance company makes the assessment that the cattery qualifies to receive zero-rated financial supplies.

The charity

The charity has an activity that largely involves the provision of emergency housing and supplying donated goods. It does not charge for the provision of the emergency housing and receives a small revenue stream from the sale of the donated goods. The charity is very dependent on donations to maintain its operations. As most of the supplies made by the charity are exempt, the finance company decides that the charity cannot receive zero-rated financial services.

The watchmaker

The watchmaker sells and restores watches and clocks, including repairing and servicing personal watches and selling watch accessories. The watchmaker holds some fine gold as stock for restoration purposes but does not sell it separately. He also sells a number of restored pieces on credit and estimates that 15 percent of his annual income is from interest on those accounts. He makes input tax adjustments in respect of those supplies. The finance company seeks further confirmation of the level of exempt supplies made by the watchmaker and, on the basis of that information, decides that the business is eligible to receive zero-rated financial services as the level of exempt supplies does not exceed 25 percent.

Unregistered persons

52. Supplies of financial services to unregistered persons (final consumers) cannot be zero-rated. In some instances, however, final consumers may be provided with financial products and services as part their association with a registered person – for example, because they are the owner of a business. In these circumstances, care must be taken that supplies of financial services to final consumers are not zero-rated and continue to be treated as exempt supplies.

Example – loan for private purposes

A local builder approaches a finance company to secure a loan to renovate and modify her family home. On the application form the builder gives her business bank account as the account into which the funds should be deposited. As the reasons specified for the loan relate to the private assets of the builder, the finance company cannot zero-rate the interest in respect of the loan.

Deductions from output tax

Paragraphs 62 to 77 set out Inland Revenue's approved method for deducting input tax in relation to any taxable, including zero-rated, supplies made by a financial services provider. Financial services providers that have elected to zero-rate supplies of financial services using the guidelines must comply with those paragraphs.

Paragraphs 78 to 90 provide guidance on the application of section 20C.

Overview

53. The effect of the zero-rating rules is to increase the extent to which providers are able to deduct input tax. This is in contrast to the previous broad exempt treatment of financial services that had applied since 1 October 1986, when GST first applied to goods and services supplied in New Zealand. Exemption means that GST is not charged, and providers are unable to deduct input tax.

54. A further special deduction is allowed in respect of supplies of financial services made to other financial services providers. This deduction is calculated using the formula in paragraph 78.¹⁹

Evidential requirements

55. When deducting input tax, financial services providers must exercise reasonable diligence to determine the correctness of a GST return. Providers must hold tax invoices and any necessary calculations, samples and ratios that are used to support the deduction of input tax when apportioning input tax between taxable and non-taxable supplies.

Principal purpose test

56. If over 50 percent of a provider's financial services are to qualifying GST-registered customers, or those supplies together with other taxable supplies exceed the 50 percent threshold, the provider will be able to deduct input tax on the basis that its principal purpose is that of making taxable supplies. The principal purpose test allows providers to deduct 100 percent of the GST paid on goods and services acquired in making those taxable supplies.²⁰ Adjustments to input tax may be required to the extent that there are non-taxable supplies.²¹

57. If the provider's principal purpose remains that of making exempt supplies, it will not be able to deduct 100 percent of the GST paid but may, instead, recover a proportion of the GST paid using the rules concerning adjustments for change in use – see paragraphs 59 to 61.

¹⁹ See section 20C.

²⁰ See section 20(3)(a) and (b).

²¹ See section 21.

Test	Input tax that can be claimed	Adjustment required?	Timing of any adjustment ²²
The goods and services are acquired for the principal purpose of making taxable supplies	100 percent of the GST paid may be deducted	Yes, if the goods and services are applied for a purpose of making supplies of non -taxable goods and services	At any one of the following times: <ul style="list-style-type: none"> – period-by-period – annually – one-off
The goods and services are not acquired for the principal purpose of making taxable supplies	No deduction is available	Yes, if the goods and services are applied for a purpose of making taxable supplies of goods and services	At any one of the following times: <ul style="list-style-type: none"> – period-by-period – annually – one-off if less than \$18,000 or Inland Revenue agrees

58. These guidelines set out a method for financial services providers to determine the deduction of input tax in respect of both their zero-rated supplies and other taxable supplies, focusing primarily on how to value zero-rated supplies for this purpose.

