Regulatory Impact Statement: GST on management services supplied to managed funds

Coversheet

Purpose of Document	
Decision sought:	*Analysis produced for the purpose of informing: final Cabinet decisions on the GST treatment of management services supplied to managed funds*
Advising agencies:	*Inland Revenue*
Proposing Ministers:	*Minister of Revenue*
Date finalised:	*25 May 2022*

Problem Definition

The current Goods and Services (GST) treatment for different types of management services supplied to managed funds is complex and inconsistent. The status quo can distort competitive behaviour by favouring certain types of managed funds, business structures, based on the taxpayer's interpretation of the existing GST rules.

Executive Summary

GST is a tax on the supply of goods and services in New Zealand. However, there are types of goods and services that are deemed to be 'exempt' from GST, that is, GST is not imposed on these supplies. One form of exempt supply is financial services (such as the services managed funds supply to their investors).

However, there is uncertainty and a range of different commercial practices for the GST treatment of fund manager services and investment manager services supplied to managed funds.

There are two main issues with this:

- The GST treatment varies across the industry and that inconsistency may create an uneven playing field which distorts competition; and
- The uncertainty and range of different practices on managed funds imposes compliance costs of having to identify and determine the GST treatment of different types of services. It also increases the risk of errors such as incorrectly classifying the type of service provided, or incorrectly charging GST, or incorrectly claiming GST deductions on inputs.

Four options were considered including the counterfactual (no policy change and enforcement of the current GST law). These options were consulted on in both public consultation and in meetings with GST advisors and industry representative groups. While the counterfactual is not supported by stakeholders, stakeholders have different views on the preferred policy solution.

Inland Revenue's preferred option, which is also recommended in the Cabinet paper, is option two – make all fees subject to 15% GST as well as repealing the existing GST exemption for the management of a retirement scheme.

Option two is being recommended because it will provide certainty and consistency in the GST treatment for management services supplied to managed funds and simplify GST compliance. Compared to the other options which involve an exemption, the preferred option is more likely to remain consistent or sustainable over time, including in retirement savings vehicles such as KiwiSaver schemes.

Option two would collect additional GST of approximately $225 million per annum from 1 April 2026, with the GST collected per annum increasing at an assumed growth rate of 10% per annum. It is assumed this cost will largely flow through to retail investors in the form of higher fees. If investor fees are increased, this will reduce after-fee returns and therefore the total amounts that are reinvested and saved over time.

Stakeholders have advised that while some fund managers would incur no material transition costs (the boutique fund managers that are currently applying 15% GST to their fees), other fund managers (such as the larger fund managers) may incur significant transition costs. Option two is the preferred option of the boutique fund managers, but the least preferred option of the larger fund managers who prefer option one - legislating to allow the current inconsistent GST practices to continue.

The preferred option proposes to mitigate the compliance and transition costs incurred by establishing a transition period of 36 months between enactment and when the rules will apply, to allow affected taxpayers to amend their IT systems, commercial contracts and investor disclosure statements to the new rules.

Limitations and Constraints on Analysis

The impacts of increased GST revenues and increased fees charged to investors are sensitive to the assumptions used, particularly assumptions of fee growth as estimates based on 2021 data have been projected to 2026 (the year the proposed reforms would apply from).

An assumption is that the dollar value of the manager's basic fees will grow by 5% for 2022 and 10% per annum thereafter. This assumption is supported by the manager's basic fees growing by an annualised average of 20% for the three years between 31 December 2018 and 31 December 2021. A more conservative 10% assumption is used as the last three years have had historically high investment returns and a lower 5% growth rate for 2022, to reflect that managed funds have generally experienced strongly negative investment returns for the first four months of 2022.

Another assumption is that a manager currently incurs taxable inputs of 20% of the value of the management services they provide to the managed funds. Under the proposal, it is anticipated that a manager could claim the additional GST input deductions on their expenses and offset these deductions against the GST charged on their fees, reducing additional GST collected. This assumption was informed by financial information from the 2021 annual report of the Guardians of the New Zealand Superannuation.

A key assumption on the impact of the changes is that the additional GST cost will largely flow through to the fees charged by managed funds to retail investors, resulting in higher fund fees.

The scope of the options is limited to measures the fund manager and investment manager industry could implement and administer. The options were consulted on in a public consultation paper which also asked for submissions on any alternative options which led to option four (legislating to allow the current GST practices to continue) being submitted as the preferred option for one group of stakeholders.

Responsible Manager(s) (completed by relevant manager)

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s9(2)(a)

25 May 2022

Quality Assurance (completed by QA panel)

Reviewing Agency:	Inland Revenue
Panel Assessment & Comment:	The Quality Assurance reviewer at Inland Revenue has reviewed the *GST on management services supplied to managed funds* Impact Summary and considers that the information and analysis summarised in it meets the quality criteria of the Regulatory Impact Analysis framework. This issue has been subjected to wide consultation, including through a public issues paper. As identified in the Key Limitations or Constraints on Analysis section, a difficulty with assessing the revenue implications of the various options has been establishing the managed funds' likely responses/behavioural changes to GST changes, and the extent to which deductions are currently being claimed on the various input costs associated with providing management services to the managed funds.

