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Jonathan Rodgers
Office of the Chief Tax Counsel
Inland Revenue
By email

Dear Jonathan

GST – Unit Trust Management Fees

In your letter dated 22 December 2017, you responded to the FSC's submissions on the draft QWBAs on the GST treatment of fees payable to the manager of a unit trust and the GST treatment of outsourced services in relation to the unit trust.

This letter outlines further submissions from the FSC. These should be read together with our earlier submissions (particularly when we refer to investment management services – we are focussed on a particular type of investment management services.)

The current treatment proposed by Inland Revenue in relation to investment management services is a significant change from how the relevant law has been applied by both Inland Revenue and the financial services sector. It will give rise to a GST cost that does not currently exist. If the proposed treatment is to be applied, legislative change will be required.

1 Responses to the matters covered in the letter

1.1 Required control for investment manager

Inland Revenue's view

Inland Revenue remains of the view that services supplied by an investment manager do not constitute arranging the transfer of securities.

Its view is that full legal control is required to be arranging this service. This is based on *General Motors of Canada Ltd v Canada* [2008] GTC 256.

Inland Revenue's view is that the FMCA 2013 requires the Supervisor to have full legal control. As the investment manager does not have full legal control, it does not arrange the service.

FSC response

As well as the *General Motors of Canada* case, Inland Revenue's letter refers to *Canadian Medical Protective Association v The Queen* (2008) GTC 461.

Canadian Medical Protective applies a different test than full legal control when it determined the supplies were not taxable supplies. The case supports the view that practical investment control is sufficient.

Further, Inland Revenue has applied *Canadian Medical* and not *General Motors* to reach the conclusion that a unit trust manager ("the manager") has sufficient control. Its view is the Supervisor has full legal control. The manager cannot also have full legal control. Inland Revenue therefore also takes the view that full legal control is not required.

In addition, we understand that Inland Revenue has reached an agreement with Trustee Corporations Association ("TCA") under which less than full legal contracting is required. In that case, the manager's activity means the Supervisor's activity is not a financial service. However, the technical point is that Inland Revenue accepts that less than full legal control allows an activity to be a financial service.

A sub-investment manager, despite the manager retaining oversight, has in our view sufficient practical control per *Canadian Medical Protective*, contrary to Inland Revenue's conclusion.

This is more fully explained and discussed in our original letter. Briefly, we see the manager and Supervisor as having veto control only. Their control is exercised after the fact and by exception. The investment manager (noting that FSC acknowledges that not all investment managers operate in this way for all their contracts, in which case, GST may apply) in our view meets the practical investment control test applied in *Canadian Medical Protective*.

In our view, when viewed commercially and practically, the responsibilities of the manager under the FMCA is insufficient justification for concluding that *Canadian Medical Protective* does not apply to the investment manager's services.

It appears that Inland Revenue, for the Investment Manager, has applied the *General Motors* test when the relevant test is that in *Canadian Medical Protective*. It is unclear why Inland Revenue has not applied *Canadian Medical Protective* or, if it has, why it considers the test in that case is not met.

We cannot agree that Inland Revenue has reached the right conclusion given *Canadian Medical Protective* and how investment management arrangements actually operate in practice.

1.2 Managers' ability to contract directly

Inland Revenue's view

Inland Revenue considers that:

- only Supervisors can contract for a unit trust; and
- activities subject to the managers' responsibilities under the FMCA cannot be contracted out.

This means that the manager contracts in its own name and for itself. The manager cannot contract on behalf of the unit trust.

We understand that:

- this view was developed in conjunction with MBIE and the FMA but that the FMA's response was not a full legal opinion.
- This applies to both investment managers and other service providers.

FSC response

Practically and historically, managers have contracted for a unit trust. For example, the statutory audit of the fund has been contracted for by the manager for the unit trusts it manages. We therefore disagree with the first conclusion.

Discussion amongst members following receipt of your letter suggests that the second conclusion is also not accepted. In fact, members' views on the ability of managers to contract for unit trusts were the basis of the original request. However, resolution of this difference, given time constraints, may be best left as a discussion between the managers and the relevant agencies.

Instead, we assume, whether or not its conclusion is correct, that Inland Revenue would agree that if contracts were entered into by the manager for the trust the supply would be to the trust.

This is on the basis that Inland Revenue applies the tax law based on what is actually done and not on whether something is able to be done.

If that assumption is correct, Inland Revenue is able to confirm that a contract for a certain activity in the name of the manager for the unit trust is for a supply to the unit trust?

Although FSC would prefer to see how this is drafted in the QWBA, this approach would allow an earlier acceptance of it.

2 Wider impact of Inland Revenue's view

We have raised the implications, particularly for KiwiSaver and superannuation schemes and broker supplies, of Inland Revenue's view. Those concerns have not been addressed. Given the significance of this issue, a response and remediation to make the supplies exempt is required.

