GST equivalent taxation of financial services  
(Supplementary financial tax)

Executive Summary

This paper has been prepared for the South Australian Department of Premier and Cabinet to discuss options to address the under taxation of financial services under Australia’s GST.

The discussion is divided into four Chapters dealing with:

- Australia’s GST base - its exclusion and inefficiencies
- The GST treatment of financial services in Australia and internationally
- Determining an equivalent GST treatment of financial services
- A margin-based supplementary financial tax for margin-based financial services

Australia’s GST base

Australia’s GST is an indirect, broad based consumption tax charged at the rate is 10%. The tax base for the GST is the value of household final consumption expenditure (HFCE) plus the value of private dwelling investment where these are supplied in the course of an enterprise.

If GST is applied at a uniform rate to a broad base of HFCE, the GST is proportional to the price paid for goods and services generally and does not affect relative prices of items of consumption. As such, a broadly based GST minimises the extent to which the decisions of firms and household are distorted by the application of GST in the economy.

But the transaction based recording of outputs and inputs under the international value added tax model makes its technical application difficult in some areas, the most important of which for present purposes is financial services.

For financial services, the full application of GST using a transaction-by-transaction basis is technically difficult if service charges are made by way of an implicit fee on, or a margin or spread arising from, financial transactions (referred to as “margin-based” transactions or products) entered into by the institution over a period of time with a number of customers.

Consequently, the common international approach is to “input tax” financial services, whether or not the service is a margin based product or is charged for by explicit fees. The consequence of input taxation is that GST is paid on the inputs to the financial services but not on the rendering of the service itself. That is, the resources consumed in rendering the financial services are taxed but the value added by the financial institution is not.

In the Australian GST, the Commonwealth Treasury’s Taxation Expenditure Statement 2014 estimates the extent of under taxation arising from the input taxation of financial services at $4,690 million in the 2015/16 financial year.

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1 Footnotes are omitted from the Executive summary. The references can be found in the Chapters of the discussion paper.
The difficulty of the input taxation of financial services is not limited to the resultant undertaxtion of household consumption. In theory, input taxation, as a feature of value added tax systems leads to:

- Substitution of the undertaxed service for other, fully taxable services
- Over taxation of goods and services that use input taxed services as inputs, with consequential cascading of embedded tax through the production and distribution chain
- Under investment in sectors that can not pass on the cost of embedded tax
- A bias by input taxed sectors to vertically integrate their supply chain as a result of the tax cost differential between outsourcing and self-supply
- Advantages to offshore financial service suppliers that do not suffer the cost of embedded taxes
- Advantages to offshore service suppliers to financial institutions if the institution can access otherwise taxable goods and services in GST-free form from offshore suppliers
- Compliance and complexity because of the need to quantify the extent to which purchases relate to input taxed supplies

The Interim Report of the Murray Inquiry made the observation that, because the full GST is not levied on most financial services, the financial system may be larger than it might otherwise be.

**The GST treatment of financial services in Australia and internationally**

In the European Union, the “input taxed” treatment of financial services extends to both margin-based and explicit fees – providing a neutral treatment to the item of consumption irrespective of the means of charging.

The input taxation of financial services in the EU includes:

- Core financial intermediation – for example
  - the making of deposits and debt investments with an intermediary who provides the relevant funds to users of capital in the form of loans; and
  - the intermediation of buyers and sellers of commodities, currencies, debt and equity securities brokerage.
- Incidental financial services - including “the operation and maintenance of accounts, data processing, … clearing and settlement services (including credit card operation) general accounting and record-keeping services, … custodial services and trust and estate administration”.
- Risk intermediation - the acceptance by the intermediary of exposure to a specified risk that the transferor is unwilling to bear, and the transfer by the intermediary of that exposure to another person willing to accept it.

In theory, the broader the exemption, the greater the revenue cost. The cost of the exemption is the amount of GST that would be charged to households in respect of the value added by financial institutions.

While a broad exemption achieves greater neutrality in tax treatment across a wider range of financial services (i.e., savings, funds, etc.) it comes at the cost of less overall efficiency in the operation of the GST; particularly the embedded taxes on business-to-
business (B2B) transactions and an overall disincentive to outsource inputs to financial services.

Since New Zealand’s landmark “modern” value added tax system in 1985, Singapore, South Africa, Malaysia and Australia have made adjustments to the broad input taxation model to address the under and/or over taxation of financial services. The “modern” approaches can be categorised as follows:

- The adoption of a “margin-based” approach to GST for non-life insurance and gambling – narrowing the input taxation
- Business-to-business input tax relief – addressing the cascade
- Narrowing the input taxation base and partial input tax relief – addressing outsourcing and cascade
- Taxation of fee based services – limiting input taxation to margin-based charges.

In particular:

- The New Zealand, Singaporean, South African, Malaysian and Australian GST systems apply GST (that is, input taxation, does not apply) to the margin for non-life insurance and gambling services.
- Singapore and Australia charge GST on services of agency, facilitation and arranging services in respect of the supply of financial products and various incidental services (such as clearing and settlement services for credit card operations).
- South Africa and Malaysia impose GST for most financial services charged for by means of explicit fees.
- New Zealand, Singapore and Malaysia grant input tax relief calculated by reference to business-to-business financial supplies made by the financial institution.

Singapore and Malaysia adopt a fixed input recovery rate (FITR) for use by financial institutions to claim relief for a fixed percentage of total input tax credits. The fixed percentage is an approximation and will not accurately reflect the true input costs of providing the services.

The fixed recovery rates in Singapore are

- Full bank - 72%
- Wholesale bank - 94%
- Offshore bank - 96%
- Merchant bank - 94%
- Finance companies - 53%

In Malaysia, the FITR is 70% for commercial banks and 75% for investment and development banks.

- Australia grants a special input tax relief for acquisitions of specific facilitation services which would generally be input taxed under the European model. The reduced rate is 75% (and 55% for certain trusts and funds).
In those jurisdictions in which explicit fees are taxed, household consumers of taxable financial services will bear higher GST costs than if it is margin-based. Accordingly, the South African and Malaysian systems allow for different methods of charging for financial services to be selected for different customers. Given that customers are accustomed to both fee and margin-based charges, arbitrage is possible if it is advantageous to both parties.

In general, it can be said that the jurisdictions (other than South Africa) reduce the distortions of over taxation on B2B transactions by granting additional input tax relief to the sector. But the fundamental feature of the jurisdictions is input taxation – and therefore under taxation of financial services supplied to households.

**Determining a GST Equivalent Taxation of Financial Services**

The benchmark tax base for GST includes the value of household consumption of financial services.

In principle, the household consumption of financial services – whether charged by implicit or explicit fees or margin-based – should be taxed in an equivalent way to consumption in other parts of the economy.

Reviews by European Commission, International Monetary Fund and Australia’s Future Tax System on the manner in which margin-based financial products might be fitted into the value added tax system have been carried out - particularly since the global financial crisis.

An IMF report, entitled “A Fair and Substantial Contribution by the Financial Sector” examined two taxation approaches:

- A financial transactions tax (FTT) - the common theme of a FTT is that it applies to a wide range of transactions at a low rate.
- A financial activities tax (FAT) – a new form of tax to address the under taxation of financial services under the international model of value added tax.

Prior to the IMF Report, the European Commission and IMF had considered so-called “cash flow”, “tax calculation account” and “reverse charge” methods of calculation of the value of financial services.

And, earlier, the Court of Justice of the European Union (CJEU) had considered the value of gambling and foreign exchange activities for the purposes of the EU GST concluding that that the “price” of a gambling and foreign exchange service was the amount that the organiser or bank keeps for itself - that is, the net result of all transactions over a period of time.

**Financial transaction taxes (FTT)**

The types of financial transaction taxes discussed in the IMF Report is similar to a securities transaction taxes (STT) - a turnover tax applying to certain types of securities (equity, debt and their derivatives).

While ten of the Member States of the European Community have agreed to implement a FTT in 2016 (an STT applying to the purchase and sale, exchange or repurchase of a financial instruments - such as shares, bonds and derivatives - at a minimum rate of 0.1%, or 0.01% for derivatives), its future seems uncertain.
The FTT is designed to obtain a contribution from the financial sector for costs incurred in its stabilisation during the global financial crisis and is not designed as a GST on household consumption. As such, the moves in Europe in this regard are not suitable as a mechanism to address the under taxation of financial services in Australia’s GST.

Financial activities tax (FAT)

The reviews referred to above have focussed on:

- transaction based approaches that are consistent with a invoice credit, transaction based GST; and
- addition methods of calculation of GST.

In addition, there is international experience of the use of:

- “Margin schemes” to tax the full value of gambling and general insurance; and
- Selective payroll taxes that seek to compensate for the under taxation of input taxation of financial services.

Selective payroll taxes - France and Denmark

Payroll taxes are used in these two European Member States to raise revenues to compensate for the under taxation arising from input taxation. France and Denmark levy a payroll tax on input taxed sectors to raise tax on at least part of the value added in making input taxed supplies – including financial services.

According to Government sources over 85% of the French payroll tax revenue is raised from financial institutions and, in Denmark, approximately 70% of the total tax raised comes from the financial sector.

A properly structured payroll tax is regarded as having a similar tax base to GST – it taxes the value added by labour. On the face of it, a coordinated State and Territory (or Federal) selective tax on payroll of financial institutions could recover part of the value added in making input taxed supplies.

As a selective tax on financial services it would operate as an intermediate impost in respect of which relief may need to be given from over taxation of B2B transactions and exports (see later comments re Israel’s addition method).

Transaction based FATs

Cash flow methods

The basic cash flow approach to GST and financial services operates on a transactional basis so that a part of the margin of the financial transaction (and its GST component) can be allocated to each of the recipients in a similar way to the credit invoice, transaction based GST model.