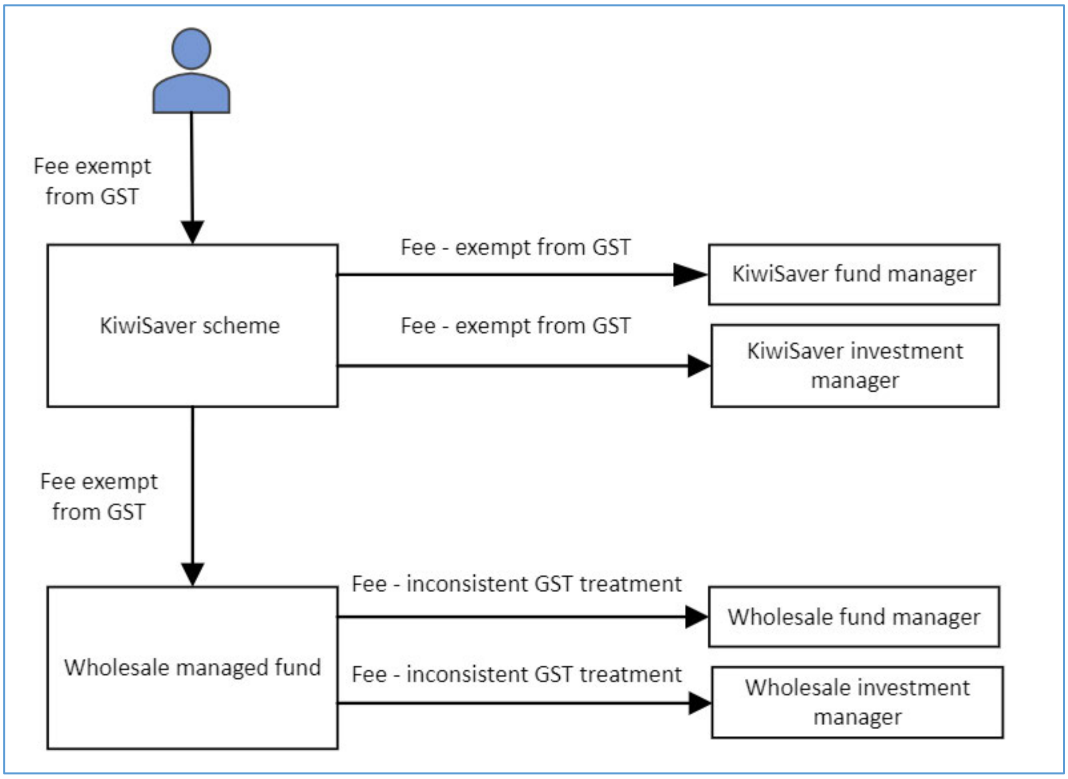
Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

1. Goods and Services Tax (GST) is a 15% consumption tax on goods and services supplied to consumers in New Zealand by GST-registered persons (such as businesses). A GST-registered person can deduct GST paid on their purchases (such as buildings and utilities) that they use in their business, to ensure GST is ultimately borne by the end-consumer.
2. However, some goods and services are exempt from GST, meaning GST is not charged on the good or service, but also the business cannot claim back GST paid on their costs incurred to supply that exempt good or service.
3. One of these exempt services is *financial services*. This exemption includes services that involve arranging a financial product and the management of a retirement scheme. Non-financial services such as providing "advice" on potential investment opportunities or administrative services are subject to 15% GST.
4. The rationale for the financial services exemption is that GST should not be imposed on savings but should be imposed on services such as financial advice. However, for

many savings products, such as bank accounts, it is difficult to value the financial services as it is combined with the return on savings. These valuation issues do not arise for manager and investment manager services provided to managed funds, as these services are charged to the fund as a separate fee.

5. An example of these fees charged is a KiwiSaver scheme that invests into several underlying wholesale funds that hold different types of investments (such as US shares or New Zealand fixed interest). Each of these funds has a manager and investment manager. The KiwiSaver scheme will buy services from a KiwiSaver manager, and for each wholesale fund they invest into they will be charged for services supplied by managers and investment managers. There are over 1,000 funds offered to retail investors.[1]



6. KiwiSaver funds and other types of managed funds purchase three main types of services from third parties:
   a. Manager services. A fund manager has overall responsibility for managing the fund. This includes offering and issuing units in the fund to investors, managing the fund's investments, reporting to investors, and procuring services from an investment manager and various administration service providers.
   b. Investment manager services. An investment manager recommends which assets (shares, bonds, cash) or other funds the fund invests into. When reporting to investors, manager services and investment manager services are both reported as "management fees" which are set as a small percentage (typically between 0.2% and 2%) of the funds under management.
   c. Various administrative services such as legal, accounting, ICT (information and communications technology) or reporting services.