Adjustments for change in use

59. If a financial services provider cannot deduct input tax using the principal purpose test, an adjustment may be permitted using the change-in-use provisions.²³ These provisions allow a deduction when goods and services acquired for the principal purpose of making non-taxable supplies are applied to making taxable supplies. The deduction allowed under these sections is proportionate to the use to which those goods and services are put. There are a number of adjustment methods by which input tax is allocated between taxable and non-taxable (including exempt) supplies.

60. The methods of allocating input tax are:

- **Actual use:** This method of allocation requires the taxpayer to attribute the use of the goods and services directly to the extent that they are used for a purpose of making taxable supplies. This method should be used in preference to others whenever possible.
- **Turnover method:** This method is used in cases where the actual use method is too difficult to apply – for example, in the case of overhead expenses. The formula expressed in the GST Act is:

$$\frac{\text{Total value of exempt supplies for taxable period}}{\text{Total value of all supplies for taxable period}}$$

²² Any further changes to the timing of any change in use adjustments can only be made with the Commissioner's approval. See sections 21C(4) and 21G(3) depending on the nature of adjustment.

²³ See sections 21E to 21G and see *Tax Information Bulletin* Vol. 12 No. 12 December 2000 pp 31 to 37.

- **An alternative (or special) method:** This method is available, provided that Inland Revenue approves it, if it results in allocated amounts that are as fair and reasonable as under the actual use method. If providers are unable to allocate input tax on the basis of actual use they should use the special method described in paragraphs 62 to 77, or another special method agreed in writing by Inland Revenue – see paragraph 12, rather than the turnover method. If a provider has been using a method that is approved by Inland Revenue and it produces a fair and reasonable result, the provider may continue to use that method instead of the one recommended in these guidelines.

61. In all cases the method of allocation used must result in a fair and reasonable allocation of input tax between taxable and other supplies.²⁴

Valuing supplies of financial services and adjusting for changes in use

62. Financial services providers who do not allocate input tax according to actual use will have to value their supplies of financial services for the purposes of allocating input tax between taxable and exempt supplies. These supplies will need to be valued, usually every taxable period or annually, every time an adjustment for any change in use is made. The valuations will not always be straightforward because, unlike a normal supply of goods and services, the financial services will often not be calculated by reference to an express consideration.

63. The objective of valuing financial services when adjusting for changes in use is to identify charges for financial intermediation rather than valuing the underlying financial instruments involved in the transaction.²⁵ This is because it is the value of the services that is being measured for GST purposes, not the value of the financial products.

64. When valuing financial intermediation services, it is important that providers disregard amounts received as a result of non-financial transactions and non-financial asset sales such as land, buildings, vehicles and equipment. A non-financial transaction is a supply of goods and services that is not included within the scope of the definition of “financial services” for GST purposes.

65. Financial services providers price their intermediation services either by setting a specific, explicit fee or by setting a margin. The net margin can be based on a proportion of a set figure, such as an interest rate or commission percentage (for example, 10% of funds managed) or a difference between rates or percentages (for example, a 2% charge, the difference between a lending rate of 6% and a borrowing rate of 4%). The value of any financial intermediation services supplied should be either the explicit fee charged or the net margin received.

²⁴ See section 21A(3).

²⁵ Also see *Commissioners of Customs and Excise v First National Bank of Chicago* 1998 (Case C-172/96), European Court of Justice, 14 July 1998.

66. Inland Revenue expects that in determining the value of financial margins relevant New Zealand generally accepted accounting practice (GAAP) will be applied.

Special adjustment method using net margins and gross fees to value financial intermediation services

67. Inland Revenue will accept calculations using net margins and gross fees to value financial intermediation services when making adjustments for changes in use for GST paid on goods and services that are not directly attributed to taxable or exempt supplies. The valuations determined under this method should be recorded as zero-rated supplies in box 6 of the provider’s GST return.