At its simplest, the cash flow model treats capital and revenue financial inflows as GST taxable sales and outflows as input tax creditable purchases. The differences between the output tax and input tax associated with these cash flows equates to net GST on the "margin" for the transaction.

The TCA approach is a modification of the basic cash flow approach to overcome some of the complexities. One major difference is that the TCA involves an allowance for a normal rate of return.
An illustrative example of the two approaches appears at Appendix A.

Reverse charge

The reverse charge mechanism is a further development of the cash flow methods and also operates on a transaction-by-transaction basis that is compatible with the invoice credit, transaction based GST. However, tax and credits apply to interest and charges and not to principal.

Because GST on the financial service is allocated by the financial institution on the differences between the interest charges to depositors and borrowers, the margin for any particular service is an average of all current deposit and lending transactions in the pool.

Comparison of transaction based FAT methods

With the exception of TCA’s allowance for a normal rate of return, the mechanics of all three transaction based forms of FAT collect GST on the difference between interest paid to lenders and interest paid by borrowers. And give effect to this on a transaction by transaction basis so that GST credits can be granted to registered borrowers.

Zee (the author of the reverse charge method) asserts that the mechanisms to achieve this result in the cash flow and TCA methods are too complex to undertake.

Addition method FAT’s

Both IMF and AFTS Reports support an addition method value added tax under which GST is payable by financial institutions on the sum of “profits plus wages” for a period. Israel has an addition based impost on the sector to apply full GST to financial services.

Israel: Full taxation using addition method

Israel’s GST is a credit invoice, transaction based value added tax at the rate of 18%. Financial services are input taxed meaning that input tax relief is not generally available to financial institutions. But Israel also imposes a separate addition method tax on financial institutions and insurance companies, administered by the income tax authority, at the 18% rate on the sum of total wages and profits.

Consequently, the main criticism of the Israeli approach is that the addition method GST gives no relief for exports and the business consumption of financial services.

Addition method FAT: profit + wages

The IMF’s consideration of addition based FAT found that the under taxation of household consumption of financial services should be addressed by “a uniform tax on profits plus payments to workers using the definitions and rules currently provided for the income taxation of businesses and individuals.”

The AFTS Report suggested an addition method calculated from the wages and economic rent of financial institutions. The addition method would be calculated under existing income tax concepts, after making adjustments for:

- a deduction for the allowance of a normal return to capital (using a long term bond rate);
- the addition of deductions for depreciation; and
• the addition of wages - being payments made to a person as an employee, director or office holder and include the taxable value of fringe benefits.

Adjustments to profit + wages

Chapter 3 of this paper considers a variety of matters relevant to the extension of GST to household consumption of financial services using an addition method:

• The calculation the “profit” and “wages” elements to arrive at the amount of value added over the period and whether this might be done differently for different activities – e.g., whether deposit taking intermediation is to be treated differently to foreign exchange services;

• The allocation of the aggregate value of the financial services over the period between the variety of entities that have received the services – e.g., can the value be allocated to identify the portion of aggregate value added to be treated as B2B and exported services and without a GST liability;

• Determining the type of entities (referred to as the “perimeter”) to which financial services GST should apply. The perimeter could be as broad as including all entities that provide financial services in the course of their business or as narrow as financial institutions that come within the supervisory authority of government agencies;

• Applying GST to imported financial services. If the supply of financial services to households is made by entities that are established outside of Australia, whether there is a mechanism to address the threat to the revenue base;

• Whether output GST should apply to those (explicit) fees that are able to be subject to the normal GST regime.

• Determine the proper treatment of input tax incurred by financial institutions – that is, whether full input tax relief is to be granted against the GST paid using the addition method and (if appropriate) explicit fees.

This paper concludes that, if an addition method is to be used, it ought to apply:

• Only to margin based products and their related fees and charges, allowing the existing system to continue for explicit fees currently subject to GST in the normal way and insurance and gambling; and

• Full input tax relief ought to be allowed against normal GST and “addition based GST”.

Both of these conclusions are based on doing as little damage to the existing GST system, taxing what you can under the existing system and using the supplementary financial tax on an addition method only for those difficult to tax areas.

But, of significance to this conclusion, is the consequence that purchases for which input tax credits are allowed would need to be added to profits and wages to ensure that full GST is collected on the total value added through the production and distribution chain.

Once this is accepted, the question arises as to whether, instead of an “addition method”, a “margin based” calculation might be preferable – after all, this is the outcome of the cash account and reverse charge methods.
A margin-based solution

The above discussion illustrates that (absent the allowance of a rate of return on capital) all methods are consistent in the view that the “price” of margin-based financial intermediation is, in principle, the amount that the financial institution gets to keep for itself from its activities of financial intermediation.

This approach is consistent with:

• the existing treatment of general insurance and gambling;
• the allowance of full input tax relief against taxable GST explicit fees and margin-based taxation of margin-based products;

both of which are part of the regime for full taxation of household consumption of financial services.

Consequently, a simple approach is to calculate a “margin” as the base for the value added by financial institutions on margin-based products – in principle, the amount that the institution keeps for itself out of the underlying intermediation function.

In the case of deposit taking and lending, it is the difference between the interest paid and interest earned over a period.

For foreign exchange transactions and derivative trading, it would be the difference between sales and purchases over a period. Fees and charges on margin-based products – which currently are input taxed – would be included in the margin based gross profit tax base.

A margin-based supplementary financial tax for margin-based financial services

After consideration of the international practice and examination of proposals for the full taxation of household consumption of financial services, this paper concludes that the preferred option is a GST equivalent taxation of financial services by means of a supplementary financial tax using a margin-based calculation of value added by financial institutions.

The recommended base is consistent with the principles underlying the EU cash flow, Zee’s reverse charge and the IMF’s addition method of calculation of the value of financial services.

The suggested approach

The recommended approach is to:

• Retain the existing margin-based approaches to gambling and insurance and bringing explicit fees (other than those that are part of the price of margin based products) into the scope of the normal GST rules;

• Impose a “margin-based” GST on margin-based financial services. Fees and charges that are part of the margin-based product (and are currently input taxed as such) would be included in the gross margin and subject to the supplementary financial tax;

• The supplementary tax payable under margin-based method be adjusted by either:
  – Reducing the aggregate margin for a period to take account of the proportion of business done with other registered taxpayers or as exports; or
Applying a reduced rate to the aggregate margin for a period to reflect the proportion of margin on B2B and exported supplies.

- A supplementary financial tax charged using a margin base be accompanied by full relief under the normal GST system for input tax on acquisitions.

- The RITC regime be discontinued.

The incidence of the suggested approach, to a large extent, depends upon decisions concerning the scope and implementation of the new supplementary financial tax impost.

In general, the closer the regime to a direct tax (or one on profits) the more likely the immediate incidence will fall on the financial institution. But, as with any tax, the actual costs are likely to be shared between employees, shareholders and customers.

The approach to the design of the proposal has paid particular attention to the administrative feasibility and compliance costs. In particular, the decision to apply the existing system to explicit fees, allow full input tax credits and calculate the net interest margin as an initial base are consistent with present accounting and tax compliance systems.

In addition, in setting an overall discount to make allowance for B2B and exports is an approach presently adopted in Malaysia, Singapore and New Zealand.

By using the existing GST system, the approach improves the efficiency of the GST overall and delivers, from a combined GST and supplementary financial tax perspective, horizontal equity to decisions about how financing the acquisitions of goods and services.

Vertical equity issues will depend on the design of the system and whether the costs of the impost can be passed through to customers. In general, it is not considered that the incidence would be likely to flow wholly to customers in a margin-based measure as proposed. If the full cost was able to be passed through, the NATSEM analysis would suggest that the proposal does not increase regressivity as a percentage of disposable income.

The 2015 TES estimates that revenue gain of $4,690 million. Budget Paper Number 3 indicates that South Australia’s share of the revenue from a supplementary financial tax in 2015/16 would be approximately 7.09%, i.e. $332.65 million.
1. Australia’s GST base - its exclusions and inefficiencies

1.1. The GST tax base

Australia’s GST is an indirect, broad based consumption tax charged at the rate is 10%. The tax base for the GST is the value of household final consumption expenditure plus the value of private dwelling investment where these are supplied in the course of an enterprise.

Household final consumption expenditure (HFCE) is a robust and reliable tax base that is less susceptible than direct taxes to variations and fluctuations.

If GST is applied at a uniform rate to a broad base of HFCE, the GST is proportional to the price paid for goods and services generally and does not affect relative prices of items of consumption. As such, a broadly based GST minimises the extent to which the decisions of firms and household are distorted by the application of GST in the economy.

1.1.1. Exclusion of financial services from GST base

Australia’s GST excludes some items of household expenditure from the benchmark HFCE tax base. These are detailed in Treasury’s Taxation Expenditure Statements (TES). Estimated tax expenditures above $4 billion for the 2015/16 financial year are:

- Health, residential and child care and health insurance - $7,095 million
- Food - $6,700 million
- Financial services and reduced input tax credits - $4,690 million
- Education - $4,300 million

This paper is only concerned with the treatment of financial services.

Australia’s GST is a value added tax employing an invoice credit, transaction based method. Under this system, it is necessary to ascertain the value and the GST payable for each transaction made by a merchant to its customer. Generally, if the customer is also registered for GST, a credit is given for the GST component of the input to its business activity.

For financial services, the technical application of GST is difficult because the financial institution’s service charge is often an implicit fee, margin or spread arising from financial transactions entered into by the institution over a period of time with a number of customers. In this paper, transactions that are charged in this way are referred to as “margin-based” transactions or products.