[1] 331 KiwiSaver funds (operated by 39 KiwiSaver schemes) and 758 non-KiwiSaver managed funds.

7. The current GST treatment of different types of services supplied to managed funds is complex and inconsistent, leading to a range of differing GST practices and an uneven playing field across the industry. The industry applies the following GST practices:
    - GST exempt. There is a GST exemption which applies when management services are provided directly to a retirement scheme (such as a manager providing services directly to a KiwiSaver scheme). However, this exemption does not apply to most structures, where a retirement scheme invests into a variety of underlying wholesale funds (NZ fixed interest, international shares etc.) as the managers and investment managers will be providing their services to the wholesale fund rather than to the retirement scheme.
8. For fund manager and investment manager services provided to other types of managed fund (including wholesale funds which other funds invest into) there are two different GST practices:
    - 90% exempt. The largest fund managers and investment managers typically treat 10% of their services as being subject to 15% GST and the remaining 90% as exempt from GST (because they consider their services are mostly “arranging” the buying and selling of investment products and so should qualify for the GST exemption for financial services). This may allow them to charge lower fees to the wholesale funds (as they effectively only charge 1.5% GST on their management fees).
    - GST on all fees. A group of boutique fund managers and investment managers apply 15% GST to all of their services (as in their view their services are providing investment “advice” or other types of services that are subject to 15% GST). This simplifies GST compliance and allows the fund manager or investment manager to claim GST deductions (refunds) on their purchases such as commercial rent, market research, software, ICT and administrative services etc.
9. The practice of applying a 90% exempt ratio was first accepted by Inland Revenue from 2001, as part of an operational agreement s9(2)(ba)(i) [redacted] which established that it was acceptable to exempt 90% of unit trust manager[2] fees from GST, with the remaining 10% being subject to 15% GST (meaning 10% of their GST inputs could be claimed back). Although this operational agreement did not actually apply to investment manager’s fees, it has been found that some investment managers have also been treating 90% of their fees as exempt. This agreement expired in 2014.
10. In 2017, Inland Revenue formally considered how the GST would apply to two types of managed fund fees under existing law– *unit trust manager fees* and *investment manager fees*. The draft conclusion was that the unit trust manager fees should be fully exempt – as they are considered to be arranging financial products, which falls within the financial services exemption, whereas the investment manager fees should be subject to 15% as they are considered to be providing advice on investment opportunities and therefore sits sufficiently outside the financial services exemption.
11. Fees can have a large impact on the financial wellbeing of investors as they directly contribute to the level of accumulated savings, including retirement savings for retirement schemes such as KiwiSaver. Generally, fees as a proportion of funds under management should decrease over time through economies of scale as the amount of funds under management grow and the benefits are passed onto consumers. For this reason, the Government (through the KiwiSaver default provider appointment process)

[2] Provides similar services to a fund manager.

and the Financial Markets Authority have focussed in recent years on ensuring KiwiSaver members receive value for money.

What is the policy problem or opportunity?

12. There are two main issues with how GST applies to services supplied to managed funds.
13. The first issue is the inconsistency in the GST treatment on manager and investment manager fees. Because different types of fund manager and investment manager services can have complex and differing GST treatments, the current GST rules can distort competition by favouring certain types of managed funds, business structures, or judgements about how the supplier may choose to interpret the GST rules.
14. The inconsistent GST practices may have allowed some fund managers to structure themselves in order to develop a competitive advantage over others, though there is limited evidence of this.
15. Additionally, some stakeholders have experienced the issue of funds ‘shopping around’ potential fund managers and enquiring about the particular GST treatment they would be subject to. If the particular fund manager cannot match the most favourable treatment, they may not be chosen as the service supplier.
16. The second issue is the uncertainty has resulted in additional compliance costs to fund managers. For example, professional advice may need to be sought to determine the GST treatment of different types of management services or to correct any tax positions previously taken.
17. There is no data available on the level of additional cost borne by fund managers because of the uncertainty, inefficiencies, and competitive distortion. However, several fund managers have indicated the status quo is having a material impact on their ability to compete in the marketplace.

What objectives are sought in relation to the policy problem?

Consistency of industry practices and fair competition

18. The main objective is to resolve the issues outlined above, by providing certainty and consistency to the managed funds industry.
19. The current GST rules may distort commercial competition by favouring certain types of managed funds, business structures, or judgements for how the supplier may choose to interpret the GST rules. This approach can impose its own costs as fund managers invest in themselves to pursue favoured tax advantages. This suggests it may be important for all fund managers and investment managers to apply the same GST treatment.
20. However, requiring fund managers and investment managers to implement a new GST treatment could have a large impact on the fees charged to funds and retail investors (such as KiwiSaver members) as well as impose transition and compliance costs and, so this Regulatory Impact Statement also considers an option of legislating to allow the current inconsistent GST practices to continue (see option 1 below).

