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Office of the Chief Tax Counsel
Asteron Centre
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Attn: Jonathan Rodgers / Gloria Yee

Dear Jonathan and Gloria

GST - unit trust management fees

Further to the Financial Services Council's ("FSC") teleconference on 15 March 2017 with Office of the Chief Tax Counsel ("OCTC"), Service Delivery Group ("SDG") and Policy Advice Business Group ("PAS"), outlined below are FSC's responses and clarifications requested.

1. Financial Markets Conducts Act 2013

This section specifically addresses paragraph 12 of OCTC's letter of 14 March 2017.

We understand Inland Revenue's reading of the Financial Markets Conduct Act 2013 ("FMCA") is that a unit trust manager is unable to contract out of its obligations under the FMCA. It has reached this conclusion from its own reading of the FMCA.

The FSC agree that the FMCA does not allow unit trust managers to contract out of obligations imposed by the FMCA. However, this does not mean that the unit trust manager must contract for services on its own behalf. A unit trust manager can contract for the actual supplies for the unit trust as long as the unit trust manager does not contract out <u>of its responsibility</u> for the supplies made.

In short, the FSC considers that a unit trust manager can contract another party to actually deliver a service or supply but it cannot absolve itself of responsibility for the supply delivered.

The functions of a unit trust manager are prescribed in section 142 of the FMCA. Those functions include "administering the scheme". Section 142 does not, sensibly, prescribe the specific methods through which a unit trust manager is to administer a unit trust. The wording is clearly broad enough to encapsulate a range of situations regarding third party services. Entering into third party contracts for the unit trust manager would clearly be within the concept of administration.

Section 146 of the FMCA provides permissive scope to the unit trust manager to contract out aspects of the management of a unit trust (but not the responsibility), with appropriate oversight as expressed in section 146(2) (a). Nothing in section 146 could be construed as limiting the ability of a unit trust manager to enter into contracts with third parties for the unit trust in advancing its function of administering the unit trust.

The FSC's members have implemented the FMCA on this basis. They do not read the FMCA as limiting their ability to contract supplies directly for the unit trust. They consider they are able to sub-contract particular services or to contract direct.

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2. Third party investment management

This section of the letter specifically addresses paragraphs 10 and 11 of OCTC's letter of 14 March 2017.

The GST treatment of investment management services provided by a third party depends on whether the third party investment manager is "advising" on financial services or "arranging" financial services. We agree with OCTC's analysis that "advising" on financial services constitutes a taxable supply for GST purposes but the "arranging" of financial services constitutes an exempt supply.

FSC acknowledges that there will be investment management agreements which are advisory in nature.

The issue is where the boundary between "arranging" and "advising" lies. FSC considers that, where a third party investment manager implements the investment mandate given to it ("a portfolio investment manager"), this is an exempt supply.

OCTC have concluded that, based on its review of contractual documentation provided by FSC, such investment managers can only perform an advisory function. Custodians have the final say on implementation of the investment decisions made by the investment manager (i.e. OCTC's view is that custodians have the power of veto). This means portfolio investment managers cannot arrange a financial service.

Please note that further contracts have not been provided as the following analysis should apply to contracts that OCTC already has.

2.1. Degree of control required

We understand from our discussions that OCTC consider activities conducted by a portfolio investment manager is advising (taxable) where the unit trust manager or custodian can veto the investment decision per QWBAbb. The implied requirement is that no other person can have any control of the investment for the supply to be an "arranging" supply.

2.2. There is no power of veto

When the portfolio investment manager (i.e. the sub-investment manager) is provided with its investment mandate (which itself is within the investment mandate agreed by the unit trust and supervisor), it conducts all required activities to fulfil the mandate. It does so by providing a proper instruction to the custodian to give effect to its buy/sell decisions. The custodian will verify that the investment manager's instructions are proper (e.g. ensuring that the instruction to settle a particular trade is in the correct systems format, that there is sufficient funds in its bank account to action the settlement etc.). It will then carry out the instructions of the portfolio investment manager.

Whilst there are instances where the instruction will result in a failed transaction (e.g. because the formatting of the instruction did not meet system requirements or there are insufficient funds), this is not a power of veto. This is simply a failed transaction. In fact, the custodian must action the instruction if it is a proper instruction. It cannot and does not "veto" the portfolio investment manager's proper instructions.

In fact, the custodian's systems will alert either the portfolio investment manager or the unit trust manager if the investments it records means the portfolio investment manager is either outside the investment

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mandate or close to it. As the custodian implements an instruction for an action which is potentially outside the mandate, this shows it does not veto transactions.

It should also be noted that the custodians generally communicate directly with the investment manager in relation to investment instructions. That is, the investment manager does not instruct the unit trust manager to instruct the custodian. The custodian will also correspond directly with the investment manager in relation to failed transactions.

We consider therefore that the custodian's role (as well as other parties' involvement in the transaction, such as the trustee and supervisor) is not sufficient to conclude that the portfolio investment manager is advising rather than arranging the investment.