Example – value of supplies as a net margin

Interest received from advances made	\$10,000
Interest paid to account holders	<u>\$8,000</u>
Net interest margin	\$2,000

68. This special method of valuation requires providers to value the margin derived by way of interest income, net proceeds from transactions in securities and gross fees. It is not necessary to continually review individual loan balances or periodically review the value of individual holdings in securities.

69. Services that are directly charged by way of transaction fees and commissions should be valued at their invoiced price or the gross amount recognised as income for financial reporting purposes.

Formula for valuing change-in-use adjustments under these guidelines

$$\frac{\text{Total value of taxable supplies}}{\text{Total value of all supplies}} = \text{Input tax recovery ratio}$$

The total value of taxable supplies is calculated based on:

- net interest from transactions to businesses
- net margins from exchange and derivatives transactions to businesses
- other net/margin revenue from businesses
- gross fees and commissions received from transactions to businesses
- all other zero-rated supplies
- all supplies that are subject to GST at the rate of 12.5%

The total value of all supplies is calculated using:

- all net interest
- all net margins from exchange and derivative transactions
- all other net/margin income
- all gross fees and commissions
- all other supplies

When determining the value of taxable supplies to be included in the formula, providers should be mindful of the following:

- **Exports:** In the absence of directly attributing input tax to any exported goods and services, amounts relating to exports should be included in the numerator.
- **Imported services:** Any imported services that have been subject to the reverse charge **must be excluded** from both the numerator and the denominator.²⁶

The information required to apply the formula should be able to be sourced from financial statements. Determining the margins from treasury transactions such as foreign exchange and derivative transactions to businesses may require sampling. Any sampling period will need to include the last day of a financial quarter (such as 31 March, 30 June, 30 September and 31 December), as this day is typically busier than others. Providers can contact Inland Revenue to ascertain whether the sampling they propose is appropriate to their circumstances.

The reference to “business” means those registered persons that qualify to receive zero-rated supplies – meaning the business does not have more than an incidental activity of making exempt supplies (less than 25 percent of total turnover in a given 12-month period).

²⁶ See section 5B.

Valuing supplies of financial services for specific transaction types

70. For specific transaction types, the following will apply.

Debt

71. Transactions involving debt are to be valued by reference to the interest margins that arise from the principal. The principal itself should be ignored. If the transaction involves the supply of goods and services under a credit contract or the lease of goods and services under a finance lease, financial services providers should refer to “GST and finance leases – classification, method of accounting and treatment of residual value clause”, *Tax Information Bulletin* Volume Eight, No. 1 July 1996.

Equity

72. Intermediation services involving the provision of equity will generally involve a specific fee or commission. If they do not, providers for whom equity is part of a taxable activity should refer to Inland Revenue for specific guidance. Transactions involving the issue or repurchase of a provider’s own equity must be ignored.

Transactions involving financial instruments such as derivatives and secondary market debt

73. Intermediation services for other financial instruments that do not involve a fee or commission can also be referred to Inland Revenue. Transactions involving the issue or repurchase of a provider’s own financial instruments must be ignored.

Special transactions

74. When valuing supplies of financial services using net margins and gross fees, some transactions may present special difficulties.

Transactions with associated persons

75. As an anti-avoidance measure special valuation rules²⁷ apply to financial services supplied to an “associated person”.²⁸ When zero-rated financial services are supplied to associated business customers and financial services providers at greater than market value, market value must be used. Otherwise the agreed value can continue to be applied.

Net loss margin

76. Sometimes the net margin from a financial instrument will be a net loss – for example, when a financial instrument is realised at a loss or a movement in foreign exchange gives rise to a loss under a foreign exchange hedging contract. If this occurs, the margin should be treated as zero for the purposes of the valuation formula.

²⁷ See sections 10(3), 10(3A) and 10(3B).

²⁸ See section 2A.

Net treasury income

77. Most financial services providers will engage in transactions using reserves to derive income in addition to that received from any core intermediation activity. This is done as a means of reducing exposures to risk that may arise in respect of transactions with customers that are undertaken as part of that core activity. To the extent that the treasury function is (or is part of) a taxable activity, such transactions should be valued only when financial contracts are closed or financial instruments are realised. The net realised amount is the value that should be included in the valuation formula.

