GST Direct: Pointing the way

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Financial Services Special

This GST Direct is a special edition covering the financial services industry. It also provides brief coverage of other topical GST issues.

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Financial Services Providers and GST

New GST recovery rules - good news/bad news

Businesses that make supplies of financial services for GST purposes have a choice about the new GST recovery rules, introduced from 1 April 2011.

According to the Government, the rules are intended to reduce compliance costs because they are simpler and require fewer adjustments. Is this really true?

The good news:	The bad news:
• Businesses that primarily make exempt supplies recover more GST up-front	• Businesses that mainly make taxable supplies recover less GST up-front
• There is an "end date" after which adjustments are no longer required (except for land)	• Complying with the new rules will be onerous where numerous adjustment calculations are required
• Total adjustment amounts over time are no longer open ended	• Increased record keeping will be required to track individual assets and adjustments made since their acquisition
• A method that is fair and reasonable may be used as an alternative to asset-by-asset adjustments	

The detail

The new adjustment rules must be applied in tandem to old and new assets for at least five years in some cases. This means businesses will need to maintain two sets of records with different adjustment methods and periods. Businesses with even a moderate level of assets should not underestimate the record-keeping involved.

Every business should invest the time to get on top of the new rules to reap the benefits. Under the old rules, some businesses could not claim any GST up-front and instead had to recover over time via 'drip-feed' adjustments. Now GST may be claimed based on the intended taxable "use"

percentage of goods and services (the so-called "apportionment" approach). The converse is the GST claimable reduces for those businesses that were able to recover in full up-front when they met the old principal purpose test. There are winners and losers.

For example:

a. Previously, a 70% (taxable)/30% (exempt) business could claim 100% GST up-front and adjust this down (by repaying GST) over time, but under the new rules they can only claim 70% of the GST up-front.

b. Previously, a 70% (exempt)/30% (taxable) business could not claim any GST up-front (as this would be claimed over time), but under the new rules they can claim 30% up-front.

Under the new rules the number of compulsory annual adjustments depends on the value of the goods and services. The calculations each year take into account all GST adjustments that have been made over the years, from when the asset was first acquired until now or until such time those adjustments are no longer required. Businesses may find that having tracked through their records and prepared calculations for potential adjustments, the amounts fall below de minimis thresholds and no adjustment is required. That outcome won't necessarily be known without doing the work.

Favourable features of the new rules are the number of years over which adjustments must be made are now capped (apart from adjustments involving land) and the overall adjustment amount is no longer unlimited (including land). For example, if assets that have been subject to adjustments are sold a "wash-up" adjustment pegs the amount of overall GST deduction to the original GST paid on acquisition.

If this seems like a lot of work for little reward, there is an easier option. Businesses that make exempt supplies have the choice of applying an alternative method for apportioning input tax between taxable and exempt supplies, provided the method gives a fair and reasonable result having regard to the new adjustment rules. Some businesses will prefer this option.

Reverse charge (imported services)

Under recent changes to the reverse charge rules, it is necessary to look at the intended "use" of the actual imported service rather than the quantum of taxable supplies.

The reverse charge rules now focus on the use of the imported services, as opposed to the previous quantum approach. For example, if at the time the services are acquired the intended taxable use is more than 95%, the reverse charge will not apply. The new adjustment rules require intended use estimates to be reviewed each year and if the review finds that actual taxable use is less than 90% the reverse charge applies and an adjustment may have to be made.

The reverse charge is a common source of errors and the changes further increase the complexity and compliance requirements.

Business-to-Business ('B2B') zero-rating

The B2B GST zero-rating regime is available to suppliers of financial services when their GST registered recipients make taxable supplies that are 75% or more of their total supplies. Financial services suppliers benefit under the B2B rules because the GST recovery levels can be enhanced.

Financial services providers should check the zero-rating eligibility criteria regularly, particularly the 75% threshold test which is determined over a 12-month period. Businesses should ensure appropriate systems are in place to identify and track taxable to total supplies.

Are you paying too much GST?

Unless you have considered ways to improve your GST recovery percentage as part of your overall GST risk management policy, chances are your business is paying too much GST.

Lifting the GST recovery ratio translates to direct bottomline savings. Many financial service providers have benefitted dramatically from reviewing their approach to GST recovery. The bottom line savings can be significant.