2.3. Alternative analysis

Despite the above conclusion, we have considered the position assuming that OCTC's conclusion on the contractual and factual matrix is correct.

2.4. Power of veto inconsistent with QWBAaa

In any event, the conclusion on portfolio investment management appears inconsistent with the conclusion in QWBAaa. If a unit trust investment is done by the unit trust manager (with no outsource), the unit trust's custodian will perform the same activity and have the same obligations as if the investment management is outsourced. A custodian would always have residual control over the unit trust's assets.

A custodian and the unit trust manager have negative powers of control (i.e. an audit role) for a portfolio investment manager outsource contract. The commercial reality is that the portfolio investment manager is the person with the positive power to control the investments. This means that the supply is an "arranging" supply in the same way that the unit trust manager's supplies are also exempt supplies.

If the OCTC's logic was applied to the unit trust manager's supplies, a unit trust manager can also only "advise". This is contrary to the QWBAaa conclusion. A custodian's control extends only to actioning the buy/sell instruction from the investment manager which the custodian must adhere to provided it is a proper instruction.

Similarly, sharebrokers generally provide the buy/sell instructions but in many cases the shares will be held by a custodian. The custodian will perform the actual execution. Based on the QWBAbb conclusion, sharebrokers may thus be "advising" only. This is contrary to the conclusions of Interpretation Statement IS0052 on Financial Planning Fees.

Given the accepted position in these other situations, FSC considers that too much weight has been given to the residual control held by a custodian and unit trust manager as the power is a negative one of monitoring. That residual control applies to other situations which have been considered to be "arranging" supplies.

The FSC considers that the distinction is between a positive versus negative power to control investments.

2.5. Analysis of contracts - commercial context required

We understand that IR's view is entirely based upon interpretation of the contracts provided. The commercial reality of what occurs in practice has not been considered.

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As noted by FSC during the teleconference, we disagree that the contractual documentation should be the sole determining factor. (We further note the contracts may not go as far as asserted.) This approach belies "commercial common sense" and simply does not reflect industry practice.

OCTC has expressed a willingness to consider commercial reality in addition to strict contractual interpretation (i.e. accept that contractual interpretation is not the sole determining factor) provided that FSC can provide relevant legal precedent for such an approach.

Consideration of commercial reality when reviewing contracts is well established in case law.

New Zealand Shipping Co Ltd v AM Satterthwaite & Co Ltd [1974] 1 NZLR 505 is a leading Privy Council case on contract law. In this case, Lord Wilberforce set the precedent for the well-established principle that commercial law should take a practical approach according with commercial reality (see specifically page 510). It was Thomas J's view in *Wattie and Anor v Commissioner of Inland Revenue* (1997) 18 NZTC 13,297 that he "did not apprehend that commercial reality has any lesser place in tax law…".

These approaches are not remarkable in the New Zealand context.

Arnold v Britton & Ors [2015] UKSC 36 is a recent judgement from the United Kingdom Supreme Court which simply outlines the principles of contract interpretation and reinforces the above principle.

Lord Neuberger, in delivering the judgement, held that in assessing the meaning of relevant words, that meaning has to be assessed (amongst various other factors) in light of:

(i) *the natural and ordinary meaning of the clause;*

(ii) *any other relevant provisions of the lease;*

(iii) *the overall purpose of the clause and the lease;*

(iv) *the facts and circumstances known or assumed by the parties at the time that the document was executed; and*

(v) *commercial common sense; but*

(vi) *disregarding subjective evidence of any party's intentions*

[emphasis added]

It is clear that a strict literal interpretation of the contracts incorrectly ignores the facts known by the portfolio investment management and unit trust manager. The portfolio investment manager in practice makes investment decisions which are implemented (i.e. a positive power). The parties expect and act on the basis that this is the portfolio investment manager's role.

In this context, the residual power of the manager and the requirements of the custodian are better considered as "audit" roles. They ensure that the activities of the portfolio investment manager are in accordance with the contract (i.e. the negative power) and the unit trust manager retains ultimate responsibility of the output to the investor despite not undertaking the actual investment selection itself. The portfolio investment manager arranges the investment.

We consider that OCTC has placed undue weight on its strict contractual interpretation. The FSC considers that OCTC should also consider the following:

— The facts and circumstances known or assumed by the parties at the time of signing the documents (i.e. that the portfolio investment manager would be responsible for the investment decisions); and

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- The accepted industry practice (which reflects the portfolio investment manager being responsible for its investment decisions).

2.6. Alternative methods of investment contracting

An investment manager can be contracted either for direct investment of a portfolio or indirectly through investing in a fund managed by that investment manager. In the latter case, if the investment manager is the unit trust manager, the supplies made will be exempt supplies. This will be a different outcome from a direct contract per OCTC's draft QWBAbb conclusion.

Although we acknowledge that contracting investment management through investing in a fund has different legal and cost effects, that the form of the contract should have different GST effects means that the GST is not an efficient tax.

An interpretation that provides an efficient answer should be preferred.