Example of making change-in-use adjustments under these guidelines

Adjusting for changes in use

The finance company makes adjustments for changes in use every year in the taxable period after its end of financial year. The adjustments are based on the accounting reports prepared by the company for the financial year.

Adjustments are required for both revenue and capital expenditure.

Adjustment worksheet for the period 1/1/2006 to 31/12/2006

<i>Income</i>	<i>% taxable</i>	<i>\$'000</i>	<i>\$'000</i>
Interest received (exempt)		14,500	
Less interest expense (exempt)		8,700	
Net interest (exempt)			5,800
Interest received (taxable)		13,800	
Less interest expense (taxable)		11,600	
Net interest (taxable)	100%		2,200
Treasury income		7,100	
Less Treasury expense		5,100	
Net treasury income	80%		2,000
Commissions and fees (exempt)			5,400
Commissions and fees from advisory service	100%		2,820
Total income			18,220
Less provision for doubtful debts			220
Income after provisions			18,000
<i>Operating expenses</i>	<i>% taxable use</i>		
Wages and salaries		7,850	
Insurance		2,600	
Rental		570	
Consultants	100%	1,700	
Phone		30	
Travel	100%	44	
Power		560	
Depreciation		240	
Selling costs	40%	2,580	
Total operating expenses			16,174
Operating surplus before taxation			1,826

Example – direct attribution

Travel

All travel expenses were incurred in relation to the finance company's business clients and were incurred for the principal purpose of making zero-rated financial services. As the travel expenses can be directly attributed to making taxable supplies, the finance company deducts input tax in the taxable period in which those expenses were incurred.

Consultants

As part of providing an advisory service to its clients, the finance company contracted various consultants. The cost of these consultants can be directly attributed to providing standard-rated advisory services, so the finance company deducts input tax on the consultants' fees in the taxable period in which those expenses were incurred.

Selling costs

The finance company directly attributes 40 percent of its selling costs to supplies of zero-rated financial services to its business clients.

Example – revenue adjustment

The finance company is adjusting office overheads for the taxable supplies made over the year. Over the year it has not deducted input tax in respect of overhead items because these costs have been acquired for the principal purpose of making non-taxable supplies.

- Exempt supplies for 12 months \$11.6 million (\$5.8 + \$5.4 + 0.4 million)
- Taxable supplies for 12 months \$6.62 million (\$2.2 + \$2.82 + 1.6 million)
- Total supplies for 12 months \$18.22 million

Step 1	Work out the percentage of taxable use for the year. <u>Total value of taxable supplies for period</u> Total value of all supplies for period = % of total supplies that are taxable	$\frac{\$6.62 \text{ million}}{\$18.22 \text{ million}} = 36 \text{ percent}$ This is the percentage of taxable supplies.
Step 2	Add up expenses over the year on which GST has been paid. Call this amount E.	The overheads to be adjusted for the year are: Insurance \$2.6 million Rental \$0.57 million Phone \$0.03 million Power \$0.56 million Total \$3.76 million
Step 3	Multiply E by the taxable percentage from step 1.	\$3.76 million x 36 percent is \$1.3536 million.
Step 4	Divide this amount from step 3 by nine. This is the adjustment to show on the IR372 calculation sheet under “Business use of private or exempt goods and services for annual or period-by-period adjustments”. Transfer the totals to Box 13 of the GST return.	The adjustment the finance company shows on the IR372 calculation sheet is \$150,400 (\$1.3536 million/9). This represents the input tax that can be deducted in respect of GST incurred on overhead expenses.

Example – capital adjustment

In the same year, the finance company purchases a new office building to cater for new business. The cost of the new building is \$8 million including GST. The building is reinforced concrete. The finance company also makes a change-in-use adjustment for the new office building. Note that a capital adjustment can be calculated using the amount determined as depreciation.