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2 The system of taxation is referred to as a value added tax or VAT. In this paper, we use the term GST to describe the Australian GST system as well as the VAT that operates in many other countries.
3 The Australian Treasury, Tax Expenditures Statement 2014, January 2015. (TES)
6 The term in the Australian GST law used to describe an activity that is within the scope of GST is “enterprise” and includes an activity in the form of a business. In this paper we use the term “business” to describe the type of activity that in the various GST regimes would be within the scope of the tax.
In the HP Mercantile case, the late Justice Graham Hill described the practical limitation on the invoice credit, transaction based method that underpins the international model of value added tax:

In terms of GST theory, it is generally accepted that there are certain kinds of activities where the basic system of output tax on supplies and input tax credits on acquisitions will not lead to taxation on the value added by each supplier in the chain. The most important example is said to be financial transactions of financial institutions such as, but not confined to, banks, because they constantly borrow and lend and turn over money in a way that amounts, such as interest charged, will not represent the real value added by the financial institution … it is the margin or imputed margin that is the real economic subject of the supply.

It is important to emphasise that, while the value added for financial transactions entered into by a financial institution over a period can be ascertained, the practical difficulty of applying the GST system come from allocating the aggregate value over the period between the variety of entities that have received the services.

Because of these technical limitations, financial services are “input taxed” in almost all countries that operate an invoice credit, transaction based GST. The consequence of input taxation is that GST is paid on the inputs to the financial service but not on the rendering of the service itself. That is, the resources consumed in rendering the financial services are taxed but the value added by the financial institution is not.

In the Australian GST, the 2014 TES estimates the extent of under taxation arising from the input taxation of financial services at $4,690 million in the 2015/16 financial year. The TES states that the reliability for this estimate as “low”.

1.1.2. Empirical evidence of undertaxation of input taxation

Internationally, the input taxed treatment of financial services has been the subject of perhaps more academic and government reviews than any other aspect of value added taxation. The better view of the literature is that the input taxation of financial services is a favourable tax treatment of the sector, in the sense that the sector is generally under taxed.

The Interim Report of the Murray Inquiry made a similar observation:

GST is not levied on most financial services. This may contribute to the financial system being larger than it might otherwise be. Financial service providers that do not charge GST still must pay GST on inputs, but cannot claim input tax credits. Providers pass this cost on to consumers in the form of higher prices. As a result, households could be over-consuming financial services compared to what they otherwise would if GST was applied to these services. Because the GST is embedded in prices charged to businesses but not charged explicitly, businesses

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8 In other value added tax jurisdictions the terminology equivalent to “input taxed” is “exempt”. Under the international value added tax model, an exempt supply does not give rise to a GST liability but the supplier is not entitled to a credit for the inputs acquired to make the supply. In this paper we use the term “input taxed” even when discussing those other systems that use the term “exempt”.
10 Financial System Inquiry, Interim report, July 2014
cannot claim input tax credits and therefore pay a higher price for financial
services, which would lead them to consume less financial services than they
otherwise would.

1.1.3. Inefficiencies of input taxation
As indicated above, value added tax regimes worldwide have adopted the input taxation
approach to financial services. While empirical evidence of the distortions is lacking, in
theory, input taxation in general (not merely for financial services) is inefficient and
distorts economic behaviour in the following ways.

Under taxation and substitution
Input taxation gives rise to the under taxation of financial services and creates a bias in
favour of household expenditure on and production of input taxed services. Input
taxation encourages the substitution of concessionally taxed financial services for other
taxable goods or services.

Over taxation, cascade and/or under investment
Input taxation of financial services gives rise to over taxation of inputs to financial
institutions. To the extent that the taxation of inputs is passed through to other GST
registered entities supplying taxable goods and services, the unrecovered GST is
embedded in prices paid by households. In this case there may be an under consumption
of over taxed goods and services at the household level. To the extent that the input
taxation of financial institutions cannot be passed through in higher prices or
backwards to suppliers in the form of lower prices, the tax on inputs could result in
lower rates of returns of financial institutions and under investment in the financial
sector.

Self-supply
Input taxation may give rise to a bias to “self-supply” or vertical integration as a result
of the tax cost differential between outsourcing and self-supply - causing efficiency
costs to the extent that outsourcing would otherwise be preferred.

Advantage to offshore financial service suppliers
The potential competitive advantage arising to non-resident financial institutions may
arise for both domestic business and household consumers of financial services. This
distortion may lead to domestic suppliers to move the supply of financial services
offshore.

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11 Edgar 2007. “The apparently casual empiricism of tax policymakers suggests that the household consumption of
financial services is income elastic and price inelastic, so that under-taxation with [input taxation] is not considered
especially problematic.”
12 Burns, L., Consumption Taxation of Supplies of Financial Services in the Asia Pacific Region, Asia Tax Forum,
August 2008, p20 (Burns 2008); Edgar, T, The Search for Alternatives to Exempt Treatment, GST in Retrospect and
Prospect, 2007 p136-141 (Edgar 2007); and NZ Internal Revenue Department GST & financial services, A
government discussion document, Policy Advice Division of the Inland Revenue Department of NZ, October 2002,
p15 (NZ IRD 2002).
**Advantage to offshore service suppliers to financial institutions**

A potential advantage to domestic financial institutions arises if the institution can access otherwise taxable goods and services in GST-free form from offshore suppliers.  

**Compliance and complexity**

Input taxation gives rise to the complexity and compliance costs of apportionment of input tax credits if financial institutions must allocate their business inputs between their input taxed and taxable components.

In practice, the apportionment is done by applying formulae to aggregated expenditure, resulting in input tax relief that is inaccurate and in some cases arbitrary.

**Exemption creep**

The distinction between the facilitation of financial transactions and the mere processing of elements of the transaction is difficult to distinguish on a principled basis. Consequently, the scope of transactions (particularly “new” functions that were not contemplated in the 1970’s) that come within the input taxed definition has grown over time and extended “upstream” to another layer of suppliers, a phenomenon referred to as “exemption creep”.

**1.1.4. Inclusion of the value of financial services in the GST base**

The practical difficulty of applying GST to financial services does not alter the conclusion that, as with other forms of household consumption, “the consumption of financial services by Australian households should be fully taxed …”.

A number of attempts have been made to “reform” the input taxed treatment of financial services to ameliorate the inefficiencies listed above:

- The New Zealand, Singaporean, South African, Malaysian and Australian GST systems apply GST (that is, input taxation, does not apply) to the margin for non-life insurance and gambling services.
- Singapore and Australia charge GST on services of agency, facilitation and arranging services in respect of the supply of financial products and various incidental services (such as clearing and settlement services for credit card operations).
- South Africa and Malaysia impose GST for most financial services charged for by means of explicit fees.
- New Zealand, Singapore and Malaysia grant input tax relief – mostly on a formulaic basis - calculated by reference to business-to-business financial supplies made by the financial institution.

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13 Many jurisdictions seek to counter this bias by a “reverse charge” or imported services regime to neutralise the substitution effect – see below


15 Ebrill, Keen, Bodin and Summers, The Modern VAT, IMF, 2001 at p89. (Ebrill 2001)

16 Australia’s future tax system, Report to the Treasurer, December 2009 at D4, page 303 (AFTS).
Australia grants a special input tax relief to acquisitions of specific facilitation services which would generally be input taxed under the European model. These “reforms” have an affect on both the under and over taxation that is evident in the European system of “input taxation”.

1.1.4.1. Reverse charge

As indicated above, one of the potential distortions of input taxation is the incentive for on-shore financial institutions to access services from off-shore in GST-free form.

To address this non-neutrality and underpin the input taxed tax base, many countries have adopted a “reverse charge” mechanism to collect GST on imported services. Under this mechanism, GST is charged acquisitions of services from offshore if the services are for use in making input taxed supplies by GST registered taxpayers. The GST is payable by the domestic importer rather than the offshore supplier.

Of the countries examined later in the report all have a reverse charge with the exception of Singapore. Singapore’s legislation contemplates a reverse charge but, to date, it has not been implemented.
2. The GST treatment of financial services in Australia and internationally

While the definition of financial services (and the extent of input taxation) varies between jurisdictions, it generally includes “providing loans, taking deposits, trading in financial securities such as shares and units in trusts, life insurance, mortgages and dealings in [derivatives and] currency.”

In the European Union, the “input taxed” treatment extends to both margin-based and explicit fees – providing a neutral treatment to the item of consumption irrespective of the means of charging.

The input taxation of financial services in the EU includes:

- Core financial intermediation – for example
  - the making of deposits and debt investments with an intermediary who provides the relevant funds to users of capital in the form of loans; and
  - the intermediation of buyers and sellers of commodities, currencies, debt and equity securities brokerage.

- Incidental financial services - including “the operation and maintenance of accounts, data processing, … clearing and settlement services (including credit card operation) general accounting and record-keeping services, … custodial services and trust and estate administration”.

- Risk intermediation - the acceptance by the intermediary of exposure to a specified risk that the transferor is unwilling to bear, and the transfer by the intermediary of that exposure to another person willing to accept it.

The European Union adopts a broad scope of input taxation of financial services.

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18 Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, Article 135m states that the following services shall be exempt from VAT:
   (a) insurance and reinsurance transactions, including related services performed by insurance brokers and insurance agents;
   (b) the granting and the negotiation of credit and the management of credit by the person granting it;
   (c) the negotiation of or any dealings in credit guarantees or any other security for money and the management of credit guarantees by the person who is granting the credit;
   (d) transactions, including negotiation, concerning deposit and current accounts, payments, transfers, debts, cheques and other negotiable instruments, but excluding debt collection;
   (e) transactions, including negotiation, concerning currency, bank notes and coins used as legal tender, with the exception of collectors' items, that is to say, gold, silver or other metal coins or bank notes which are not normally used as legal tender or coins of numismatic interest;
   (f) transactions, including negotiation but not management or safekeeping, in shares, interests in companies or associations, debentures and other securities, but excluding documents establishing title to goods, and the rights or securities referred to in Article 15(2);
   (g) the management of special investment funds as defined by Member States;
   (h) the supply at face value of postage stamps valid for use for postal services within their respective territory, fiscal stamps and other similar stamps;
   (i) betting, lotteries and other forms of gambling, subject to the conditions and limitations laid down by each Member State;
20 Edgar 2007 at p. 152.
2.1. Broad input taxation - European Union

The input taxation of financial services in the EU (exported financial services are GST-free\textsuperscript{21}) covers the broadest range of transactions, whether or not the charge is margin-based, including the activities of agents, negotiators, facilitators and intermediaries – such as brokers.

