GST AND FINANCIAL SERVICES: THE NEW ZEALAND EXPERIENCE

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Introduction

It is now 14½ years since I first was introduced to the vagaries of the application of a value added tax to financial services. The proposed introduction of a Goods and Services Tax in New Zealand was announced in the first Budget of the Labour Government delivered by Sir Roger Douglas in November 1984. I commenced advising the New Zealand Bankers' Association in December 1984. In many respects, this paper is the narrative of one practitioner's journey amid unchartered waters over 14½ years, with at least one circumnavigation of the globe.

This paper does not address questions of Australia's need for a GST.

There are five aspects on which I propose to comment in this paper. They are:

- The scope of the definition of "financial services";
- Exemption and Zero-Rating;
- Deduction of GST paid by providers of financial services;
- The issue of outsourcing;
- Property ownership issues.

Although the scope of the definition of "financial services" encompasses banking, insurance, sharebroking and superannuation funds, happily the focus of my work coincides with the banking focus of this Association.

Within the confines of this paper, I do not address the interesting policy issues concerning the exemption from GST of financial services. Although both New Zealand and Australia have considered proposals for including the provision of financial services within the GST net in one form or another, neither country has been prepared to break with the usual international pattern of exempting financial services. A useful analysis of the issues is contained in Bakker & Chronican **Financial Services and the GST: A Discussion Paper**.[1] I do wish to state my personal view that a value added tax system would operate in a more coherent manner if an appropriate proxy could be adopted so that financial services were not exempted.

I note that the New Zealand Government recently commenced a major review of the operation of the GST system, but without putting key policy aspects "in play". The review has been treated by Government as the first review of the system, conveniently omitting mention of the ineffective review conducted in 1987 by Inland Revenue. The current review is also being conducted by Inland Revenue, and unfortunately has a focus on protection of the tax base, rather than on operational issues. The review was commenced in March 1999 by means of **GST: A review: A tax policy discussion document**.[2] The ultimate outcome of the review is likely to be revealed later this year.

Before commencing my analysis of my five chosen topics, I wish to note an interesting facet which emerged out of the innovations in tax reform of the New Zealand Labour Government in 1984 and 1985. The fringe benefit tax was the first tax reform actually implemented by the Labour Government, and was, to the best of my knowledge, the first time that any country had

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[1] (Victoria University Press, 1985)
[2] (Inland Revenue, 1999).

sought to tax the employer rather than the employee in relation to the provision of fringe benefits. The New Zealand fringe benefit tax rules were contained in 20 pages of legislation. The innovation was applied in Australia, but in legislation spanning many more pages. In a similar manner, the New Zealand Goods & Services Tax legislation originally covered 92 pages (and now covers 158 pages), while the Australian legislation (as introduced in 1998) covers 291 pages. Later in this paper, I note two New Zealand provisions which are required to "work overtime" because of their brevity and cryptic nature. No such criticism can glibly be leveled at the Australian legislation.

A. Scope of "Financial Services" Exemption

It is somewhat trite to observe that boundary issues plague the administration of many of the world's value added tax systems. Within the New Zealand GST system, the policy decision was that there be as few exemptions as possible so that there would be less boundary issues arising for resolution. Apart from the exemption of financial services, the only exemptions contained in the New Zealand GST system are for supply of residential accommodation (and sales of land which has been so leased for more than five years), and the supply of donated goods and services by a non-profit body, and most supplies of fine metals (unless zero-rated at the time of supply of new fine metal by the refiner).

The New Zealand Government also decided that there be a broadly drafted definition of "financial services".

On the basis of a concept of "activity-based" legislation which had been developed in other commercial law areas in New Zealand, the Parliamentary draftsman of those other statutes was employed to draft the definition of "financial services" (while the balance of the GST Bill was drafted in the usual manner).[3]

The current version of section 3(1) which contains the definition of "financial services" is contained in Appendix One. The principal focus of the definition is to specify a wide range of activities. There are virtually no references to any types of entity, with one exception being the reference to "superannuation schemes" in section 3(i)(j). The only other exception is the reference to a futures exchange in section 3(1)(k), although notably the reference is one proposed to be deleted in the GST Review document released on 3 March 1999.

The definition is of considerable breadth although its formulaic nature has posed a number of difficulties in applying the provision. One activity which is not specifically referred to in the section 3(1) list of "financial services" is the operation of a bank account. That concept is used in Schedule 9, Group 5, of the Value Added Tax Act 1994 of the United Kingdom. However it was not adopted in New Zealand. Therefore it is necessary to consider the concepts of the issue, payment and collection of cheques, the issue of debt securities, and the provision of credit under a credit contract. Each of these actions is a subset of the operation of a bank account.

In the absence of a general concept relating to teh operation of a bank accoutn, it was necessary to adopt a somewhat liberal interpretation of the intent of Parliament in 1986 when considering how to apply the (then) new legislation. Some of these difficulties have been

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3 The concept of "activity-based legislation" was first promoted in the mid-1970s in the context of prospectus rules and led to the use of the concept in the Securities Act 1978. See also the reference in RP Darvell and RS Clarke **Securities Law in New Zealand** (Butterworths, 1983), pp.6-7.

alleviated by amendments made in 1989, which I will comment on in the context of outsourcing.