Minimising any significant biases that GST may create

21. It is important that any policy solution does not provide a significant bias towards certain types of savings products, managed funds, business structures or larger funds over others. This includes creating a potential bias for in-sourcing costs, given that

outsourcing may be more commercially efficient or more consistent with financial market regulations.

22. In particular, the policy solution needs to consider the existing exemption for the management of a retirement scheme, as there could be a bias for managed funds to invest into specialist retirement funds, rather than more general funds. This bias can be removed by applying the same GST treatment to retirement schemes as other types of managed funds, particularly as most retirement schemes invest into general wholesale funds.

Minimise compliance costs

23. Transitional and compliance costs should be minimised. This includes providing impacted taxpayers a reasonable time period to amend their IT systems, commercial contracts, and investor disclosure documents.
24. Where possible, the new rules should align with existing industry definitions (such as those used by the Financial Markets Authority) and commercial practices. The rules should be easily understood and simple to apply to various commercial arrangements.

Section 2: Deciding upon an option to address the policy problem

What criteria will be used to compare options to the status quo?

25. The following criteria was used to assess the options:
    - Certainty. The GST treatment of a particular service is clear and it becomes easier to correctly apply GST.
    - Consistency of GST practices across the industry. The option does not provide a tax-advantage for some service providers compared to similar service providers.
    - Impact on managed fund fees. The impact of a particular GST treatment when applied to the manager's fees charged to a managed fund, that consequently imposes an unrecoverable GST cost on a managed fund. Effectively, the managed funds are likely to pass through these GST costs to retail investors, such as KiwiSaver members by charging higher fees. To the extent that fees increase, this will reduce after-fee returns and therefore the total amounts that are reinvested and saved over time.
    - Compliance costs and transition costs. Compliance costs should be minimised as much as possible. The option should be easy for the affected parties to understand and apply.
    - Sustainability of the rules. The option is less likely to require amendments in the future due to on-going uncertainty or to address unintended consequences or future developments.
    - GST base integrity. The GST system is designed to collect tax revenues on all goods and services supplied to consumers in New Zealand. Some of the options will collect materially more or less GST than other options.

What scope will options be considered within?

26. The scope of the options is limited to measures the managed funds industry could implement and administer. Options two, three and four were consulted on in a public consultation paper which also asked for submissions on alternative options which led to option one (legislating to allow the current GST practices to continue) being submitted as the preferred option for one group of stakeholders.

What options are being considered?

Option One – Legislate to allow the current inconsistent GST practices to continue

27. Under this option, managed funds will be able to choose between one of three GST treatments. These three approaches represent the current practices undertaken by the industry:
    a. Fully exempt. This option includes retaining a GST exemption for when management services are directly provided to a retirement scheme (such as a manager providing services directly to a KiwiSaver scheme); or
    b. 90% exempt. Treating 90% of their services as exempt and effectively charging 1.5% GST on their fees (15% GST on 10% of their fees). This practice is applied by most retail managed funds and wholesale funds that other funds such as retirement schemes invest into; or
    c. Full GST. Charging 15% GST on all their services. This practice is applied by a small number of boutique funds.

28. One of the main stakeholders, the Financial Services Council[3], which represents the largest managed funds, has expressed a preference for legislating to effectively allow the current GST practices to be able to continue.
29. It is necessary to legislate to achieve this outcome because most of the current industry practices are not consistent with current GST legislation, which is unclear and largely depends on the type of service being supplied.
30. As this option is intended to align with current industry practice it would have no significant impact on the amount of GST collected, the fees charged to retail investors and the net returns on investments. Consequently, this option will avoid reductions in future balances (including retirement balances) that an increase in GST costs would cause.
31. The main advantage of this option, over the other options, is it will not impact on fees charged to investors of managed funds, including KiwiSaver members.
32. This option does not impose transition costs on the managed funds industry at a time when they are dealing with other significant regulatory changes[4]. However, officials consider that any change costs from the other policy reform options can be mitigated by a gradual transition, so the reforms only become mandatory 36 months after the legislation is enacted – this allows a reasonable time period to renew or renegotiate contracts, update systems and issue new disclosures about fee changes to the funds and retail investors.
33. The main disadvantages of legislating the status quo are that it entrenches the complexity and inconsistency of the current practices and the associated impacts on uneven competition and compliance costs.
34. It would also introduce new integrity risks such as ‘cherry-picking” whereby a manager may choose a taxable GST treatment to maximise GST deductions when they are in a start-up phase and to later switch to an exempt treatment to minimise the GST they charge once they are larger and produce a large amount of fee revenue.
35. This option would also involve two different exemption rules – a full exemption for management of retirement schemes and an optional 90% exemption for managers and investment managers which provide services to other types of funds (including the wholesale funds that most retirement schemes invest into). These differing exemptions could be complex to apply which increases the risks of inconsistency, errors, and disputes.
36. There is also a risk that these exemptions would not be consistent or sustainable over time. For example, some service providers may consider that administrative services, which are generally subject to GST, qualify for the exemption, particularly if these services are bundled with exempt management services. This behaviour would have the effect of broadening the boundary of the GST exemption beyond the policy intent and could require future legislative changes to address.
37. Because this option aligns with the current GST positions in the revenue baselines, it would be fiscally neutral.