If the financial institution has inputs that relate to both input taxed, taxable and GST-free supplies, its entitlement to input tax credits is, generally, calculated under a revenue based formula\textsuperscript{22} that calculates the proportion of the value of total supplies represented by the value of taxable, GST-free and “out of scope” supplies.

The EU model is the “traditional” treatment of financial services. The inefficiencies of the broad “input taxation” are discussed in 1.1.3 above.

The broader the exemption, the greater the revenue cost.\textsuperscript{23} The cost of the exemption is the amount of GST that would be charged to households in respect of the value added by financial institutions.

From a revenue perspective, there is an over taxation of financial transactions consumed by GST registered businesses.

While a broad exemption achieves greater neutrality in tax treatment across a wider range of financial services (i.e., savings, funds, etc.) it comes at the cost of less overall efficiency in the operation of the GST; particularly the embedded taxes on business-to-business (B2B) transactions and an overall disincentive to outsource inputs to financial services.

2.2. Addressing the inefficiencies of exemption

As indicated above, New Zealand, Singapore, Australia, South Africa and (most recently) Malaysia have made adjustments to broad input taxation to, either, address the under and over taxation of financial services. These “modern” approaches (in addition to the treatment of non-life insurance and gambling) can be divided into five categories:

- Business-to-business input tax relief – addressing the cascade
- Narrowing the input taxation base and partial input tax relief – addressing outsourcing and cascade
- Taxation of fee based services – limiting input taxation to margin-based charges.

2.2.1. B2B input tax relief with broad input taxation - New Zealand

NZ adopts a broad definition of financial services similar to the EU model.\textsuperscript{24}

\textsuperscript{21} In other value added tax jurisdictions the terminology equivalent to “GST-free” is “zero-rated”. Under the international value added tax model, a zero-rated supply does not give rise to a GST liability but the supplier is none-the-less entitled to a full input tax credit for the inputs acquired to make the supply. Thus, the Australian terminology of “GST-free” is a more accurate description of the application of GST to the transactions

\textsuperscript{22} The UK Value Added Tax Regulations 1995, Part XIV

\textsuperscript{23} A PwC study \textit{How the EU VAT exemptions impact the banking sector}, PwC Luxembourg

\textit{http://www.pwc.lu/en_LU/lu/vat/docs/pwc-vat-study-181011.pdf} found that imposing GST on financial services might at best be a break-even operation, Kerrigan, A., concludes “The conclusions reached in this study are however an exception the general results of other work and acknowledge that using different assumptions would give other outcomes.” Exemption of Financial Services in the EU VAT system – What are the Options for Change?, Taxing Banks Fairly Workshop, 27th March 2013. (Kerrigan 2013)
In 2005, New Zealand changed the treatment of financial services between GST registered entities from input taxed (no GST applied, no input tax credits claimed) to GST-free (no GST applied, input tax credits claimed). The focus of the reform was, primarily, the cascade arising from embedded GST in B2B transactions.

In conjunction with the B2B reform, New Zealand introduced a reverse charge mechanism so that GST applies to imported services for use in making input taxed financial supplies. A reverse charge is also a design feature in the EU model, Australia, South Africa and Malaysia. Singapore has not, to date, implemented a reverse charge.

In essence, the NZ B2B GST-free rules allow an additional input tax deduction to a financial service provider by reference to the taxable status of the recipients of its financial supplies. The legislation envisages that input tax relief under the B2B GST-free rules will apply on a transaction-by-transaction basis (i.e., an acquisition is made in the course of making a B2B supply of financial services), in practice a formulaic approach can be adopted if it produces a fair and reasonable approximation.

It must be remembered that this approach does not affect the amount of output tax paid on financial services but, by treating the service as GST-free and not input taxed, a financial institution qualifies for higher input tax relief.

2.2.1.1. Effectiveness

The NZ system reduces the GST costs of financial institutions to the extent that their customer base consists of other GST registered entities. By decreasing GST costs at an intermediate level of production, the system improves efficiencies but also reduces revenue.

To the extent that full relief is available because the financial institution is GST-free, the bias in favour of self-supply is eliminated – again increasing efficiency. But the relief from a GST cost on inputs for financial institutions does not automatically flow through to a reduced price of the financial service to the recipients of the service. In fact, in the case of financial intermediation and the relatively low amounts involved, it is unlikely to be reflected in differential fees between business and non-business customers. In these cases, the savings in B2B GST-free treatment are likely to remain with the sector. This could improve efficiency if the taxation born by the sector under input taxation would lead to under-investment.

Financial institutions that operate at the household level suffer a higher cost structure to those at the wholesale level. As a result there would generally be distortions that occur due to lower rates of return – assuming that the input taxed costs cannot be passed on to households.

The NZ regime imposes GST costs on outsourcing (whether domestically or overseas) to the extent that the financial institution cannot access B2B relief, i.e., for financial services.

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24 The NZ law input taxes “agreeing or arranging” financial transactions that are listed as being input taxed. This terminology has a similar effect to the “negotiating”, “dealing in” and “intermediation” in the EU model. As indicated earlier, gambling and non-life insurance are taxed on the margin.

25 GST-free status applies where the supply of financial services is made by a registered person to another registered person who has the predominant activity of making taxable supplies.

26 GST & financial services, a Government discussion document, the Policy Advice Division of the Inland Revenue Department NZ, October 2002 by (IRD 2002).
service providers to households, the self-supply and offshore competition distortions remain.

2.2.2. Narrow input taxation with partial input tax relief - Australia

Whereas the EU has taken a deliberately expansive approach to the input taxation of financial services, Australia’s input taxation regime has a narrower application. The Australian regime does not input tax the arranging or negotiating of a financial transaction by an agent or facilitator (including various incidental financial services). The narrower definition of financial services is accompanied by a special regime that grants recipients (being financial institutions) input tax relief on specified kinds of inputs to the institution’s financial services. The relief (referred to as reduced input tax credits or RITCs) that is granted is 75% (or 55%) of the input tax that would otherwise be denied because of the input taxation of financial services.

On introducing the reform, the Government saw the RITC relief as achieving the same effect as the input taxation of arranging, negotiation and management of financial transactions contained in the Council Directive albeit by the use of an arbitrary percentage to achieve the outcome.

For the 2015/16 financial year the TES estimates the tax expenditure arising from the RITC regime to be $940 million.

2.2.2.1. Effectiveness

The purpose of the RITC regime is not to address the tax cascade but, rather, it seeks to achieve neutrality between the supply of a financial product and the facilitation and agency activities in its delivery.

The RITC relief incorporates an assumption that the profit and wages of the service provider amounts to 75% (or 55%) of the provider’s charge to the financial institution – that is, it provides relief equivalent to profit and wages comprising 75% (or 55%) of the price of the outsourced service.

The arbitrary nature of this percentage creates distortions if the actual inputs of service providers is less or greater than the predetermined percentages.

As such, in seeking to address the bias against outsourcing, the RITC regime promotes other distortions to behaviour.

As the regime only provides relief for incidental and arranging type services acquired by GST registered entities, households suffer full GST costs for consumption of these services. A broad input taxation regime, however, achieves neutrality between different means of delivering financial services. In Australia, households are not indifferent from a GST perspective as to the form in which they consume financial services.

2.2.3. Narrowing input taxation with fixed rate input tax relief - Singapore

Input taxation under the Singapore GST applies to defined financial services similar in scope to that in Australia; the Singapore definition excludes “arranging”.

27 As indicated above, gambling and non-life insurance are taxed on the margin.
29 Gambling and non-life insurance are taxed on the margin.
Financial institutions and households incur GST costs on a greater range of inputs than is the case where the broad input taxation regime exists. Without relief, financial institutions will incur greater GST costs with commensurate risks of cascade and over taxation.

Consequently, the Singapore GST includes provisions to overcome the inefficiencies of input taxation of financial services. Under a Fixed Input Recovery Method (FITR), financial institutions are able to claim relief for a fixed percentage of total input tax credits. The percentage\(^{30}\) differs according to the type of financial institution and reflects an allowance for both exports and B2B relief. The fixed percentage is an approximation and will not accurately reflect the true input costs of providing the services.

The formula used to determine the input tax recovery ratio in respect of each category of banking licence and for finance companies for each annual period is, in essence:

\[
\frac{\text{B2B} + \text{offshore loans}}{\text{total loans}}^{31}
\]

The fixed recovery rates with effect from 1 April 2015 are as follows

- Full bank - 72%
- Wholesale bank - 94%
- Offshore bank - 96%
- Merchant bank - 94%
- Finance companies - 53%

### 2.2.3.1. Effectiveness

The Singapore system is designed to reduce the GST costs of financial service providers where the customer base is other GST registered entities or offshore recipients. By decreasing GST costs at an intermediate level of production, the system improves efficiencies.

However, the FITR does not reflect a particular supplier’s circumstances. As such, it is general relief for all financial institutions in the particular classification and not referenced to the particular circumstances of an institution that would justify relief.

The relief from a GST cost on inputs for financial institutions does not automatically flow through to a reduced price of the financial service to the recipient of the supply. The relief is unlikely to be reflected in differential fees between business and non-business customers.