One of the pivotal definitions of "financial services" is contained in paragraph (b) which refers to:

> "The issue, payment, collection, or transfer of ownership of a cheque or letter of credit".

The term "cheque" is defined in section 3(2) to mean:

> "A cheque as defined in the Bills of Exchange Act 1908, an instrument specified in section 5(2) of the Cheques Act 1960, a postal note, a money order, a traveller's cheque, or any order or authorisation (whether in writing, by electronic means, or otherwise) to a financial institution to credit or debit any account".

The parenthetical words were, to the best of my recollection, contributed to the Parliamentary draftsman in a meeting by Brian Small of the Bankers' Association and the writer in an attempt to obtain certainty. The words appear to have survived the development of more forms of electronic banking over the past 13 years.

The concepts of "payment" and collection" seemed in the mid 1980's to have relatively well established meanings at least in the context of documentary transactions. The application of those provisions to an electronic world has been somewhat more problematic.

The various difficulties in interpretating section 3(1) led the Association to follow an approach which had previously been adopted by the British Bankers' Association in developing a List of Services. The development of such a List involved some effort in 1986 for members of the Taxation Committee of the New Zealand Bankers' Association. The List was then negotiated with the Inland Revenue Department.[4] The correspondence was subsequently relied upon by the banks in their outsourcing case, **Databank Systems Limited** v **CIR**.[5] The correspondence involved Inland Revenue adopting a generous interpretation of section 3(1). It asserted that it was necessary to consider whether "the specific service ... is reasonably incidental to any supply described in paragraphs (a) to (l) of the definitions of financial services". It subsequently expressed the view that the issue of a bank statement was "an integral part of the payment or collection of cheques".

The List has not been published by the New Zealand Bankers' Association or by Inland Revenue. It was originally a non-binding ruling by Inland Revenue. It has been revised in the 1994-97 period by negotiation culminating in an agreement with Inland Revenue and then further discussions on a few items.

One area where there has been debate is the treatment of interchange fees paid between the banks in relation to the use of automatic teller machines by customers of other banks. The treatment of the ATM interchange fees in relation to cash withdrawals and account transfers is agreed to be an (exempt) financial service within the scope of section 3(1)(b). However, the treatment of fees in relation to declined transactions and account balance enquiries has been debated, with Inland Revenue contending that the fees are taxable rather than exempt. In some respects the debate has been a re-run of the Databank litigation.

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[4] Some details of the history are set out in M Lynch "Goods and Services Tax - The New Zealand Banking Experience" (ICM 'GST and the Finance Industry' Conference, 22 February 1999).
[5] [1987] 2 NZLR 312, (HC); [1989] 1 NZLR 422 (CA); and [1990] 3 NZLR 385 (PC).

B. Exemption and Zero-Rating[6]

Section 14 of the Act provides that certain supplies of goods and services shall be exempt from GST. Paragraph (a), as originally enacted in 1986, provided for exemption of "financial services" except for supplies of financial services which would be taxed at a rate of 0% under section 11(2). The provision was amended in 1989 as part of the so called "Databank amendments".

Section 14(a) currently provides an exemption for:

> (a) The supply of any financial services (together with the supply of any other goods and services, supplied by the supplier of those financial services, which are reasonably incidental and necessary to that supply of financial services), not being--
>
> (i) A supply of financial services which, but for this subparagraph, would be charged with tax at the rate of zero percent pursuant to section 11 (2) of this Act; or
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> (ii) A supply of goods and services which (although being part of a supply of goods and services which, but for this subparagraph, would be an exempt supply under this paragraph) is not in itself, as between the supplier of that first-mentioned supply and the recipient, a supply of financial services in respect of which this paragraph applies:

The precise effect of the parenthetical words in section 14(a) of "reasonably incidental and necessary" is unclear. However those words do appear to enable registered persons, and Inland Revenue, to take a more holistic interpretation of the exemption for financial services, so that some of the difficulties referred to earlier in relation to the operation of a bank account may not necessarily arise.

The full meaning of section 14(a)(ii) is somewhat unclear. It was an attempt by Parliament to reverse the effect of the Court of Appeal's decision in **CIR v Databank Systems Limited**. However, in view of the ultimate decision of the Privy Council in that case, it is arguable that the subparagraph is now otiose.

The next aspect to be considered is the reference to zero-rating of financial services, noting that this was an original part of the 1986 legislation.

Section 11 provides for zero-rating of supplies of goods and services. Subsection (1) applies to the supply of goods, while subsection (2) applies to the supply of services. Although it is not expressly stated in the GST Act, "financial services" are considered to be "services", so that section 11(2) is the relevant provision. It is to be noted that the term "services" excludes the supply of money, so that the simple supply of money without any additional service, is not a supply of goods or services.

The relevant paragraphs of section 11(2) are paragraphs (d) and (e). They provide for zero-rating where:

> (d) The services are physically performed outside New Zealand; or

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[6] The equivalent terms used in the Australian proposed legislation, A New Tax System (Goods and Services Tax) Bill 1998, are "input-taxed" and "GST-free".

(e) The services are supplied for and to a person who is not resident in New Zealand and who is outside New Zealand at the time the services are performed, not being services which are supplied directly in connection with -

(i) Land or any improvement thereto situated inside New Zealand; or

(ii) Moveable personal property (other than choses in action and other than goods to which paragraph (ca) of this subsection applies) situated inside New Zealand at the time the services are performed;

and not being services which are the acceptance of an obligation to refrain from carrying on any taxable activity, to the extent that the conduct of that activity would have occurred within New Zealand.