Option Two – Make the fees subject to 15% GST (100% taxable)

38. Under this option, all manager and investment fees will be subject to 15% GST.

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[3] Non-profit member organisation with members in the life insurance and managed funds industry (including KiwiSaver and workplace savings schemes).

[4] Mandatory climate-related disclosure regime (The Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021), Conduct of Financial Institutions regime and changes to the anti-money laundering rules.

39. The boutique funds prefer this option. This is because it provides a level playing field with other funds and reduces some compliance costs. This is the least preferred option for the larger fund managers. The fund managers and investment managers that are currently charging 15% GST on their fees (many which supply services to boutique funds) would not be impacted by this option.
40. This option would be consistent with the policy rationale that the financial services exemption should generally be limited to cases where there are valuation issues.
41. As part of this option, the GST exemption for retirement schemes would be removed and these manager fees would also be subject to 15% GST. This is because if the exemption was retained, it could create a stronger bias for investing through retirement funds rather than other types of managed funds, as well as providing a tax incentive for retirement schemes to be structured so they receive their manager services directly, rather than indirectly through investment in other funds.
42. The main advantage of this option is that it would provide consistency across the managed funds industry, and reduces concerns that GST practices could be distorting competition.
43. Applying 15% GST to all services provided by fund managers and investment managers would simplify GST compliance as they would be able to claim deductions for GST on their external costs (such as commercial rent, ICT services).
44. However, because the services that funds provide to investors would still be exempt from GST, applying GST to the manager's fees charged to funds would impose an unrecoverable GST cost on managed funds.
45. The main disadvantage of this option is that the additional GST collected will lead to higher fees for retail investors, such as KiwiSaver members. The extent to which GST will lead to higher fees for retail investors is uncertain. Some of the GST cost may be absorbed by the fund manager or investment manager, instead of being passed on as higher fees to managed funds. As well, under this option fund managers and investment managers can claim back more of their GST inputs, whereas previously some of the inputs may have been unclaimed and consequently passed on in higher fees.
46. To the extent that fees increase, this will reduce after-fee returns and therefore the total amounts that are reinvested and the available balances at future dates (e.g., KiwiSaver members would have less available when they withdraw funds to purchase a first home, or at retirement).
47. Feedback from stakeholders was mixed regarding how much they expected fees would increase. The boutique funds advised that the additional GST costs may have little impact on fees charged to retail investors due to increasing pressures to compete on fees and the proposed transition period which would allow time to adjust. In contrast, other stakeholders (such as the Financial Services Council) considered the full impact of the GST cost would be passed through to retail investors.
48. The Financial Markets Authority has advised that overall, fees for KiwiSaver schemes have fallen by 0.15% or 15 basis points over the past two years. Their view is the increased costs of GST will be passed onto members in the form of increased fees.
49. Modelling by the Financial Markets Authority shows that this option will lead to KiwiSaver fund balances being reduced by $103 billion by 2070 (KiwiSaver balances of $2,196.9 billion), while fund balances for non-KiwiSaver managed funds would be lower by $83 billion (fund balances of 1,757.05 billion).
50. Stakeholders have advised that while some fund managers would incur no material transition costs (the boutique fund managers that are currently applying 15% GST to their fees), other fund managers (such as the larger fund managers) may incur significant transition costs. Officials from both the Ministry of Business, Innovation and

Employment and the Financial Markets Authority have supported a 36-month transition period.

51. This option would collect additional GST of approximately $225 million per annum from 1 April 2026 onwards, with the GST collected per annum increasing at an assumed growth rate of 10% per annum. It is assumed that most of the additional GST would flow through to retail investors, such as KiwiSaver members, in the form of higher fees. To the extent that fees increase, this will reduce after-fee returns and therefore the total amounts that are reinvested and saved over time, including savings in retirement schemes such as KiwiSaver.

Illustrative examples of potential upper-limit impacts on fees and future balances

Assume the fund is purchasing management services which are currently treated as being 90% exempt, 10% subject to GST (GST is effectively 1.5% on management services) and that management fees comprise 90% of the fund's total fees (the other 10% are administration fees).

Also assume the retail investor's balance grows by 5% in 2022 and 10% each year thereafter (before fees) as they continue to regularly contribute funds and reinvest returns.