Financial institutions that are granted a lower recovery rate will suffer a higher cost structure than those with recovery rates at the higher level. As a result there would generally be distortions that occur due to lower rates of return – assuming that the input taxed costs cannot be passed on to households.

The Singapore regime imposes GST costs on outsourcing (whether domestically or overseas) to the extent that the financial services provider cannot access B2B relief, i.e.,

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\(^{30}\) Calculated by the Monetary Authority of Singapore.

\(^{31}\) Burns 2008.
for financial service providers to households, the self-supply and offshore competition distortions remain.

2.3. Taxation of fee based services – South Africa and Malaysia\textsuperscript{32}

2.3.1. South Africa

In South Africa, the input taxation of financial services is narrower than Singapore and Australia because it includes explicit fees in the taxation base.\textsuperscript{33} As such, South Africa has a broader tax base for financial services than almost all other jurisdictions.

The general approach to claiming input tax relief for financial institutions is a “turnover based” formula:

\[ \frac{A}{B} \]

Where,

\[ A = \text{the tax-exclusive value of taxable and GST-free supplies; and} \]
\[ B = \text{tax-exclusive value of all supplies}. \]

Because of the large value of financial services that are fully taxed, financial institutions are entitled to greater input tax relief for their acquisitions than would be the case under a broad input taxed system.

The South African experience is that the extent of input tax relief is increasing year by year as financial institutions increase the value of services charged buy way of explicit fees.\textsuperscript{34}

2.3.2. Malaysia

Malaysia’s GST commenced on 1 April 2015. The scope of input taxation of financial services is similar to that in South Africa – that is, GST applies to an “explicit fee, commission, merchants discount or other similar charge.”\textsuperscript{35}

Malaysia has also followed the Singapore FITR regime for specific banking institutions – thus achieving an arbitrary percentage of B2B relief and GST-free relief for exports.

The FITR is 70% for commercial banks and 75% for investment and development banks.

2.3.3. The effect of taxation of explicit fees

Because explicit fees are taxed, household consumers of taxable financial services will bear a higher GST costs than if it is margin-based. Accordingly, the South African and Malaysian systems allow for different methods of charging for financial services to be

\textsuperscript{32} Similar regimes gave been adopted in Botswana and Namibia.
\textsuperscript{33} Section 2(1) of the South African VAT Act 1991 defined input taxed financial services to include the exchange of currency, the dealing with a cheque, letter of credit, a debt security, an equity security or a participatory security, the provision of credit, the provision, or transfer of ownership, of a long-term insurance policy or interest in a superannuation scheme and the buying or selling of any derivative or the granting of an option. But the input taxation does not apply if the amount payable is any fee, commission, merchant’s discount or similar charge, excluding any discounting cost.
\textsuperscript{34} Morden, C., Fifteen Years of Value added tax in South Africa (1991 to 2006) GST in Retrospect and Prospect, 2007.
\textsuperscript{35} Subregulation 12(2), Malaysian Goods and Service Tax (Exempt Supply) Order 2014
selected for different customers – adopting a pricing structure to gain the maximum benefit for the institution – and leading to a significant non-neutrality.

Given that customers are accustomed to both fee and margin-based charges arbitrage is possible if it is advantageous to both parties.  

2.4. Comparative Effectiveness

In general, it can be said that the jurisdictions (other than South Africa) reduce the distortions of over taxation on B2B transactions by granting additional input tax relief to the sector. But, the fundamental feature of the jurisdictions is input taxation – and therefore under taxation of financial services supplied to households.

The extent of the under taxation is different depending on the categorisation of the financial service and whether it is charged by margin or explicit fee.

3. Determining an Equivalent GST Treatment of Financial Services

The benchmark tax base for GST includes the value of household consumption of financial services.

In principle, the household consumption of financial services – whether charged by implicit or explicit fees or margin-based – “should be taxed in an equivalent way to consumption in other parts of the economy”.\(^{37}\)

In our examination of the GST practice in Australia and overseas we have seen that:

- South Africa and Malaysia apply GST to financial services charged for by way of explicit fees but input taxation applies to margin-based products.
- New Zealand, Australia and Singapore, while extending GST to some explicit fees,\(^{38}\) grant additional input tax relief for financial institutions that would otherwise suffer higher costs of input taxation. But these developments are not directly concerned with the under taxation of household consumption of financial services.

The under taxation of financial services arises from the input taxation of household consumption of those services. The narrowing of the scope of input taxation in South Africa, Malaysia, Singapore and Australia has the consequence that the household consumption of some explicit fee based financial services are subject to the same GST system that applies to other forms of consumption.

However, the revenue effect of this narrowing of input taxation is not clear:

- Firstly, the reforms in the jurisdictions referred to have are intended to reduce the over taxation (mostly of B2B) arising through input taxation of financial institutions. If this is effective, there is a cost to the revenue – estimated in AFTS 2009 to amount to $790 million in 2011/12.
  
  A PwC study\(^{39}\) concluded that imposing VAT on financial services might at best be a break-even operation.

- Secondly, allowing different methods of charging for financial services for different customers makes arbitrage possible if it is advantageous to both parties.\(^{40}\)

3.1. IMF review of financial services taxation

In April 2010, the G-20 ministers and central bank governors asked the International Monetary Fund (IMF) to report on the options for financial institutions to bear the burden of the costs to governments of the failure of the sector during the global financial crisis.

The IMF report, entitled “A Fair and Substantial Contribution by the Financial Sector”\(^{41}\) examined two taxation approaches:

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\(^{37}\) AFTS 2009, page 304.

\(^{38}\) And for New Zealand extending its GST to imported services.


\(^{40}\) Kerrigan 2010.

A financial transactions tax (FTT) - the common theme of a FTT is that it applies to a wide range of transactions at a low rate.

A financial activities tax (FAT) – a new form of tax to address the under taxation of financial services under the international model of value added tax. Prior to the IMF Report, the European Commission and IMF had considered so-called “cash flow”, “tax calculation account” and “reverse charge” methods of calculation of the value of financial services.

And the Court of Justice of the European Union (CJEU) had considered the value of gambling and foreign exchange activities for the purposes of the EU GST.

In doing so, the CJEU’s view was that the “price” of gambling and foreign exchange services is the amount that the organiser or bank keeps for itself; that is, the net result of all transactions over a period of time.

Later in this paper, we consider the all of these methods of calculating the value of margin-based financial services.

We commence with the IMF’s suggestion of FTT.

3.1.1. Financial transaction taxes (FTT)

The IMF Report identified financial transactions taxes as a means of securing a fair and substantial contribution to meeting the costs associated with government interventions to repair the financial sector and “address [the] adverse externalities … of systemic risks and excessive risk taking”.

The types of financial transaction taxes with which the sector has experience are:

- Bank transaction taxes (BTT) applying on an ad valorem basis to withdrawals and/or deposits to accounts;
- Currency transaction taxes (CTT) apply to foreign exchange transactions, currency futures, options and swaps;
- Securities transaction taxes (STT) - a turnover tax applying to certain types of securities (equity, debt and their derivatives).

The IMF Report noted that, if the aim was to collect revenue comprehensively and neutrally, many of these transactions taxes imposed tax a narrow range of financial products for which the tax revenue would vary according to how often a transaction occurs rather than its value. Having a narrow base of products, FTT’s will lead to

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43 Previously referred to as the ECJ.

44 HJ Glawe Spiel und Unterhaltungsgeraete Aufstellungsgesellschaft mb H & Co KG v Finance & Finanzamt Hamburg, Case C-38/93; Fischer v Finanzamt Donaueschingen (Case C-283/95) [1998] STC 708.

45 Customs and Excise Commissioners v The First National Bank of Chicago, Case – 172/96.

46 Each of these is discussed in Kerrigan 2013.

47 IMF Report.

48 The authors of AFTS had a similar view and preferred a proxy for household consumption.
relocation of activities, distortions and diminution in the tax base – with resultant uncertain revenue.49

The conclusion of the IMF Report was that an FTT did not appear well suited to address adverse effects of financial sector behaviour.

3.1.1.1. The EU FTT proposal

After the IMF Report, the European Council undertook work to develop an FTT proposal.50 On 6 May 2014, the Council authorised 11 Member States (Austria, Belgium, Estonia, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia and Spain) to implement, from 1 January 2016, a Directive for “enhanced cooperation in the area of financial transaction tax”.51

Under the proposal, an FTT would be imposed on transactions involving one or more financial institutions and apply to the purchase and sale, exchange or repurchase of a financial instruments (such as shares, bonds and derivatives) at a minimum rate of 0.1%, or 0.01% for derivatives.

While in January 2015 the Joint Statement by Ministers of Member States confirmed their commitment to a January 2016 introduction, there must be consensus of participating member states over key design issues. A more realistic commencement date is now 1 January 2017.52

The FTT is designed to obtain a contribution from the financial sector for costs incurred in its stabilisation during the global financial crisis and is not designed as a tax on household consumption. As such, the moves in Europe in this regard are not suitable as a mechanism to address the under taxation of financial services in Australia’s GST.

3.1.2. Financial activities tax (FAT)

While input taxation collects GST on the inputs of financial institutions, the value added by the financial institution in the supply of financial services to households is not taxed.

Over the last decade in particular, investigations have sought to identify ways to extend or supplement the GST system to collect tax on the value added in the supply of input taxed financial services.

The reviews have focussed on:

- transaction based approaches that are consistent with a invoice credit, transaction based GST; and
- addition methods of calculation of GST.

In addition,

- The use of “margin schemes” to tax the full value of gambling and casualty insurance are now widespread; and

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49 IMF Report at 8.3.5; Matheson, T., Taxing Financial Transactions: Issues and Evidence, IMF working paper March 2011.
• there is some international experience with the use of selective payroll taxes that seek to compensate for the under taxation of input taxation of financial services.