Of these two provisions, section 11(2)(e) is the provision which has the most obvious application in the context of the provision of financial services by banks and other entities. In simple terms, transactions with non-resident counterparties are likely to fall within the scope of section 11(2)(e). An obvious exception is the provision of counter foreign exchange services at airports and bank branches, often referred to as "Bureau de Change". "Bureau de Change" activities do not fall within section 11(2)(e) because the non-resident will be inside New Zealand at the time of performance of the services by the bank.

There are some difficulties of interpretation in the provision. The first concerned the meaning of the words "supplied **for and to** a person". That issue was considered by the Court of Appeal, in a different context, in **Wilson & Horton Limited v CIR.**[7] In that leading case, non-resident persons purchased advertising space in a New Zealand newspaper and it was held that the words "for and to" bore the same meaning, namely "contractually to". The decision of Hillyer J in the High Court[8] that the word "for" meant "for the benefit of" was reversed, with the Court noting that such an interpretation brought in a very wide and not easily ascertainable group of persons.

Inland Revenue subsequently issued a binding Public Ruling[9] in December 1996 adopting the reasoning in the Court of Appeal case. (The Ruling also considered an argument relating to the connection between the advertisement services and the newspaper in New Zealand as a piece of moveable personal property within section 11(2)(e)(ii).)

The interpretation of the phrase "services which are supplied directly in connection with land or moveable personal property" is an issue which has not arisen under section 11(2)(e). However, in **Malololailai Interval Holidays New Zealand Limited v CIR,**[10] the equivalent phrase contained in section 11(2)(b) was interpreted by Neazor J. His Honour held that marketing of the sale of time share rights was not a service provided directly in connection with land. Neazor J also expressed the view, in an *obiter* manner, that the transaction between the vendor and purchaser of time share right in relation to land was "directly in connection with land". Neazor J adopted the analysis of Hillyer J in **Wilson & Horton Limited** of the transactions being "one step removed from the direct transaction".

On that basis, the lending of money on mortgage over land in New Zealand would not be sufficient to exclude the operation of section 11(2)(e), because that is a transaction which is "one step removed" from the purchase of land.

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[7] (1995) 17 NZTC 12,325(CA).
[8] (1994) 16 NZTC 11,221(HC).
[9] BRPub 96/10.
[10] (1997) 18 NZTC 13,137 (HC).

The third issue which arises under section 11(2)(e) is whether the recipient of the services is outside New Zealand at the time of performance of the services. Where the counterparty is an individual, the location of that person at the relevant time will often, but not always, be able to be ascertained by the bank. Greater difficulties arise in the context of corporate counterparties. The issues were considered in the **GST Review.**[11] The main problem is the presence in New Zealand of employees of a non-resident company. Legislation relating to the issue was introduced in the Taxation (Annual Rates and Remedial Matters) Bill 1999 which will take effect from 20 May 1999. The Bill proposes a new section 11(2B) that "a minor presence in New Zealand or a presence in New Zealand that is not effectively connected with the supply" will be irrelevant for a company or unincorporated body. (However it is also proposed that a new section 11(2A) will exclude the operation of section 11(2)(e) where there is an agreement by the supplier with a non-resident to provide services to an employee or director.)

Reference has already been made to the List of Services of the New Zealand Bankers' Association, in the context of the definition of "financial services". The List also identifies situations where zero-rating of financial services applies. The major changes from the 1986 version of the List to the April 1998 version relate to the operation of section 11(2)(d).

The issue under section 11(2)(d) concerns the location of physical performance of services outside New Zealand. The issue arose in the context of foreign currency transactions. Inland Revenue had originally, although after some vacillation, accepted the proposition that the settlement of a foreign currency transaction occurs in the jurisdiction of the relevant currency being delivered particularly where delivery was made by the vendor to an account in a foreign jurisdiction. Inland Revenue began resiling from that position in 1994. Ultimately the banks and Inland Revenue decided not to litigate the matter and so there is no New Zealand jurisprudence on this issue. It is however useful to describe the legal position. This issue does not appear to have arisen in other jurisdictions.

Inland Revenue expressed the view that the total activity involved in the foreign currency transaction needed to be considered for the purpose of determining the location of the physical performance of the service. The banks opposed that view because of the transactional and contractual focus given by the majority judgment in the Privy Council in **CIR v Databank Systems Limited** and by the minority judgments in the Court of Appeal in that case.[12] In the writer's view, the transactional approach means that the focus must be on the exchange of currency in determining the place of physical performance of the service. On that basis, sales of foreign currency would ordinarily be zero-rated (unless delivery was made to a New Zealand based account).

The decision in **Libyan Arab Foreign Bank v Bankers Trust Co**[13] is relevant. In that case, the plaintiff had a call account with the London branch of the defendant American bank. A Presidential Order freezed all Libyan property in the United States or in the possession of control of United States persons, including overseas branches of United States persons. The defendant refused to pay on the plaintiff's demand for payment of US Dollars on the basis that it would be an illegal act. The issue was whether the payment would be an illegal act **in the place where the act was to be performed**. The overall effect of the decision of Staughton J is that it is necessary to look at the bank account of the counterparty rather than the underlying bank account in the home jurisdiction of the currency being delivered. On that basis, the delivery of currency (whether domestic or foreign) to a foreign bank account of the counterparty would be able to be zero-rated under section 11(2)(d).