Retirement Schemes

The GST costs are likely to be passed on to KiwiSaver investors (of which there are approximately 2.7 million).[1] We note, in this respect, that the level of investor fees have been an ongoing focus for KiwiSaver. It is intended to be an affordable way for individuals to save for retirement and increase household savings. Inland Revenue's view that GST applies is inconsistent with the policy behind the KiwiSaver regime. It would impose a significant layer of GST cost, which is fundamentally not the right outcome.

There are two further key issues.

Impact on supplies acquired by retirement scheme

Currently, a retirement scheme may be able to rely on two tests for investment management supplies to it being a financial service - arranging a financial service or management of a retirement scheme. Inland Revenue's view on investment management for a unit trust potentially applies for a retirement scheme. This places additional pressure on the alternative test.

We would expect that the Commissioner's view on what the meaning of "managing" is in the context of trusts, per Inland Revenue's guidance on the Common Reporting Standard for Automatic Exchange of Information, would be consistently applied. That guidance states that a financial institution is "managing" where that financial institution has discretionary authority to manage an entity's investment assets, in part or in whole.[2]

An investment manager's management of a retirement scheme's investment assets, even if the scheme as a whole is not managed by the investment manager, is on the Commissioner's view management of the retirement scheme.

Inland Revenue needs to confirm this view in this context that management of a retirement scheme's investment assets by an investment manager are exempt from GST.

Impact on investment structure and New Zealand activity

Imposing GST on investment management costs could also have significant broader outcomes for New Zealand. KiwiSaver schemes are currently able to invest by way of investments in wholesale unit trusts. Inland Revenue's view will make this more costly than investing via a wholesale retirement scheme (to

[1] *KiwiSaver Annual Report 2017*, Financial Markets Authority, p. 4.

[2] Guidance on the Common Reporting Standard for Automatic Exchange of Information (June 2017), p. 119

minimise the GST cost). Wholesale retirement schemes may be required. This will add cost for KiwiSaver funds which have been reduced by the PIE regime.

Alternatively, from a purely GST perspective, Inland Revenue's position may encourage:

- investments to be shifted out of New Zealand wholesale unit trusts to offshore funds.
- the management of New Zealand unit trusts to move offshore.

In both cases, no GST cost may arise. Such outcomes are fundamentally inconsistent with policies of successive New Zealand Governments to promote an active investment management sector in New Zealand.

These responses to Inland Revenue's conclusion, which are valid options to be considered, are likely to increase costs and may also mean that there is reduced economic activity in New Zealand.

There are wider effects of Inland Revenue's view on the structure of investment funds and how they operate. The FSC considers that these wider consequences are appropriate for the GST effects on "mum and dad" investors in KiwiSaver to be considered by the Tax Working Group.

If Inland Revenue does not change its conclusion, it must agree with the Government that legislation be progressed urgently to remedy this by making the supplies clearly exempt. The FSC and it members will certainly be making strong submissions to the Tax Working Group on this matter given its significance for retirement savings and the New Zealand economy.

Brokers

It is also unclear what the implications of Inland Revenue's view of the arranging test will be for brokers. As agents, brokers do not meet the test of having full legal control. If Inland Revenue adopt the same position, this would be a significant issue that would also require legislative remedy.

Summary

It is not clear whether Inland Revenue has taken these matters into consideration or what its view is. These consequential impacts of the Inland Revenue view are important for investors (especially KiwiSaver investors). In our view, they do raise questions for the validity of the conclusions given there are alternative approaches.

Inland Revenue should reconsider and explicitly address these effects. Depending on the outcome, a legislative remedy to ensure exempt financial service treatment will be required.

Notification to the Minister

If Inland Revenue does not change its view, we consider that the significant broader implications for investors highlighted in this and earlier letters mean that Inland Revenue should report to the Minister outlining these implications before finalising its view.

3 Implementation

Inland Revenue's letter does not address the timing of when the QWBAs will apply from. It has previously confirmed that they will apply prospectively, with a reasonable period for implementation. We have assumed that continues to be the case.

If Inland Revenue's view proceeds without remediation, this will likely trigger re-pricing and require changes to disclosure documentation. The lead-in time required by the industry before the QWBAs apply to unit trust manager fees may therefore be longer than previously anticipated.

We also consider Inland Revenue should publish an operational statement alongside the finalised QWBAs to clarify the operation of the QWBAs in practice.

4 Next steps

Please contact Richard Klipin on 09 985 5762 or John Cantin on 04 816 4518 if you would like to discuss.

Yours sincerely

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The FSC represents New Zealand's financial services industry having 32 members at 28 February 2018. Companies represented in the FSC include the major insurers in life, disability, income, and trauma insurance, and some fund managers and KiwiSaver providers plus law firms, audit firms, and other providers to the financial services sector.