YOUR business should consider this checklist – have YOU asked these questions?	
Optimum GST recovery method	Are you using the most accurate method? Most businesses use the 'turnover' method (value of taxable supplies as a proportion of the value of total supplies), but any method that best represents the actual use of costs can be employed. Other approaches should also be considered.
Single vs multiple methods	Do you believe one method is appropriate for your diverse business? Multiple methods may be employed for different sectors within a business. For example, the 'turnover' method may be appropriate for a high-volume low-margin equities brokerage division, but distortionary for a low-volume high-margin corporate finance sector. A single high-value GST-exempt deal could 'swamp' the value of many taxable deals which consumed considerable internal resource and cost. Other methods like transaction count may provide a more accurate basis.
Consistent value approach	Are you using a consistent value basis when applying the 'turnover' method? Care should be taken to not mix valuation approaches e.g. 'net margin' valuation on some components, 'gross income' on others.
Zero-rating	Can you identify all zero-rated supplies? Zero-rating an otherwise exempt supply raises the proportion of taxable supplies. Many financial services businesses do not maximise the benefits of zero-rating, either under the B2B zero-rating rules or by identifying non-resident customers.
Allocation of overhead costs	Do you allocate costs to the correct profit centres? If your business has multiple divisions, you need to consider the appropriate level of cost allocations to profit-centres (before applying the division's GST recovery percentage).
Direct supplier deductions	Have you missed out on taking direct supplier deductions? Additional deductions can be claimed if financial services are provided to another financial institution which in turn deals with a taxable customer (like an operating company).
GST grouping	Have you applied the GST grouping rules to best effect? If your business has multiple entities with different GST profiles, you need to think about how the grouping rules are used and which entities should be grouped together.

For financial services businesses, there are generally two options for calculating how much GST to recover up-front on any outlay:

- Estimate the percentage of taxable usage for the acquisition by applying a method that provides a 'fair and reasonable' result (this method can be agreed with Inland Revenue but does not need to be) and claim this percentage; or
- Apply an industry-specific recovery method or percentage as agreed with Inland Revenue.

If your business is covered by an industry-wide agreement, there may be opportunities within the framework of the agreement to improve the position.

The key is to always determine a method which generates a "fair and reasonable" result. In simple terms, you need to use a method that represents the actual economic usage of costs for making supplies that are subject to GST (at either 0% or 15%).

Investment and holding entities – can they recover GST?

The GST on costs incurred by entities holding equity investments could be recovered under relatively new rules (subject to criteria). Ordinarily it is not possible for holding companies which do not make supplies to register and recover GST on their costs (although the grouping rules may offer a solution).

However, in combining a number of GST specific rules it is sometimes possible to conclude there is a deemed supply to the subsidiary company. This deemed supply can provide a basis for GST registration and recovery in certain situations. Many businesses are not aware of this opportunity to enhance the bottomline.

Finding the boundary – insurance

The provision of general insurance cover is subject to GST. By contrast, cover for obligations and guarantees relating to debt securities and the provision of life products are generally exempt from GST.

Finding the boundary is critical to ensuring that the right amount of GST is charged and recovered by the insurer. For example, there are different GST treatments for contingent debt insurance and trade credit cover versus consumer credit or payment protection insurance.

Another example – where does the boundary lie between a life insurance contract and a retail investment product? If the right treatment is not adopted, insurers may be under-recovering GST on costs.

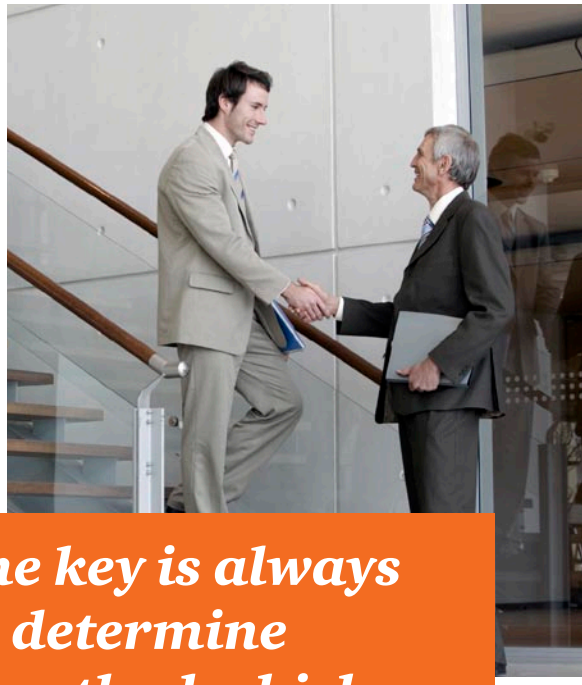
Leases – are you getting it right?

Leasing often throws up complex issues for businesses. Be careful to navigate the rules and ensure the right amount of GST is paid at the right time so that cashflows are not adversely affected or opportunities are not missed.

The income tax distinction between a finance lease and an operating lease is not relevant for GST purposes. Generally, leases are defined as "Agreements to hire" and they come in two flavours - those that are credit contracts, and those that are not.