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[11] Paragraphs 14.6-14.9, at p.82.
[12] See the analysis of these decisions below.
[13] [1989] 1 Q.B. 728.

C. Deduction of GST Payments

The principal implication for a business or organisation which carries on an exempt activity is that no deduction of GST paid by the business or organisation is available. This affects the provision of financial services. The New Zealand legislation uses the terms "zero-rated" and "exempt". The Australian legislation uses different terminology but with little change in meaning or effect. In the writer's view, the phraseology used during the consultation period in 1985/1986 in New Zealand of "exemption with credit" and "exemption without credit" is the most eloquent description.

For the purposes of this paper, it is not necessary to consider the subtly different rules which apply to registered persons who have different accounting bases under section 19 of the Goods & Services Tax Act. The payments basis and hybrid basis do not concern us in the context of banking activities. Each of the seven paragraphs in section 20(3) permit a registered person to deduct amounts from the output tax attributable to the relevant taxable period.

Section 20(3)(a), (e), (f) and (g) are relevant. Paragraph (a) permits a deduction of:

- the amount of "input tax" in relation to the supply of goods and services made to the registered person during that taxable period, or
- a proportionate amount of input tax in relation to a supply of second-hand goods made during the taxable period (to the extent of payment made during the taxable period), or
- the amount of "input tax" invoiced or paid pursuant to the Customs and Excise provisions of the GST system, or
- an amount calculated in accordance with section 25 or 26 in relation to credit notes or debit notes and bad debts.

Paragraph (e) permits deduction of an amount calculated in accordance with section 21(5), which is a partial use adjustment provision. Paragraph (f) permits a deduction of input tax where the requirement to hold a tax invoice was not satisfied in a previous period and the tax invoice has subsequently been obtained. Paragraph (g) permits deduction of GST incurred in relation to the calculation of income tax or GST or in respect of tax objections or litigation (under section 20A).

Of all of these paragraphs, it is paragraph (a) that is pivotal to most registered persons, while paragraph (e)'s reference to section 21(5) is important to banks as suppliers of exempt supplies. However the significance of the partial use adjustment provision can only be seen after an examination of the concept of "input tax".

Concept of "Input Tax"

The term "input tax" is defined in section 2(1) of the GST Act. It means tax charged under the domestic charging provision, section 8(1), tax levied under the customs and excise provision, (section 12(1)) on goods entered for home consumption, and the tax fraction of the consideration and money for the supply of any secondhand goods which are not supplied by way of a taxable supply, and then in each case being "goods and services acquired for the principal purpose of making taxable supplies". The proviso to the definition stipulates that the consideration and money for the supply is deemed to be the lesser of the purchase price or the open market value of the supply in circumstances of a secondhand goods transaction where the supplier and recipient are associated persons. A similar rule applies where the consideration relates to more than one supply.

Principal Purpose Test

The concept of "principal purpose" has been the subject of some judicial comment. Some propositions are clearly established: the term "purpose" means the object or end which the taxpayer has in mind or view, and it is different from motive or intention of the registered person: **Case M53**[14] and **CIR v BNZ Investment Advisory Services Limited**.[15] In the New Zealand context, the term "purpose" has been considered in a number of different contexts in relation to income tax law, with Richardson J in **CIR v Haenga**[16] noting that it must be considered in its statutory context for the purpose of determining whether an objective appraisal is required to be made or whether the subjective state of mind of the taxpayer is relevant.[17]

Inland Revenue in its **GST Guide** has noted that the concept of "principal purpose" meant more than a 50% purpose. However that approach has not been adopted by the New Zealand courts as the word "principal" has been interpreted to mean "the main or primary or fundamental" purpose: see **BNZ Investment Advisory Services**[18] , **Coveney v CIR**[19] and **Case T39**.[20] If there were more than two purposes, the Taxation Review Authority has noted that the principal purpose could be less than 50% of the total purpose: **Case P5**[21] and **Case P62**.[22]

As already noted, the New Zealand approach to an objective or subjective interpretation of the word "purpose" has varied in different contexts. This issue has not been decisively resolved in the context of "input tax". The writer's own view was adopted by Willy DCJ in **Case P62** where he noted:

> There will conventionally be a mix of evidence relating to the question of principal purpose. Some of that evidence will consist of what the [registered person] says was the intention at the relevant time. Some will consist of facts which may be called objective which illustrate how that stated intention was carried into effect." [23]

That decision was, however, reversed on appeal but Doogue J stated that he did not see it important in the context of that case "whether an objective, subjective or some other intermediate position should be taken".[24]