Each of these different approaches are explained hereunder.

3.2. Selective payroll taxes - France and Denmark

Payroll taxes are used in these two European Member States to raise revenues to compensate for the under taxation arising from input taxation of financial services. France and Denmark levy a payroll tax on the financial sector to raise tax on at least part of the value added in making input taxed supplies of financial services.

3.2.1.1. France

The French taxe sur les salaires imposes a special tax on a GST registered employer if less than 90% of its turnover is subject to GST. The tax rates are progressive, ranging from 4.25% to 13.6 % and are levied on the value of total remuneration of the employees, reduced by the percentage turnover subject to GST.

According to Government sources over 85% of the payroll tax revenue is raised from financial institutions. 53

3.2.1.2. Denmark

Denmark’s payroll tax applies to GST input taxed sectors including entities in the financial sector. The rate of tax is 9.13% of payroll (wages including payments in kind). Approximately 70% of the total tax raised comes from the financial sector. 54

3.2.1.3. Effectiveness

A properly structured payroll tax is regarded as having a similar tax base to GST – it taxes the value added by labour. 55 On the face of it, a coordinated State and Territory (or Federal) selective tax on payroll of financial institutions could recover part of the value added in making input taxed supplies.

As a selective tax on financial services it would operate as an intermediate impost in respect of which relief may need to be given from over taxation of:

• B2B transactions and exports (see later comments re Israel’s addition method); and

• Other supplies of GST taxable goods and services.

3.3. Transaction based FATs

For many years, international attention has focussed on transaction based methods by which GST could be extended to household consumption of financial services. The transaction method solutions most commonly discussed are:

• The Cash Flow Methods
  – Basic Cash Flow Method

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54 Keen, Krelove, and Norregaard,
55 AFTS 2009, D-3.
– Tax Calculation Account Methods (TCA)

- Reverse charge method
- The “margin-based” approach adopted by most of the reference jurisdictions referred to in section 2 of this paper in respect of gambling and general insurance.

### 3.3.1. Cash flow methods

#### 3.3.1.1. Basic cash flow method

The cash flow approach to GST and financial services operates on a transactional basis so that a part of the margin of the financial transaction (and its GST component) can be allocated to each of the recipients in a similar way to the credit invoice, transaction based GST model.

At its simplest, the cash flow model treats capital and revenue financial inflows as GST taxable sales and outflows as input tax creditable purchases. The differences between the output tax and input tax associated with these cash flows equates to net GST on the "margin" for the transaction. On the business customer side of the transaction, output tax (on inflows) and input tax credits (on outflows) allows business relief for the financial services GST.

The method’s practical difficulties come from:

- The cash flow costs of generating large GST liabilities for business customers on (temporary) capital inflows.
- There are significant costs and risks in accounting, recording and calculating input tax credits relating to cash outflows.
- The transitional complexities in the commencement of the cash flow system and cross border lending and borrowing.

#### 3.3.1.2. Tax calculation account method

The tax calculation account (TCA) method is designed to address some of the difficulties of basic cash flow method.

- firstly, it adopts a suspension account mechanism so that the output tax and input tax on financial transactions are recorded but liabilities and entitlements are deferred until the end of a particular period at which time the balance of deferred output tax and input tax credit is payable or refundable
- secondly, if a balance is payable there is interest (at a “risk-free” rate) on deferral of the liability.
- lastly, transactions between financial institutions are GST-free.

A further refinement of the TCA method relieves the necessity for non-financial institutions to maintain the TCA. But financial institutions provide tax invoices to customers for the institution's margin of the transaction to generate tax credit entitlements “to the customer under the normal GST system.”

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3.3.2. Comparison

Appendix A shows an example of the cash flow and TCA systems for illustrative purposes. The example is taken from the Mirrlees Review and is altered in Appendix A to reflect Australian GST rates and currency.

In the example, the cash flow approach gives a GST liability each period equal to 10% of the difference between the borrowing and lending interest rates.

The TCA account gives the same result but at the cash flows present value using a risk-free rate of return as a discount factor.

The TCA can be calculated separately for each deposit/loan for each customer, or with a single consolidated calculation: the value of the bank’s net financial assets (outstanding loans less outstanding deposits) could be recorded at the start of the year, and the bank’s net interest income (interest received from borrowers less interest paid to savers) for the year could be taxed in so far as it exceeded risk-free rate of net assets.

3.3.3. Reverse charging method

In 2005, after a trial of the TCA approach in some European banks, a reverse charge method of collecting GST on financial services was developed by Howell Zee of the IMF.

The reverse charge mechanism operates on a transaction-by-transaction basis that is compatible with the invoice credit, transaction based GST.

Unlike the cash flow methods, Zee's reverse charge tax and credits would apply to interest and charges and not to principal.

GST on the financial service is allocated by the financial institution on the differences between the interest charges to depositors and borrowers, the margin for any particular service being an average of all current deposit and lending transactions in the pool. But only the borrower is treated as a recipient of a financial service (being the entity that pays interest to the financial institution). The value of any service received by the depositor is subsumed into the "margin" charged to the borrower.

In this way, while the net GST is remitted to the authorities by the financial institution, the burden of the tax is borne by the recipient of the service.

The total net GST paid by the borrowers is the GST rate of the intermediation services – the difference between its total loan interest received and deposit interest paid. But registered borrowers are entitled to a credit for the GST borne by them.

3.3.4. Comparison

The amount of GST that the three methods seek to collect from the financial institution is the difference between the banks interest receipts and interest payments over a period. Any GST borne by a borrower who is registered is credited against the borrowers other taxable sales.

The TCA variation to this is that it indexes deferred payment of GST for a time value.

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57 VAT and Financial Services, Chapter 8, Tax by Design, The final report from the Mirrlees Review, Institute of Fiscal Studies, Oxford University Press, September 2011.
With this one exception, the mechanics seek to collect GST on the difference between interest paid to lenders and interest paid by borrowers. And to give effect to this on a transaction-by-transaction basis so that GST credits can be granted to registered borrowers.

Zee asserts that the mechanisms to achieve this result in the cash flow and TCA methods are too complex to undertake.

In all of the discussion of these approaches, the focus is on the deposit-taking and lending activities of financial institutions. But there are a myriad of other activities by which financial services are supplied by financial institutions.

In such cases, the operational design of the proposed approach may need to incorporate rules and procedures that are tailored for the special characteristics of a specific activity (e.g., the trading of certain financial instruments), but the underlying principle of the approach would remain the same.\(^{59}\)

Kerrigan 2013 observes”

The myriad pools of financial assets that underlie the range of financial intermediation services provided by a financial institution are not discrete and self-contained but are fungible and intermingled. .... It is also not clear how the model would work when financial intermediation services are supplied by non-mainstream institutions or even in a disintermediated fashion.\(^{60}\)

### 3.4. Addition method GST

The IMF Report favoured an addition method GST on financial institutions.

Both IMF and AFTS Reports support the consideration of an addition method FAT under which GST is payable by financial institutions on the sum of “profits plus wages” for a period.

… a FAT would effectively be a tax on value added, and so would partially offset the risk of the financial sector becoming unduly large because of its favorable treatment under existing VATs.\(^{61}\)

The object of this paper is to identify approaches that might be adopted to address the under taxation of the financial services that is implied by input taxation under the invoice credit, transaction based GST.

Israel has sought to correct for this by imposing on the sector some form of addition-based tax.

#### 3.4.1. Israel: Full taxation using addition method

Israel’s GST is a credit invoice, transaction based value added tax at the rate of 18%. Financial services are input taxed meaning that input tax relief is not generally available to financial institutions. But Israel imposes a supplementary addition method tax on financial institutions and insurance companies, administered by the income tax authority, at the 18% rate on the sum of total wages and profits.

\(^{59}\) Zee 2005.

\(^{60}\) Kerrigan 2013.

Consequently, the main criticism of the Israeli approach is that the addition method supplementary tax no relief is given for exports and the business consumption of financial services.62

3.4.2. Addition method FAT: profit + wages

3.4.2.1. The calculation of profits and wages

IMF

Keen, Krelove and Norregaard opine63 that the under taxation of household consumption of financial services should be addressed by “a uniform tax on profits plus payments to workers using the definitions and rules currently provided for the income taxation of businesses and individuals.”

There are advantages in compliance costs, integrity and acceptance by taxpayers and tax administration of an addition method FAT if there is a close correlation with calculations that are made for the income tax system.

Under the FAT discussed by Keen, Krelove and Norregaard, the business income tax base would be adopted with adjustments for the addition of labour costs; and a deduction an allowance for equity.

The familiarity with most of the concepts involved, … is an advantage; it could pave the way, not least, for speedy implementation.64

AFTS

The AFTS Report considered both a TCA method and an addition method of calculation of tax on financial services. The addition method was to be calculated from the wages and economic rent of financial institutions.

The AFTS Report suggested that the profits part of the addition method which was “profit” calculated under existing income tax concepts, after making adjustments for:

• a deduction for the allowance of a normal return to capital (using a long term bond rate),65
• the addition of deductions for depreciation; and
• the addition of wages - being payments made to a person as an employee, director or office holder and include the taxable value of fringe benefits.

3.4.2.2. Adjustments to profit + wages

The matters that need to be considered in designing a supplementary financial tax to household consumption of financial services using an addition method are:

• The calculation the “profit” and “wages” elements to arrive at the amount of value added over the period. In addition, whether this might be done differently for

63 The Financial Activities Tax, Michael Keen, Russell Krelove, and John Norregaard, Financial Sector Taxation: The IMF’s Report to the G-20 and Background Material.
64 At page 125.
65 The allowance of a return on cost of capital arises from the desire to use economic rent as the base rather than “profit”.