Tests in two different credit contract Acts apply to determine if a lease is a credit contract or not. If a lease is a credit contract under both Acts, it must be treated as such for GST. Alternatively, if it is a credit contract under one Act but not the other, the lessor has a choice whether to treat it as a credit contract or not.

If a lease is a credit contract the rentals comprise two components. The first component is the GST liable "principal". The second is an interest component, which could be exempt or zero-rated depending on whether the lessor is eligible to apply the B2B zero-rating rules.



The key is always to determine a method which generates a "fair and reasonable" result.

Are GST systems properly configured to comply with the GST timing rules in relation to rentals?

If a lease is not a credit contract the rentals are wholly subject to GST i.e. there is no exempt interest component.

The regime is not straight forward. Parties to a lease need to consider a range of issues including:

- Is it more commercially advantageous to treat a lease as a credit contract if there is a choice? In a B2B scenario it usually doesn't matter if GST is charged on top of interest, but this will not be the case in a business-to-consumer lease.
- Leases which include an option to purchase may not be "agreements to hire", in which case the GST could be triggered up-front.
- Are GST systems properly configured to comply with the GST timing rules in relation to rentals? The GST timing rule triggers the obligation to account or recover on the earlier of the date rentals are due or paid. The issue of any invoice is irrelevant but systems often drive off the date of invoice.
- The valuation rules in relation to credit contracts "cap" the liability at the amount of GST on the "cash price". There is a question whether this is an issue in those cases where the lease has a variable/extendable term.
- Is there a need to consider the GST treatment of costs arising from lessee default?
- Can an early termination clause (or event) trigger a GST liability for a lessor? What does this mean for the lessee?
- Transitional rules for the change in the GST rate to 15% may enable existing leases to be treated as being subject to 12.5% GST. Systems and controls need to be in place to avoid incorrect accounting of GST.

Introducing our FS GST experts:

Jared Otto
Jared has extensive financial services and GST experience, including a role as the head of VAT for a large UK bank. With over 13 years' of indirect tax experience both in New Zealand and overseas, Jared is an expert in the industry with a particular specialty in optimising GST recoveries and taxable/exempt boundary issues.

Ian Rowe
Ian's experience in financial services taxation has more recently included a focus on GST after more than 20 years of advising on income tax within the industry. Ian's particular expertise is in maximising GST recoveries for financial services providers either through the B2B mechanism or in the application of the adjustment rules.

Non-FS GST issues

▶ *Warning! Supplies provided to another party*

Businesses may face issues recovering GST on supplies they pay and contract for, if they direct the supply is provided to another party.

In these circumstances, the business may be treated as not being the recipient of the supply and not allowed to claim the GST. Certain exceptions apply. This is due to recent changes to the GST Act which apply from 1 April 2011. All businesses that enter into arrangements where a third party receives the goods or services should tread with caution. Inland Revenue is reviewing this area and is expected to provide practical guidance.

▶ *More changes – land transactions and accommodation*

The current rules for zero-rating sales of land between GST-registered parties are being further amended with retrospective effect. The further amendments cover:

- Changes to the definitions of "land" and "principal place of residence".
- The adjustment rules when a person becomes a GST-registered person.
- GST recovery treatment on disposal.
- Agents acting on behalf of undisclosed principals.
- The ability to recover GST if the GST treatment of accommodation changes from exempt to taxable as a result of changes to the GST Act, and
- The core land zero-rating requirements - a recipient of the supply will also have to supply their GST registration number to the supplier.

If your business is entering into a transaction that includes land, you must consider the upcoming changes. The Bill introducing these changes is likely to be passed in the next few months. When passed, the amendments will apply with effect from 1 April 2011 (when the original land zero-rating rules came into force). We will cover these changes in more detail in an upcoming GST Direct.

▶ *Replay ... Insurance claims – don't forget the GST!*

If your business receives an insurance pay-out, it will generally have a liability to pay GST on the receipt provided the underlying insurance premium was subject to GST. Yet, some exceptions do apply.

There may be a GST liability even if the business is not a party to the contract of insurance. Caution must be taken to ensure GST is returned where required.

If there is a GST liability this should be taken into account when negotiating any settlement amount. Remember an insurance claim received that relates to making exempt supplies should not be subject to GST.

▶ *How do you value emissions units?*

Answer (currently in Bill form and to apply from 1 July 2010): If the units will be transferred in the future as payment for a supply that happens now and both parties make taxable supplies in the transaction and are not associated, the parties will now be able to agree a current price for the units. The agreed price could be zero.

This is another proposed change expected to become law in the next few months.

Contact us

If you have any questions regarding the issues covered in this publication, please contact your normal PwC adviser or a member of our GST team. Our team can help you by delivering practical GST solutions and effectively managing your GST risk.

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Further details on GST issues and opportunities can be found in our previous GST Direct publications:
http://www.pwc.com/nz/en/GSTDirect

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