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[14] *(*1990) 12 NZTC 2312 (TRA).
[15] (1994) 16 NZTC 11,111 (HC).
[16] (1985) 7 NZTC 5,198 (CA).
[17] In the context of assets acquired for the purpose of sale or other disposition, a subjective appraisal is required: **CIR v National Distributors Limited** (1989) 11 NZTC 6346 (CA). By contrast, an objective appraisal of all the circumstances is required in the context of the general anti-avoidance provision: **Newton v FCT** [1958] AC 450(PC), **Mangin v CIR** 70 ATC 6001 (PC) and **Ashton v CIR** [1975] NZLR 717.
[18] *Supra*.
[19] (1994) 16 NZTC 11,328 (CA).
[20] (1997) 18 NZTC 8261 (TRA).
[21] (1992) 14 NZTC 4034, 4037 (TRA).
[22] (1992) 14 NZTC 4427, 4446 (TRA) [BNZ Investment Advisory Services]
[23] Supra, 4446.
[24] In two Taxation Review Authority cases, an objective test has been suggested to be the appropriate approach: **Case M106**(1990) 12 NZTC 2674, 2678-9 (TRA) and **Case S61** (1996) 17 NZTC 7387 (TRA). The weighting of evidence approach was however suggested in **Case M53** (1990) 12 NZTC 2312 (TRA) and in **Case S16** (1995) 17 NZTC 7123 (TRA).

apply in relation to capital goods, in addition to consumable goods, and for services. In addition, it will often be the case that the purposes relating to the acquisition and utilisation of the goods and services being acquired is concurrent. In these circumstances, the reference to a "subsequent" application of goods and services is inappropriate.

The **GST Review** Discussion Document suggests a number of reforms to section 21(1) and (5). One suggestion concerns the use of the word "subsequently" in the two subsections. The word could have denuded the two provisions of any real effect in the context of concurrent use situations. Inland Revenue and the writer were largely agreed that the word needed to be "read down" but that view was rejected by Willy DCJ in **Case Q51**[35] who expressed the view that section 21 could only apply where there was a change in use.[36] The Discussion Document proposes clarification by means of removal of the word "subsequently".

Other changes proposed in the Discussion Document relate to changes in use. The suggestions include registered persons to choose to make a one-off adjustment or a series of periodic adjustments when there is a change of use from taxable to non-taxable. In the case of a change from non-taxable to taxable, periodic adjustments are proposed to be the only alternative (except where the proviso applies in relation to capital assets with a low value), thereby moving away from a symmetrical tax treatment.

The biggest risk for banks is not the possibility of legislative amendments, but the approach of Inland Revenue to the calculation of the partial use adjustments. Some aspects of the discussions between the New Zealand Bankers' Association and Inland Revenue are outlined by Mike Lynch in his February 1999 paper. The members of the Association use a turnover-based method of calculating the deduction of GST under section 21(1) and section 20(3)(e) in respect of the operations of the total bank. The turnover-based method has the effect of spreading the effects of the taxable (although zero-rated) transactions of a treasury division over the whole bank's activities. The method takes account of the cross-subsidisation which was prevalent in 1986 and which still appears to exist today.

Inland Revenue would prefer to see a direct allocation of input tax to particular activities of a bank, such as treasury, business banking, retail banking, and head office. Progressive developments in cost accounting systems may result in such an allocation becoming possible in the future. In that event, there is likely to be a more significant impact of GST on the New Zealand banking sector.

One of the reasons for the debate with Inland Revenue which commenced in 1994 was the perception by Inland Revenue that an earlier agreement had not operated fairly. The result of the debate was a more formal agreement which was entered into in July 1997. For a variety of reasons, resort has not been made to the Binding Ruling regime contained in the Tax Administration Act 1994. The advantage of the agreement is that it provides a framework for on-going discussion of items, as already noted.

D. Outsourcing Issue

The analysis in the earlier section concerned the inability of providers of financial services to claim a full deduction for the GST which they pay. That translates in to a GST problem in relation to outsourcing. In most situations, the service being provided by the outsourcer is one

[35] Supra, 5290-1.

[36] A similar view was expressed by the same judge in **Case P59**, supra.

which is subject to GST, so that it is not efficient from a GST perspective to rely on outsourced services. However, it is important to note that the extent of the GST inefficiency is equal to the "tax fraction on the value of the labour services and the profit margin". The cost of other components of the outsourcing providers fee will usually bear GST if met directly by the bank or indirectly through the outsourcer.

It is against this backdrop, that it is important to consider the decision of the Privy Council in **CIR v Databank Systems Limited**. New Zealand members of the audience will be familiar with the role undertaken by Databank (now EDS New Zealand Limited) in the New Zealand banking system, but it is desirable to highlight its role for Australians. Databank Systems Limited was a private company originally established in 1967 to provide a co-operative computer system. The main focus of that system was the provision of a financial clearing system which involved the clearing of cheques and other forms of payments. The relevant taxable period at issue in the proceedings was the month of October 1986, which was the first month during which GST was payable in New Zealand. At that time, Databank had a very pervasive impact on the whole of the New Zealand banking system. For a variety of reasons, the clearing house and data processing functions of Databank reduced in significance over the succeeding years. (It would be an over-simplification to assert that the ultimate outcome of the GST case resulted in those changes: there were a number of other commercial pressures at foot, relating to the need of the four banks to present themselves differently in the competitive market which emerged from 1984/86 through the deregulation of the banking sector in New Zealand).

Databank physically uplifted cheques from bank branches, read and sorted them electronically, calculated inter-bank settlement amounts, and updated the customer records of each bank in relation to each customer, and physically delivered the cheques to the paying bank branch. Similar activities were undertaken in relation to electronic money transfer transactions, including direct credits, direct debts, and automatic payments. In addition automatic teller machine and electronic point of sale transactions were all processed by Databank, in the same manner as cheques and other transactions.