Investor with $37,500 in a fund with a 0.8% annual fee

A retail investor with $37,500 invested in a fund that charged a 0.8% fee under the status quo (option 1) would currently pay a $300 annual fee. Under the proposed reform (option 2), and assuming the GST costs were fully passed through to the retail investor, their fee could increase by up to $29, to become $359 for the first year after the reform.

After 25 years of regular contributions and reinvesting, the investor would have had a $338,530 balance under the status quo and a $332,040 balance under the proposed reform, a reduction of $6,490.

Investor with $100,000 in a fund with a 1% annual fee

A retail investor with $100,000 invested in a fund that charges a 1% fee would pay a $1,000 annual fee under the status quo. Under the proposed reform, their annual fee could increase by up to $96, to become $1,194 for the first year after the reform.

After 25 years of regular contributions and reinvesting, the investor would have had a $862,308 balance under the status quo and a $841,128 balance under the proposed reform, a reduction of $21,179.

Option Three – Make the fees GST exempt (100% exempt)

52. Under this option, all fund manager and investment manager fees would be exempt from GST. This option would be inconsistent with the policy rationale that the financial services exemption should generally be limited to cases where there are valuation issues.

53. The main advantage of this option is that it could improve certainty and consistency as all management and investment management services provided to the funds would be exempt. This option would not impact on fees charged to investors of managed funds, including KiwiSaver members.

54. The main disadvantage of this option is that a GST exemption would reduce costs for funds but would increase costs for fund managers and investment managers as they

would no longer be able to claim any GST input tax deductions in respect of their purchases of outsourced costs (such as commercial rent, ICT, legal and accounting services). This option would therefore establish a strong bias towards in-sourcing costs. The impact of this option on a particular fund manager and investment manager depends on their current GST treatment of their manager fees charged to managed funds - fully exempt (not materially impacted), 90% exempt / 10% taxable (comparatively small impact) or 100% taxable (significantly impacted).

55. Submitters expressed mixed views on whether an exemption would lead to lower fees for retail investors. It seems likely that any cost savings from an exemption would be relatively small and may not be passed through to retail investors.

56. Stakeholders have advised that fund managers and investment managers would incur compliance or transition costs. The transition costs would not be borne equally, that is the transition costs imposed on the larger fund managers and investment managers (that are currently applying 90% GST exempt, 10% taxable) would be less than the boutique fund managers and investment managers (that are currently charging 100% taxable). This is because the boutique fund managers and investment managers would need to adjust from 100% taxable to 100% exempt and consequently could no longer claim GST deductions for outsourced costs.

57. Compared to the status quo / option one, this option would result in a total reduction in GST of approximately $22 million per annum from 1 April 2026 onwards, with the amount of GST forgone increasing at an assumed growth rate of 10% per annum. The estimated revenue depends on the proposed application date and estimated values of the affected managed fund assets and fees at that time. When compared to expected total management fees of approximately $2.1 billion in 2026, it seems unlikely that these reduced GST costs will have a material impact on the overall fees that funds charge retail investors.

58. The main risk with this option is whether the exemption would remain consistent and sustainable over time. This is because an exemption could create boundary issues in determining whether a service was a management service or another type of service (depending on how the relevant services are defined). For example, there could be incentives to bundle or reclassify some other types of services as being management services to further reduce GST costs for managed funds. This has been the experience in European Union countries where case law has found that the “management” of an investment fund has a broad meaning for European Union VAT purposes and can include administrative services and advice.

59. Providing an exemption for management services would lead to policy arguments that other types of services provided to managed funds should also be made exempt from GST in order to further reduce GST costs for managed funds. There does not appear be a good policy rationale for treating management services charged to funds differently to administrative services charged to funds, as both types of service are necessary inputs into the providing a managed fund product to investors. The administrative services are subject to 15% GST. Removing GST on management fees could lead to pressure to reduce GST on administrative services supplied to managed funds as well as similar outsourced services which are used as inputs by online trading platforms or bank savings products.

Option Four – No policy change and enforcement of current law (counterfactual)

60. Under this option, the law remains unchanged and Inland Revenue’s draft interpretations of the existing law will be finalised, resulting in manager fees becoming exempt and investment manager fees becoming subject to 15% GST.

61. The GST exemption for retirement schemes would be retained. The differing GST treatment of management services supplied to retirement schemes, compared to

similar services supplied to other types of funds (including wholesale funds which retirement schemes invest into), would impose compliance costs, and create a bias for certain business structures.