Step 1	Work out the percentage of taxable use for the year. <u>Total value of taxable supplies for period</u> Total value of all supplies for period = % of total supplies that are taxable	$\frac{\$6.62 \text{ million}}{\$18.22 \text{ million}} = 36 \text{ percent}$ This is the percentage of taxable supplies.
Step 2	For the taxable period in question, take the lower of the cost or current market value of the goods to be adjustment for taxable supplies. Call this L.	The lesser of the cost or open market value is \$8 million.
Step 3	Find out the straight-line depreciation rate for the asset. Call this S.	The general straight line depreciation rate for reinforced concrete buildings is 3 percent.
Step 4	$\frac{L \times S}{N}$ x percentage of taxable use from step 1 N is the number of taxable periods each year in which the change in use adjustments will be made.	$\frac{\$8 \text{ million}}{1} \times 3 \text{ percent} \times 36 \text{ percent} = 86,400$
Step 5	Divide the amount from step 4 by nine. This is the adjustment to show on the IR372 calculation sheet under “Business use of private or exempt goods and services for annual or period-by-period adjustments”. Transfer the total to box 13 of the GST return.	The adjustment the finance company shows on the IR372 calculation sheet is \$9,600 (\$86,400/9). This represents the input tax that can be deducted in respect of GST incurred on acquiring the capital asset.

Effect on operating profit

The adjustments for change in use, made in the first taxable period after 31 December 2006, have the following effect on the finance company's operating surplus.

Income after provisions	<i>GST content</i>	<i>Deductible input tax</i>	<i>Revised expenses</i>	18,000
Operating expenses				
Wages and salaries	-	-	7,850	
Insurance	288.9	104.0	2,496	
Rental	63.3	22.8	547.2	
Consultants	212.5	212.5	1,700	
Phone	3.3	1.2	28.8	
Travel	5.5	5.5	44	
Power	62.2	22.4	537.6	
Depreciation	26.6	9.6	230.4	
Selling costs	300.0	120.0	2,580	
Total operating expenses				16,014
Operating surplus before taxation				1,986

Supplies between financial services providers

Application

78. Financial services supplied to another financial services provider generally cannot be zero-rated because most financial service providers will not satisfy the requirement that 75 percent of their supplies are taxable supplies. Instead, the GST Act provides a further deduction from output tax in relation to supplies of financial services made to another financial services provider (the direct supplier). The deduction relates only to exempt supplies of financial services made to the direct supplier and is limited to the extent that the direct supplier makes taxable supplies, including supplies of zero-rated financial services, to business customers that meet the 75 percent taxable supplies threshold. The deduction is calculated according to a formula.²⁹

²⁹ See section 20C.

Formula for calculating the deduction for supplies of exempt financial services to other financial services providers

$$a \quad \times \quad \frac{b}{c} \quad \times \quad \frac{d}{e}$$

Where:

- a is the total amount in respect of the taxable period that the registered person –
(i) would not be able to deduct under section 20(3); and
(ii) would be able to deduct under section 20(3), other than under section 20(3)(h), if all supplies of financial services by the financial services provider were taxable supplies:³⁰
- b is the total value of exempt supplies of financial services made to the direct supplier in respect of the taxable period:
- c is the total value of supplies made in respect of the taxable period:
- d is the total value of taxable supplies made by the direct supplier in respect of the taxable period as determined under section 20D:
- e is the total value of supplies made by the direct supplier in respect of the taxable period as determined under section 20D.

79. This proportional deduction from output tax is in addition to that which can be recovered as a deduction from output tax using the principal purpose test or by way of a change-in-use adjustment.

80. The proportion is found by multiplying two fractions. The first fraction is the proportion of the total value of supplies made by the provider that consists of exempt supplies of financial services to a recipient financial services provider (the direct supplier). The second fraction is the proportion of the total value of supplies made by the direct supplier that consists of taxable supplies (including zero-rated supplies of financial services).

81. The formula is limited to the activities of the direct supplier. Further supplies of financial services – for example, by the direct supplier to a third or subsequent financial services provider, are not included in the formula.

Information required from the direct supplier

82. The method used to determine the deduction is based on statistical information that is provided by the direct supplier in relation to its ratio of taxable supplies to total supplies (items “d” and “e” of the formula).³¹ The presentation of this statistical information can be in the form of a percentage or fraction.