On the basis of the correspondence between the Bankers' Association and Inland Revenue in 1986, the banks were of the view that Inland Revenue was obliged to treat the services provided by Databank as being exempt financial services under a number of the paragraphs of section 3(1). Inland Revenue's position, as summarised in the High Court, was that section 3 exemption required all aspects of the service to be carried out by the banks, that Databank merely recorded crediting and debiting of accounts, and Databank ought to be treated in the same way as any third party supplier. At first instance, Davison CJ held in favour of Databank. He rejected the single person argument, noted the heavy involvement of Databank in the clearance of cheques, and stated that there was nothing in the Act preventing Databank from supplying "financial services" to a bank.

On appeal to the Court of Appeal, the Commissioner had a measure of success. The five judges split in a divergent manner in relation to two issues, being the essential issue of exemption of financial services and a new argument relating to the operation of the agency provisions contained in section 60 of the GST Act. The overall outcome, however, was that Databank succeeded.

Cooke P accepted that the services provided by Databank were "integral parts of the methods whereby the banks supply financial services to their customers" and that as it was an agent for the banks, Databank's services were exempt. Richardson J held for the Commissioner on the basis that the relevant question was the nature of the services supplied from Databank as supplier to the banks as recipients. McMullin J essentially concurred with the reasoning of

Richardson J. Somers J held that the services were financial services and adopted the agency argument. Casey J accepted the reasoning of Davison CJ that the services were financial services but then rejected the agency argument.

The overall effect was success for Databank, but on the basis of split reasoning by the Court of Appeal.

The Government's immediate reaction to the decision of the Court of Appeal, which was delivered on 28 April 1989, was to change the law, with amendments being made in sections 14(a) and 3(5). The amendment to section 14(a) has already been noted above. Section 3(5) enacted a special rule that "where any person supplies goods and services (being the supply of general accounting and record package services) to any person who is a supplier of financial services, or to a customer of the person who is a supplier of financial services, that supply shall, for the purposes of this Act, be deemed not to be a supplier of financial services". The term "general accounting and record package services" was enacted into section 3(2) and specifically included "the provision of any financial clearing system which may form part of a settlement process", "the posting of transactions to customers' accounts" and the maintenance of those accounts, and the provision of ancillary services, unless the services were supplied by a supplier of financial service and "are reasonably incidental and necessary to the supply of that financial service by that supplier of the financial service". The strange term "general accounting and record package services" was a phrase used in the original agreement which governed the provision of services by Databank to its shareholders, being the four trading banks.

The Privy Council heard the case in 1990. It allowed the appeal on a 4:1 basis with Lord Templeman delivering the majority judgment. The essence of that decision was that Databank did not collect or pay cheques because it was not a financial institution and had no money to pay and no depository for collection. In addition, Lord Templeman stressed that "the collection of a cheque means collection of the money for which the cheque is authority" and "payment of a cheque is the payment of money which the written instrument instructs to be paid". The activities of Databank were stated to be separate from the provision of financial services by the banks and not to "form part, important or integral or otherwise of the separate activity and supply of financial services".

The reasoning of Lord Templeman is strongly delivered, but there remain reservations by the writer concerning the references to Databank not being a financial institution, because that ought to be irrelevant under the structure of section 3(1)'s definition of "financial services". In addition, Lord Ackner delivered a strong dissenting judgment, which highlights the change in position adopted by Inland Revenue during the course of the dispute and litigation.

Ultimately the highest court in the land resolved the issue with the 1989 "Databank amendments" so that the Privy Council decision was largely relevant only to the parties for the early taxable periods.

The interesting postscript is that a recent decision in the United Kingdom appears to adopt the approach of the New Zealand domestic courts rather than that of the Privy Council. The British VAT Tribunal decision in **Continuum (Europe) Limited**[37] was significantly influenced by the decision of the European Court of Justice in **Sparekassernes Datacenter v Skatteministeriet.**[38]

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[37] [1998] BVC 2,131.
[38] [1997] BVC 509.

In the **Continuum** case, the question concerned the VAT treatment of supplies made to a life insurance company by a telephone call centre company which had all the dealings with the public relating to the issue and disposal of units held in a personal equity plan ("PEP"). The Tribunal noted the distinction from the **Datacenter** case "between a service which is a mere technical or physical supply, such as data-handling, however necessary it is to the main supply, and a service which is specific and essential part of the main exempt supply".[39]

E. Property Transactions

Like the problem with outsourcing of services, the imposition of GST created difficulties for banks in New Zealand in relation to the holding of property. There were two distinct problems which have eventually been overcome by Inland Revenue interpretations and legislation. In addition, it is appropriate for me to note the publicity given to property restructuring transactions undertaken by some New Zealand banks.

Progressive Sales of Properties

The first problem arose as some banks held a lot of their properties in the banking company itself. In the context of progressive dispositions of branch properties, the issue arose of whether the selling of properties was a "taxable activity" in itself. The key requirement is that of "continuously or regularly" undertaking the relevant activity. For a bank progressively disposing of its branch properties, or at least some of them, there was the open question of whether there was a sufficient degree of regularity and continuity of activity to create a "taxable activity". Inland Revenue considered this issue in 1988 and commented in a Public Information Bulletin item.[40] Inland Revenue stated:

> The disposal of the assets used principally in the making of exempt supplies will not in itself constitute a taxable activity. Instead, it is an activity which is carried on in the course of, or in the furtherance of, an exempt activity.