62. There are no clear advantages to this option.
63. The main disadvantages include the risk that this option could lead to some of the affected fund managers or investment managers restructuring their services or commercial contracts, or potentially disputing Inland Revenue's interpretations to mitigate the additional GST costs imposed by this option. This could prolong the uncertainty and inconsistency and result in some fund managers or investment managers applying inaccurate tax positions.
64. The current GST rules for fund manager services and investment manager services are unclear, which has imposed uncertainty, unintended consequences, and increased compliance costs on taxpayers. These issues are further described in the problem definition section.
65. Stakeholders have advised that they would incur significant costs to implement Inland Revenue's interpretation of the existing law. In particular, some investment manager services would incur a significant increase in GST paid (moving from 90% exempt to 100% taxable).
66. Of the two types of fees impacted, the investment manager fees are higher than the fund manager fees, so the counterfactual is estimated to lead to an overall increase in GST collected of approximately $135 million per annum from 1 April 2026 onwards, with the GST collected per annum increasing at an assumed growth rate of 10% per annum. The estimated revenue depends on the proposed application date and estimated values of the affected managed fund assets and fees at that time. This estimate assumes that investment manager fees comprise about 60% of the total amount of fund manager and investment manager fees. It is assumed this GST cost will flow through to retail investors in the form of higher fees which would reduce after-fee returns and therefore the total amounts that are reinvested and saved over time.

How do the options compare to the status quo (current GST practices)?

	Option One – Legislate to allow current inconsistent GST practices to continue	Option Two – Make the fees subject to 15% GST	Option Three - Make the fees GST exempt	Option Four – No policy change and enforcement of the current law
Certainty	0	++	+	- -
Consistency	-[5]	++	+	- -
Impact on managed fund fees	0	- -	0	-
Compliance and transition costs	0	- -	-	- -
Sustainability	-[6]	+	-	- -
GST base integrity	0	++	-	+
Overall assessment	0	+	0	- -

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

67. The preferred option is option two – make the fees subject to 15% GST.

[5] Officials are concerned this option will likely further entrench the inconsistent GST treatments over time. This option could also result in the affected parties switching to a different GST treatment depending on their particular commercial preferences.

[6] Officials are concerned that over time, other fees and services may be unintentionally captured and incorrectly classified as GST-exempt, effectively broadening the boundary of the GST exemption beyond its legislated settings.

68. The preferred option is consistent with the policy rationale of the financial services exemption, removes the distortion created by the exemption for retirement scheme funds, results in consistency across the managed funds industry and reduces concerns about the GST rules driving commercial behaviour in the industry.
69. The preferred option will likely increase the fees charged to managed fund investors, resulting in reduced returns for savers and consequently reduce the future balances in KiwiSaver and other managed funds.
70. The preferred option will impose transition costs for managed funds that are not already subjecting their manager fees to 15% GST.
71. This preferred option seeks to reduce the compliance and transition costs incurred by establishing a transition period of 36 months between enactment and when the rules will apply, to allow affected taxpayers to amend their IT systems, commercial contracts, and investor disclosure statements, to align with the new rules.
72. This option would collect additional GST of approximately $225 million per annum from 1 April 2026 onwards, with the GST collected per annum increasing at an assumed growth rate of 10% per annum. It is assumed that most of the additional GST would flow through to retail investors, such as KiwiSaver members, in the form of higher fees.

What are the marginal costs and benefits of the option?

Affected groups *(identify)*	**Comment** *nature of cost or benefit (e.g., ongoing, one-off), evidence and assumption (e.g., compliance rates), risks.*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.*	**Evidence Certainty** *High, medium, or low, and explain reasoning in comment column.*
Additional costs of the preferred option compared to taking no action			
Regulated groups *(GST registered businesses that supply manager services to managed funds and retirement schemes)*	One-off cost in amending their systems and commercial contracts to align with the changes.	Medium	Medium
Regulators *(Inland Revenue)*	One-off cost in providing education and guidance on the changes.	Low	High
Others (e.g., wider govt, consumers, etc.)	Investors (including KiwiSaver members) that invest in managed funds. Additional GST costs and corresponding increases in fees paid by retail investors. The available data is from 2021 so the estimates for 2026 and future years are sensitive to the assumptions used, particularly about fee growth.	Medium Approximately $225 million per annum from 1 April 2026 onwards, increasing 10% per annum (based on an assumption the relevant fees will increase 10% each year).	Medium Low
Total monetised costs	Additional GST costs and corresponding increases in fees paid by retail investors.	$225 million per annum in 2026 and growing by 10% each subsequent year.	
Non-monetised costs	N/A	*Medium*	*Medium*
Additional benefits of the preferred option compared to taking no action			
Regulated groups *(GST registered businesses that supply manager services to managed funds and retirement schemes)*	Ongoing reduction in compliance costs in determining the GST treatment of manager fees to managed funds.	Low	Medium

	Reduced competitive advantage due to GST treatment.		
Regulators *(Inland Revenue)*	Reduced need to amend GST positions of affected businesses as the new rules should be easier to apply.	Low	Medium
Others (e.g., wider govt, consumers, etc.)			
Crown finances	Additional GST tax revenues.	$225 million per annum from 1 April 2026 onwards, increasing 10% per annum (based on an assumption the relevant fees will increase 10% each year).	Low
Total monetised benefits	Additional GST revenue collected.	$225 million per annum from 1 April 2026 and growing by 10% each subsequent year.	Low
Non-monetised benefits	*N/A*	*Low*	*Medium*