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different activities – e.g., whether deposit taking intermediation is to be treated differently to foreign exchange services;

- The allocation of the aggregate value of the financial services over the period between the variety of entities that have received the services – e.g., can the value be allocated to identify the portion of aggregate value added to be treated as B2B and without a GST liability;

- Identifying the value of financial services that are to be treated as GST-free exports. Under the destination principle that is a fundamental feature of the international GST model, exports are free from GST and exporters are eligible for refunds of GST paid on their inputs to those exports;

- Determining the type of entities (referred to as the “perimeter”) to which supplementary financial tax should apply. The perimeter could be as broad as including all entities that provide financial services in the course of their business or as narrow as financial institutions that come within the supervisory authority of government agencies;

- Applying GST to imported financial services. If the supply of financial services to households is made by entities that are established outside of Australia, whether there is a mechanism to address the threat to the revenue base;66

- Whether output GST should apply to those (explicit) fees that are able to be subject to the normal GST regime. A further issue is whether the existing treatment of taxation of the “margin” for insurance and gambling continues or is subsumed into an overall profits calculation; and

- Determine the proper treatment of input tax incurred by financial institutions – that is, whether full input tax relief is to be granted against the GST paid using the addition method and (if appropriate) explicit fees.

Each of these aspects are examined hereunder to ascertain what adjustments might need to be made to the aggregate “profit + wages” of a financial institution.

### 3.4.2.3. The allowance for exported financial services and B2B financial services

A tax on household consumption of financial services should tax only domestic household consumption.

- To ensure that the tax fulfils the destination principle of value added taxes and an international competitive basis for Australian financial services, an apportionment of the “profit and wages” must be made to exclude the proportion of services provided for offshore use.

- To ensure that the GST is only paid on household consumption of financial services an apportionment of the “profit and wages” must be made to exclude the proportion of services provided to other registered entities – this is the B2B portion.

#### Apportionment of profit and wages

66 This is the issue that is proposed to be addressed by the so-called Netflix tax”.
The calculation of the taxable proportion of financial services would require an apportionment of profit and wages between taxable household consumption and other non-taxable supplies of services (B2B and exports).\(^{67}\) AFTS suggested that this could be done by reference to accounting data:

… financial institutions need to determine the profits and costs of each area of activity and determine the proportion of untaxed (business and foreign) customers within this area.\(^{68}\)

**A lower GST rate for financial services**

Keen, Krelove and Norregaard’s solution to the apportionment problem is to impose the supplementary financial tax on the total profits and wages at a rate below the existing standard rate.

The Singapore FITR is applied inputs to financial services “across the board” to avoid complicated apportionment calculations on an institution-by-institution basis for inputs to B2B, B2C and exports.\(^{69}\) Malaysia has adopted a similar approach to apportionment input tax credits for different classes of banks.

In both Singapore and Malaysia, the proportion of “non-taxable” value for full banks (i.e., wholesale and retail banking) is between 70% and 75%. Taking the lower of these, the rate to calculate GST on household consumption in Australia’s GST would be 3%. Arguably, like Australia’s RITC rate, the FITR in Singapore and Malaysia are overly generous.

Because a reduced rate supplementary tax is applied to revenue and not inputs, for the integrity of the tax base it should be set at a level that is not a generous interpretation of the data.

**A unilateral credit**

Keen, Krelove and Norregaard suggest an alternative to the over taxation of B2B is to allow business customers a “one sided” credit to offset the GST liability inherent in its acquisition of financial services. The Australian GST has a similar “average” credit rate in its insurance provisions for monopoly insurers.\(^{70}\) The law allows for the calculation of an “average input tax credit fraction” to which the operator of a compulsory third party scheme is entitled for payments made under policies that they issue.

The rate approximates the business use of vehicles and is arrived at on the three year rolling basis from ABS data on business kilometres travelled in each State. The credit is allowed irrespective of the actual business use of any particular vehicle.

### 3.4.2.4. The treatment of non-margin-based financial services that can be taxed under the normal GST method

The adoption of an aggregate profit and wages calculation of total value added for financial services is inconsistent with the existing system under which other supplies and some financial services may be subject to GST.

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67 AFTS suggested that this proportion could be calculated as total revenue less revenue from exports and business supplies divided by total revenue. The Singapore FITR involves a similar calculation based on the value of business and export loans.

68 AFTS 2009, page 310.

69 Refer to 2.2.3 above.

70 Division 79 of the GST Act.
If an adjustment is not made to the “profits and wages”, the value of the non-margin-based services would be taxed twice. Under the Australian system, this is problematic for agency fees, general insurance and gambling – all of which are subject to standard rate GST.

There are two solutions that could be considered:

- The taxable activities would continue their existing GST treatment – reserving profit and wages relating to supplies of input taxed services for the supplementary addition method tax.
- The supplies that are taxable under the existing scheme could be also included in the addition method tax base resulting in over taxation of these activities.
- A third approach is to treat the supplies as GST-free under the normal law and tax them solely under the addition method.

In considering this issue, it is important that this significant change to the base is executed with the least possible disruption to the ongoing GST system. It is simpler and more consistent with both administrative and compliance practices to “tax what you can” under the normal system.

The supplementary financial tax for margin-based products can, in this way, be quarantined and the existing understanding and practices maintained.

3.4.2.5. The allowance of input tax relief for acquisitions made in making financial supplies

As has been noted, Israel’s addition method is a supplementary impost from the normal GST system under which financial services are input taxed. This is necessary to collect full tax on the total value added of household consumption – GST at the standard rate is collected on inputs under the GST and addition method supplementary tax is collected on the profit (having been reduced by expenses) and wages.

Arguably, the absence of a credit for acquisitions under the normal GST would be offset by the deduction allowed in calculation of profit and wages.

An alternative, which was favoured in AFTS is to allow full input tax relief for acquisitions relating to financial and non-financial supplies under the normal GST system but, to the extent that input tax relief has been granted, to treat them (like wages) as an addition to profit and wages in the addition method.

If an addition method is to be used, it ought to apply:

- Only to margin based products, allowing the existing system to continue for explicit fees, insurance and gambling; and
- Full input tax relief ought to be allowed against normal GST and “addition based GST”.

Both of these conclusions are based on doing as little damage to the existing GST system, “taxing what you can” under the existing system and using the supplementary addition method only for those difficult to tax areas.

But of significance to this conclusion is the consequence that purchases for which input tax credits are allowed would need to be added to profits and wages to ensure that full tax is collected on the total value added through the production and distribution chain.
Once this is accepted, the question arises as to whether, instead of an “addition method”, a “margin based” calculation might be preferable – after all, this is the outcome of the cash account and reverse charge methods.

The margin based method is discussed later in the paper.

3.4.2.6. **The scope of entities to which addition method supplementary financial tax should apply**

Under the existing GST system, input taxation of financial services is not restricted to financial institutions – input taxation applies to the supplies of all entities provided that a minimum amount of input tax is incurred in relation to input taxed supplies.

If the addition method supplementary financial tax is to be adopted it should be limited to entities with substantial financial activities – perhaps those under the supervisory and regulatory control of government agencies such as the Australian Prudential Regulation Authority (APRA) and Reserve Bank.

This might be achieved under the present legislative structure by treating “financial supplies” as non-taxable supplies – having the result that input tax relief would be available for relevant inputs to other activities. This is the effect of many jurisdictions through the so-called de minimis exception to input tax denial.

3.4.2.7. **The application of GST to imported financial services**

Once it is established that only financial institutions of a particular significance are to come within the supplementary financial tax system, attention must be given to the provision of services to households by businesses that are not established in Australia and, consequently, are not within the normal powers of enforcement.

There is a proposed amendment to the existing GST law to provide for its extra-territorial application for imported services. While obtaining voluntary compliance of offshore financial institutions to pay supplementary financial tax on financial services delivered into Australia may be difficult, one aspect that would be possible to cover off the most blatant “offshoring” of financial assistance would be to adopt the South African definition of financial services – that is, include explicit fees. In this way, the proposed amendment “Netflix tax” to the GST law would cover the household consumption of, for example, brokerage.

The business consumption of explicit fee based financial services will be caught under the reverse charge mechanism if the customer is a registered person.

3.4.2.8. **Partitioning of accounting data**

Much of the above commentary suggests division of financial institutions’ financial accounts into segments that are liable to supplementary financial tax and those that are subject to the normal GST system.

In the Mirrlees review, the authors comment

> The partitioning of profit implied by these features—separating out financial activities, and perhaps financial transactions with business customers, from other profits—clearly moves it a step away from the familiar calculation of profits that these firms will be doing anyway. But the partitioning and the calculations are not difficult or sensitive—tending, as with all of these equivalent treatments, to alleviate rather than exacerbate awkward boundaries in the current system.
Similarly, Kerrigan 2013 opined:

Notwithstanding some difficulties, it is possible to identify the value added of a financial institution from its statutory accounts, taking into account the rules under which they have been prepared and subject to a number of caveats on how the information is presented. It is similarly possible to identify the overall margin achieved by institutions from financial intermediation. Some detailed adjustments are needed but they depend on routinely available accounting data. The difficulty of applying the outcome to individual transactions will, however, still remain.

3.5. A margin-based gross profit supplementary financial tax

The above discussion illustrates that (absent the allowance of a rate of return on capital) all methods are consistent in the view that the “price” of margin-based financial intermediation is, in principle, the amount that the financial institution gets to keep for itself from its activities of financial intermediation.

This approach is consistent with:

• the existing treatment of general insurance and gambling;
• the allowance of full input tax relief against taxable GST explicit fees and margin-based taxation of margin-based products;

both of which, it will be proposed, are part of the regime for full taxation of household consumption of financial services.

Consequently, rather than a number of adjustments to “profit” under the addition method, a simpler approach is to calculate a “gross profit” as the base for the value added by financial institutions on margin-based products – in principle, the amount that the institution keeps for itself out of the underlying intermediation function.