Subsequently, the meaning of the term "taxable activity" has been considered by the Court of Appeal in **Newman v CIR**. In that case, a builder had purchased land for the erection of his family home. After erecting part of the house and moving into it, he commenced to subdivide the land after he experienced financial difficulties. The question was whether the subdivision process was a "taxable activity" on the basis that the multiple steps comprised a continuous and regular activity. McKay J stated:

> ... the question is not whether those components occupied a continuous period of time. It is whether the activity of which they formed part was one which was carried on continuously or regularly.

The Court held that there was not a "taxable activity". The Court's reasoning reinforces the position which Inland Revenue had earlier adopted in relation to the sale of properties by banks.

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[39] Supra, 2,133
[40] PIB 169 - February 1988

Group Structures

The second problem applied to those banks, and other providers of exempt supplies, which held their properties in a separate company. At least one major New Zealand bank had restructured its affairs in that manner in the late 1970s. When the GST Act was first enacted, it provided for group registration in section 55, but there were technical difficulties in relation to a taxable entity making supplies to an exempt entity.

The first pre-requisite of section 55 is that each company in a group of companies is itself a registered person. Thus the grouping provision is not able to be availed of in respect of companies which do not have any taxable activity. Thus, it was difficult for banks to seek group registration in relation to the private savings banks which used to exist (for special purposes) under New Zealand banking legislation.

The second feature of section 55 is that it is elective. The group of companies is able to determine which companies will be part of a group registration, so long as each satisfies the Income Tax Act requirements for being a group of companies. Section 55(4) reinforces this point by explicitly permitting exclusion of a member of a group of companies from the group registration, while section 55(1) explicitly refers to "part of a group of companies".

The operative provisions are contained in section 55(7). The nominated "representative member" is deemed to carry on the taxable activity of each member of the group. Taxable supplies by a member of the group to another member of the group may be disregarded to the extent that input tax would be deductible by the recipient if the recipient had not been a member of that group: section 55(7)(c). The words "to the extent that input tax in respect of that supply would be deductible by the recipient if that recipient had not been a member of that group" were added in 1986 with retrospective effect from 3 December 1985. At the same time, paragraph (da) was enacted. It provides that "any supply of goods and services, other than a taxable supply, made by a member of the group, shall be deemed to be made by the representative member". Paragraph (d) provided that "any other taxable supply of goods and services by or to a member of the group is deemed to be a taxable supply by or to the representative member".

The overall effect of the provisions of section 55(7), after the 1986 amendments were only to provide for disregarding of intra-group transactions to the extent to which input tax was deductible by the recipient. It is desirable to remember that the concept of "input tax" did not encompass the allowance of a partial use adjustment under section 21(5). On this basis, the supply of the use of a property (by way of lease or licence, from a property holding subsidiary to the banking entity) was not to be disregarded within the context of a group registration.

Further amendments were made in 1989 with effect from 22 March 1989. A new paragraph (c) was enacted as well as two new paragraphs (db) and (dc) in section 55(7). Paragraph (c) now provides:

> "Subject to paragraphs (db) and (dc) of this subsection, any taxable supply of goods and services by a member of the group to another member of the group may be disregarded".

Paragraphs (db) and (dc) now provide:

> (db) To the extent that goods and services applied by any member of a group for the principal purpose of making taxable supplies are subsequently applied by the representative member of that group for a purpose other than that of making taxable supplies, that first-mentioned application of those goods and services shall,

for the purposes of section 21(1) of this Act, be deemed to have been made by the representative member of that group; and

(dc) To the extent that goods and services acquired or produced on or after the 1st day of October 1986 by any member of a group other than for the principal purpose of making taxable supplies are subsequently applied by the representative member of that group for a purpose of making taxable supplies, that acquisition or production of those goods and services shall, for the purposes of section 21(5) of this Act, be deemed to have been made by the representative member of that group."

In simple terms, the effect of the 1989 amendments was to treat the group as a single entity for the purposes of applying the partial use adjustment provisions contained in sections 21(1) and (5). The language of paragraphs (db) and (dc) closely replicate the language of section 21(1) and (5).

In my experience, it was only after the March 1989 amendments that banks and other financial institutions commenced registering groups under section 55.

A difficult question which has arisen is the effect of the group registration on assets held by a member of the group at the time of the group registration. In Public Information Bulletin No. 181 (at page 33) Inland Revenue expressed the view that the registration triggers an output tax liability. That view appears to be shared by McKenzie: **GST - A Practical Guide**.[41] The difficulty with that view is that the principal partial use adjustment provisions, sections 21(1) and (5) each contain an indication that the primary type of adjustment is a periodic adjustment. The second proviso to section 21(1) and the second proviso to section 21(5) each contain special provisions permitting a one-off adjustment in relation to capital assets having a cost of less than $10,000. In the writer's view, this is quite a compelling indication that periodic adjustments were to be the principal form of adjustment.

Special provisions apply upon the amalgamation of companies.