73. The impacts of the non-monetised costs and benefits have been determined through public consultation and discussions with interested managed funds and tax advisors who work with the managed funds industry.
74. A key assumption is that all, or nearly all, of the additional GST cost will ultimately increase the fees charged by managed funds to retail investors. The extent to which the added GST will lead to higher fees for retail investors (such as KiwiSaver investors) is uncertain. The economic literature[7] for other types of GST increases and decreases has found they are more likely to affect the prices paid by consumers (in this case, retail investors) in more competitive markets and if the GST reform is broader. Increases in GST are more likely to be passed through than reductions.
75. The boutique funds submitted that the additional GST costs would have little impact on fees charged to retail investors due to competitive pressure to reduce fees and the proposed transition period, while the larger funds considered the change would increase the overall fees that managed funds and KiwiSaver schemes charge investors and therefore reduce returns from savings.
76. There is a risk that some funds may restructure to reduce the impact of GST applying to NZ managers and NZ investment managers such as by shifting more assets into offshore domiciled funds which use offshore managers. This could reduce the additional GST revenues collected from the preferred option.
77. The monetised costs and benefits are based on 2021 data published by the Financial Markets Authority about the manager's basic fee for each KiwiSaver and non-

[7] IHS (2011), "The Effect of VAT on Price-Setting Behaviour" in IFS et al., A retrospective evaluation of elements of the EU VAT system, Report prepared for the European Commission, TAXUD/2010/DE/328.

KiwiSaver fund multiplied by the value of the funds under management as of 31 December 2021.

78. The impacts of increased GST revenues and increased fees charged to investors are sensitive to the assumptions used, particularly assumptions of fee growth as estimates based on 2021 data have been projected to 2026 (the year the proposed reforms would apply from).

79. The fiscal costs are sensitive to the growth assumption as the model projects the 2021 calculations to future years using this assumed growth rate. The growth assumption is based on the dollar value of the basic manager's fees multiplied by funds under management growing by 20% p.a. during the three years between the quarter ending on 31 December 2018 and the quarter ending on 31 December 2021.

80. A conservative growth rate assumption of 5% for 2022 and 10% for later years is used as:
    - The period between 2018 and 2021 had historically high investment returns, and the first 4 months of 2022 had negative investment returns.
    - The data used does not reflect recent reductions in fees from new lower fee default KiwiSaver providers being appointed and having assets transferred to them during December 2021.
    - Net contributions to KiwiSaver and other retirement schemes may reduce in future years as more of the population of investors reaches retirement age.
    - There is a potential risk that some funds may restructure offshore to reduce the impact of GST (as described in paragraph 76 above).

81. An assumption has been made that a manager currently incurs acquired taxable inputs of 20% of the value of the management services they provide[8]. When a manager's fees become 100% taxable, the manager could claim the additional GST input deductions on their expenses and offset these deductions against the GST charged on manager fees, resulting in less GST paid to the Crown. Given the limited data available, financial information within the Guardians of the New Zealand Superannuation's 2021 annual report was used to inform this assumption whereby the cost of their non-employee expenses was 23% and 24% of the value of the Guardians expenses. A 20% value was used for the assumption in order to provide a profit margin to the fund manager or investment manager.

82. The above assumptions do not consider any other second-order effects.

[8] Consequently, fund managers and investment managers only claim a proportion of the GST incurred on their costs (as most of the fees charged are GST exempt), with the remaining unclaimed GST being incurred as a business cost.

Section 3: Delivering an option

How will the new arrangements be implemented?

83. Inland Revenue will be responsible for the implementation and ongoing administration of the preferred option.
84. Following Cabinet approval, the preferred option will require amendments to the Goods and Services Act 1985 which could be included in the next available omnibus tax bill expected to be introduced in August 2022. The proposals are intended to apply from 1 April 2026.
85. Inland Revenue will provide information to increase awareness and support taxpayers and the managed funds industry to comply with the proposed rules. This will include producing a relevant Tax Information Bulletin item and updating guidance on Inland Revenue's website.
86. The preferred option seeks to reduce the compliance and transition costs incurred by establishing a transition period of three years between enactment and when the rules will apply, to allow affected taxpayers to amend their IT systems and commercial contracts to align with the new rules. Essentially, this would be grandparenting existing contracts that were agreed before the new rules were enacted.

How will the new arrangements be monitored, evaluated, and reviewed?

87. Inland Revenue regularly reviews tax settings on an ongoing basis and provides advice and updates to the Government accordingly. Policy officials consulted with groups of interested fund manager and managed funds when developing the policy options and will continue to engage with them to monitor the impacts of the policy changes.
88. In addition, Inland Revenue maintains strong communication channels with stakeholders in the tax advisory community and these stakeholders will be able to correspond with officials about the operation of the new rules at any time. If problems emerge, they will be dealt with either operationally, or by way of legislative amendment if agreed by Parliament.