83. Providers must obtain the ratio from the direct supplier before making the deduction. If a ratio is not provided, the deduction cannot be claimed.

84. The GST Act does not, however, require the direct supplier to provide this information.

³⁰ The definition of item “a” is in the process of being amended by the Taxation (Annual Rates, Venture Capital and Miscellaneous Provisions) Bill.

³¹ See section 20D.

85. If the direct supplier agrees to provide the necessary statistical information, the GST Act requires that the ratio must be current to each taxable period in which supplies of financial services are made.³² This will require communication between the financial services provider and the recipient of the financial services regarding the correct ratio to be applied to that taxable period.

86. If the direct supplier provides statistical information which, in the direct supplier's opinion, represents its activities over the last 12 months, that ratio may be applied by the provider for a further 12 months. Accompanying the ratio must be a written statement from the direct supplier that the ratio is a fair reflection of its activities over the last 12 months, including the taxable period in which the ratio is first sought. A new ratio from the direct supplier must be sought at the end of those 12 months.

87. If the provider receives notice from the direct supplier that its ratio is no longer considered accurate or reliable the provider must immediately cease using that ratio and seek an updated one.

Evidential requirements

88. To claim the deduction, providers are expected to have written notice or other permanent records of the direct supplier's ratio of taxable to total supplies.³³ This written notice can be in the form of an e-mail or letter. If the information is given by telephone, it must be followed up in writing for evidential purposes. The direct supplier must also state the period of time for which the ratio applies.

Disclosing a direct supplier ratio

89. If providers choose to disclose their ratio of taxable to total supplies to other financial services providers, in addition to providing the ratio in writing, they must maintain a regularly updated database of those persons that have received that ratio. The database should also detail the date that ratio was disclosed and the period to which it applies.

90. If providers become aware that the disclosed ratio is materially incorrect they must notify those financial services providers on their database, advising them to cease using the ratio until a new correct ratio is provided.

³² See section 20C.

³³ See items d/e as set out in section 20C.

Other matters

Tax invoices

91. The GST Act requires registered persons to issue a tax invoice in relation to any taxable supplies made to another registered person, if requested. This obligation also applies in relation to zero-rated supplies. In the context of zero-rated financial services (which do not give rise to a deduction of input tax for the recipient), there is no practical purpose in requiring that tax invoices be issued in respect of such supplies. A tax invoice does not, therefore, need to be issued in relation to zero-rated financial services.³⁴

Transition

92. From 1 January 2005, financial services providers that have elected to apply the new legislation should begin zero-rating supplies of financial services from the first day of the taxable period in which Inland Revenue receives written notice. Deductions of input tax in respect of such supplies should also begin from the same date.

93. Input tax deducted for goods and services consumed in the taxable period in which they were acquired will be determined by reference to the time of supply only. This means that no change-in-use adjustments will be available for such goods and services purchased before the application date, to reflect any increase in taxable supplies after that date.

94. Input tax deducted under the change-in-use provisions for goods and services acquired before the application date but used periodically after that date will be able to reflect any increase in taxable supplies after the application date in which the change in use adjustment occurs.

95. One-off change-in-use deductions to take account of any increase in taxable supplies resulting from these reforms are not permitted.³⁵

Examples – transition

In July 2003 a finance company acquired a new telephone system and supporting software. The system is treated as a fixed asset and its cost spread over its useful life. As the asset was not acquired for the principal purpose of making taxable supplies, the finance company makes an adjustment to reflect a level of taxable use. Adjustments are made annually. In January 2005 the finance company elects to zero-rate supplies of financial services. It can recognise the higher level of taxable use of the telephone system in its annual adjustment after 1 January 2005.

Part-way through 2004, the finance company renews its subscription to an information service. The service is not acquired for the principal purpose of making taxable supplies and costs less than \$18,000. The company does, however, make an one-off adjustment at the time of renewal to reflect that the service is applied for making some taxable supplies. As the subscription is only for a year and the adjustment for taxable use is made before 1 January 2005, the finance company cannot make a further adjustment.

³⁴ See section 24(6)(b).

³⁵ See sections 21G(1B) and 21H(2)(b).