The opportunity for some New Zealand banks to sell some of their property portfolio to a special purpose subsidiary appears to have been adopted, according to press reports. Such a transaction would, under New Zealand law, result in an input tax deduction for the purchaser by virtue of the secondhand goods provision. The writer's understanding is that the Australian provisions will not enable such a restructuring of a bank's property portfolio.

Conclusions

The New Zealand GST system has created more than a few issues for banks. These problems have largely to date been able to be addressed at a macro level. There are however indications that there will be a greater emphasis by Inland Revenue on the costing of individual transactions from a GST perspective.

The effect of a change in emphasis may be that there are more micro issues arising for banks to consider. The issues are not simple and do involve a number of interesting

[41] (1993 Ed) page 72.

Appendix One

Section 3(1), Goods and Services Tax Act 1985

For the purposes of this Act, the term "financial services" means any one or more of the following activities:

(a) The exchange of currency (whether effected by the exchange of bank notes or coin, by crediting or debiting accounts, or otherwise):

(b) The issue, payment, collection, or transfer of ownership of a cheque or letter of credit:

(c) The issue, allotment, drawing, acceptance, endorsement, or transfer of ownership of a debt security:

(d) The issue, allotment, or transfer of ownership of an equity security or a participatory security:

(e) Underwriting or sub-underwriting the issue of an equity security, debt security, or participatory security:

(f) The provision of credit under a credit contract:

(g) The renewal or variation of a debt security, equity security, participatory security, or credit contract:

(h) The provision, taking, variation, or release of a guarantee, indemnity, security, or bond in respect of the performance of obligations under a cheque, credit contract, equity security, debt security, or participatory security, or in respect of the activities specified in paragraphs (b) to (g) of this subsection:

(i) The provision, or transfer of ownership, of a life insurance contract or the provision of re-insurance in respect of any such contract:

(j) The provision, or transfer of ownership, of an interest in a superannuation scheme, or the management of a superannuation scheme:

(k) The provision or assignment of a futures contract through a futures exchange:

(ka) The payment or collection of any amount of interest, principal, dividend, or other amount whatever in respect of any debt security, equity security, participatory security, credit contract, contract of life insurance, superannuation scheme, or futures contract:

(l) Agreeing to do, or arranging, any of the activities specified in paragraphs (a) to (ka) of this subsection, other than advising thereon.

Appendix Two

Section 21(1), Goods and Services Tax Act 1985

Subject to section 5(3) of this Act, to the extent that goods and services applied by a registered person for the principal purpose of making taxable supplies are subsequently applied by that registered person for a purpose other than that of making taxable supplies, they shall be deemed to be supplied by that registered person in the course of that taxable activity to the extent that they are so applied:
Provided that this subsection shall not apply to any goods and services to the extent that they are applied for the purpose of making exempt supplies where at the commencement of any taxable period there are reasonable grounds for believing that the total value of all exempt supplies to be made by that registered person in that month then commencing and the 11 months immediately following that month will not exceed the lesser of—

(a) The amount of $48,000:

(b) An amount equal to 5 percent of the total consideration in respect of all taxable and exempt supplies to be made during that 12 month period:

Provided further that where this subsection applies to any goods, being goods forming part of the capital assets of a taxable activity and having a cost of less than $10,000, that registered person may, for the purposes of the return to be furnished in respect of the taxable period during which those goods were acquired or produced, make an assessment in accordance with a method approved by the Commissioner, of the extent to which those goods are to be applied for a purpose other than that of making taxable supplies, and that registered person shall be deemed to make a supply of those goods, to that extent, in that return period and not in any later return period.

Section 21(1), Goods and Services Tax Act 1985

For the purposes of this Act, where no deduction has been made pursuant to section 20(3) of this Act in respect of or in relation to goods and services acquired or produced after the 1st day of October 1986 by a person other than for the principal purpose of making taxable supplies, and any such goods and services are subsequently applied in any taxable period by that person or, where that person is a member of a partnership (as defined in section 57 of this Act), by that partnership for the purpose of making taxable supplies, those goods and services shall be deemed to be supplied in that taxable period to that person or, as the case may be, that partnership, and the Commissioner shall, to the extent to which those goods and services are so applied, allow that person or, as the case may be, that partnership to make a deduction under section 20(3) of this Act of an amount equal to the tax fraction of that part of the lesser of—

(a) The cost of those goods and services, including any tax charged or any input tax deduction claimed in respect of those goods and services:

(b) The open market value of the supply of those goods and services—

as is referable to such application:
Provided that, to the extent that subsections (1) and (3) of this section have deemed a supply to be made of any goods and services, this subsection shall apply as if no deduction had been made pursuant to section 20(3) of this Act in respect of or in relation to those goods and services, and as if those goods and services were acquired or produced by the registered person other than for the principal purpose of making taxable supplies:
Provided further that where this subsection applies to any goods, being capital assets having a cost of less than $10,000, that registered person or, as the case may be, that partnership may, for the purposes of the return to be furnished in respect of the taxable period during which those goods were acquired or produced, make an assessment in accordance with a method approved by the Commissioner, of the extent to which those goods are to be applied for the purpose of making taxable supplies, and that registered person or, as the case may be, that partnership shall be deemed to have acquired those goods for the purpose of making taxable supplies, to that extent, in that return period and not in any later return period.