In the case of deposit taking and lending, it is the difference between the interest paid and interest earned over a period.

For foreign exchange transactions and derivative trading, it would be the difference between sales and purchases over a period. Fees charged in connection with margin-based products that are input taxed under the current GST regime and would be included in the margin-based gross profit tax base.

But we will be in search of similar solutions to the difficulties discussed in 3.4.2.3, 3.4.2.6 and 3.4.2.7.

3.6. The option for reform – the margin-based supplementary financial tax

The above discussion leads to the conclusion that an extension of Australia’s GST base to include household consumption of financial services could be constructed by:

• Retaining the existing margin-based approaches to gambling and insurance;
• Imposing a “margin-based supplementary financial tax” on margin-based financial services including fees charged for margin-based products;
• The GST payable under margin-based method be adjusted by either:
  – Reducing the aggregate margin for a period to take account of the proportion of business done with other registered taxpayers or as exports; or
- Applying a reduced rate to the aggregate margin for a period to reflect the proportion of margin on B2B and exported supplies.

- A GST equivalent charged using a margin base is accompanied by full relief under the normal GST system for input tax on purchases of goods and services. Under the present legislative structure, this might be achieved by either:
  - Removing “financial supplies” from the definition of “input taxed supplies”; or
  - Treating “financial supplies” as non-supplies.

There would be no need for the RITC regime under this approach.

The next section of this paper examines this option and the other aspects of its adoption.
4. A margin-based supplementary financial tax for margin-based financial services

The discussion in the previous section concluded that a supplementary financial tax to tax household consumption of financial services could be achieved through adoption of a margin-based calculation of value added by financial institutions. The suggested reform seeks to impose a supplementary financial tax to include the value of household consumption of financial services that presently escapes GST under the input taxation treatment.

The recommended base is consistent with the principles underlying the EU cash flow, Zee’s reverse charge and the IMF’s addition method of calculation of the value of financial services.

This section of the paper restates the general model under which the reform of the GST treatment of financial services might be achieved and considers the following aspects of its adoption:

• The incidence effects of the suggested approach and its impact on costs
• The administrative feasibility and minimisation of compliance costs
• The taxation of household consumption of financial services relative to other goods and services which are subject to GST
• The impact of the approach on the overall efficiency of Australia's taxation system
• How the approach might address the revenue needs of States in the face of growing demands for health services
• The equity of the taxation of household consumption of financial services
• The potential revenue yield of the approach.

4.1. The suggested approach

Following consideration of the literature and reviews over recent years, we have concluded that the existing GST treatment of financial services can be adapted in a manner consistent with the principles contained in the IMF and Henry Report\(^{71}\) to extend the scope of the indirect tax base to include the full value of household consumption of financial services. The TES 2014 estimates the tax expenditure resulting form the present input tax treatment at $4,690 million for the current financial year.

Our suggested approach is to:

• Retaining the existing margin-based approaches to gambling and insurance;
• Imposing a “margin-based supplementary financial tax” on margin-based financial services including fees charged for margin-based products;
• The GST payable under margin-based method be adjusted by either:

\(^{71}\) AFTS 2009 section D4.
Reducing the aggregate margin for a period to take account of the proportion of business done with other registered taxpayers or as exports; or

Applying a reduced rate to the aggregate margin for a period to reflect the proportion of margin on B2B and exported supplies.

• A GST equivalent charged using a margin base is accompanied by full relief under the normal GST system for input tax on purchases of goods and services. Under the present legislative structure, this might be achieved by either:

  - Removing “financial supplies” from the definition of “input taxed supplies”; or
  - Treating “financial supplies” as non-supplies.

There would be no need for the RITC regime under this approach.

4.2. The incidence effects of the suggested approach and its impact on costs

In general, and even in a fully taxable and creditable production and distribution process, the burden of GST is not necessarily borne by households.

The real loss of income … that is the counterpart to the revenue raised by government, may also be felt by owners, employees, and/or financiers of the firms whose output is being taxed. The effective incidence of [GST] … is determined not be the formal nature of the tax but by market circumstances, including the elasticity of demand for consumption and the nature of competition between suppliers.72

Cash flow, TCA and reverse charge methods of collecting GST on household consumption of financial services would have the cost of GST on the margin of the institution borne by the borrower because, under these models, the GST is “added” on a transaction by transaction basis.73

But, the nature of the proposed system to achieve equivalent revenues from financial services as consumption of other goods and services requires that GST be applied to the margin, calculated over time, of margin-based products.

At its simplest, the proposal will operate as a tax on the net interest margin. For the four major banks, the net interest margin for the 2014/15 financial year was between 2% and 2.2%.74

The decision about an adjustment to the aggregate margin for B2B and exports is likely to affect the extent to which the supplementary financial tax cost for banks can be passed on:

• If there were a reduction in GST that was uniform across all banks75 – like the Singaporean FITR – the impact would be more costly for banks with a large foreign or business customer base than if each bank were able to arrive at its own adjustment.

72 Ebrill 2001 at page 15.
73 Zee 2005.
74 Pash, C., Australian bank profits on loans are being crushed, Business Insider, May 2015.
75 Either as a reduced rate or a common fraction subject to the 10% rate.
If each bank were to make its own adjustment to arrive at the “margin” that were to be subject to the standard rate, there would be likely to be variations between business units of each bank as well as between banks with different customer bases.

Given the competition between the banks in the fight for new customers in the low interest rate environment, an additional tax charge on the margin will put more pressure on margins. Essentially, while banks will make savings though additional input tax relief, if the additional tax cost is imposed on interest rate margins, it is the margins that may bear the cost.

Depending on the overall profitability of the sector, the closer the tax is to falling on rents, the less is the incentive for it to be passed on to customers rather than borne by owners and managers.

And, in general, the closer the regime to a direct tax (or one on profits) the more likely the immediate incidence will fall of the financial institution. But, as with any tax, the actual costs are likely to be shared between employees, shareholders and customers.

The GST costs arising from abolition of the RITC regime and full taxation of explicit fees should, in theory, be passed on to households including superannuation plans and other funds. For the latter categories, the additional GST cost of explicit fees will be part of the ultimate income distribution of the funds and may increase the existing pressure on the fees charged by wealth managers.

Again, the ACCC should have a role in ensuring that any increase in costs is justified and ensure that savings are passed on and margins are not expanded.

4.3. The administrative feasibility and minimisation of compliance costs

The proposed method of calculating the value of margin-based transactions to which the supplementary finance tax is be applied, at first instance, should be readily ascertainable from accounting data – even for the myriad of different margin based products under examination.

The task of apportioning between taxable and non-taxable parts (i.e., B2B and exports) ought be no more difficult that the existing apportionment models adopted for input tax credits.

In fact, many of these products are output based and the New Zealand IRD have had to confront similar issues in determining the proportion of inputs relating to B2B and exports. New Zealand institutions are, invariably, subsidiaries of Australian ADI’s, so there ought to be experience in this too.

If an industry average were to be adopted – and a lower rate selected – the Singapore method is to engage the assistance of the Monetary Authority of Singapore to set rates for each year. The data and experience in its analysis would, no doubt, be within the resources of the RBA and APRA in Australia.

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77 IMF Report page 22.
4.4. The taxation of household consumption of financial services relative to other goods and services which are subject to GST

In undertaking this task, we have been conscious to ensure that the proposed tax base for GST to be applied to financial services is equivalent to the consumption taxation of other services. This is the principle set out in the Henry Review - AFTS 2009.

While the adjustments for B2B and exports may be regarded as a little arbitrary, the existing system of taxation of financial services and property (in particular) can be similarly criticised.

In any event, the flow on effects of the supplementary financial tax to business is unlikely to impact relative prices significantly.

4.5. The impact of the approach on the overall efficiency of Australia's taxation system

The proposed approach seeks to eliminate the under taxation of household consumption of financial services and achieve a greater degree of neutrality to the operation of the GST system.

By including financial services within the indirect tax base – and avoiding input taxation costs – firms and households should be indifferent between how they finance acquisitions of financial services.

The existing RITC regime gives rise to distortions in how advice and assistance is provided in the financial sector. As a major cost to the sector, managing the input tax cost is complex, costly and inefficient.

4.6. How the approach might address the revenue needs of States in the face of growing demands for health services

The 2015 TES estimates that the input taxation of financial services is a cost to revenue of $4,690 million. Budget Paper Number 3 indicates that South Australia’s share of the revenue from a supplementary financial tax in 2015/16 would be approximately 7.09%, i.e. $332.65 million.

4.7. The equity of the taxation of household consumption of financial services

In terms of horizontal equity, the imposition of GST on financial services should have the result that households are indifferent between how much is spent and on what form of financial services are acquired. Equally, households should be neutral between decisions to spend on financial services or other items of consumption that are part of the tax base.

From a vertical equity perspective, the NATSEM analysis78 shows that the increase in the GST proportion of household expenditure as a result of the inclusion of financial services is higher for income groups 3, 4, and 5.

While the GST on financial services as a percentage of disposal income is highest in income groups 1, 3 and 4, it is roughly equivalent between all income groups, with an average of 4%.

78 Phillips, B, The Distributional Impact of the GST – Australian and South Australian Households, NATSEM, University of Canberra, April 2015.
The inclusion of financial services has a close to proportional impact and is marginally less regressive than overall GST. This is subject to NATSEM methodology regarding the flow assignment of a financial sector tax. As discussed above, the flow on effects of the margin-based tax to household customers of financial services are likely to be shared with other stakeholders including shareholders.

4.8. **The potential revenue yield of the approach.**

Please see 4.6 above. It should not go unremarked that, to the extent that the State acquires financial services, it ought to be able to benefit from reductions in costs because of the abolition of input taxation.