2.7. Summary

The FSC considers that a third party portfolio investment manager makes exempt supplies if they have the positive power of making the investment decisions. Briefly:

- The commercial context is consistent with the portfolio investment manager arranging the financial supplies made;
- The custodian and unit trust roles mandated by the FMCA amount to a negative power to control the investments and there is no power of veto (custodians must process proper instructions);
- In any event, consistent with other positions taken by Inland Revenue, a positive power to control is the appropriate test of the boundary between advisory and arranging supplies;
- Alternative forms of achieving third party portfolio investment management would have different results under the QWBAbb approach. A consistent approach should be preferred.

3. Outsourcing

This section addresses paragraphs 1 and 2 of OCTC's letter dated 14 March 2017.

Unit trust managers often outsource elements of unit trust management to third parties. These outsourced services may include fund administration such as fund accounting, registry services and unit pricing.

The term "outsourcing" is used generically. It covers both sub-contracts (where the unit trust manager acquires supplies from a third party) and direct contracting (where the unit trust acquires supplies from a third party provider).

A practice has developed of on charging the GST to unit trusts for the GST charged for such services. The FSC asked whether Inland Revenue considered that this could continue by in effect unbundling these services from other activities of the unit trust manager.

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Please note that further contracts have not been provided. The analysis that follows is on an "in principle" basis. In the FSC's view, the analysis will apply as outlined for a specific contract based on its appropriate characterisation. OCTC should therefore proceed on the assumption that any particular contract is capable of one of the two characterisations. It does not need to conclude for the purposes of the QWBAbb which specific characterisation applies.

3.1. Inland Revenue's view

We understand OCTC's view is that this is not possible.

This is because OCTC considers that the FMCA requires those activities to be undertaken by the unit trust manager exclusively. (We understand a service provider to a managed investment scheme is regulated. This explains the FMCA requirement. We assume that this legal requirement is unlikely to be changed but note the FSC's view of what is required by the FMCA is described at 1 above and further considered below.)

As a result, OCTC's view is that the relationship between the unit trust manager and the outsource provider is best analysed as a sub-contract where the third party provides services to the unit trust manager (per section 3.5). Therefore, based on this view, the supply is a taxable supply by the third party to the unit trust manager, giving rise to unrecoverable GST for the unit trust manager (which makes exempt supplies of financial services to the unit trust).

3.2. Historical approach

A unit trust is not a legal person. It is the manager and the trustee, in their capacity as such, who contract for the unit trust. (From a GST perspective, a unit trust is a person.)

Historically, there was no limitation on the ability of a unit trust to contract for services.

The outsource contracts were viewed as contracts entered into by the unit trust manager as manager of the unit trust i.e. as for the unit trust. They were not contracts entered into by the manager in its own capacity.

(This separate capacity approach can be more simply seen by contrasting the position of the unit trust manager's employees. In that case, the unit trust employs them as its employees and not, in its capacity as manager, for the unit trust.)

Under this view of the contracts, the supplies are made directly to the unit trust. The on charge of the GST to the unit trust reflects this position – it follows the recipient of the supplies.

This position may not have been immediately obvious as a unit trust manager generally contracts for all unit trusts that it manages. The outsource charge is then allocated to each unit trust in accordance with the trust deeds. However, this should not change the position as to who has received the supply.

3.3. Implication of the Inland Revenue conclusion

If the FMCA requires the manager to carry out the activities, a unit trust manager is unable to contract for those activities in its capacity as manager of the unit trust (i.e. for the unit trust). In this case, the contract is a sub-contract of those activities by the manager for the manager's business.

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As the supply is to the manager and not the fund, the ability of the manager to charge the GST charged to the unit trust is uncertain.

The manager, instead of the unit trust, may bear the GST cost of the outsource arrangement.

Although this is potentially not an issue for Inland Revenue, it is likely that the effect of this change due to the FMCA will be raised with Inland Revenue as unit trust managers react to the change.

3.4. Possible solutions – sub or direct contract options available

As discussed and detailed in section 1 of this letter, either a sub-contract or direct contract arrangement is available under the FMCA. The unit trust manager cannot contract out of its responsibility under the FMCA. However, the unit trust manager's administration of the scheme is not prescribed.

Therefore, neither a subcontract nor a direct contract arrangement is precluded. The FSC notes that in practice that both types of contracts are possible. Contracts may be viewed as one or the other. It acknowledges that the specific contracts may not clearly be able to be characterised as of one or other type.

We consider the potential solutions for both types of arrangements on the basis that, in principle, a contract may be of either type.

3.5. Sub-contract relationship

Outsourcing can occur as a sub-contract of the particular services between the unit trust and the outsource provider. The supply is therefore a taxable supply to the unit trust manager. The unit trust manager therefore supplies the outsourced supplies as part of its supply. The unit trust manager's supply to the unit trust remains an exempt supply.

(This characterisation is consistent with Inland Revenue's view that a unit trust manager cannot contract out of its FMCA obligations.)

3.5.1. Operation of the unit trust manager contract

The contracts with the unit trust will typically be on a "fees, plus GST, if any" basis. This may extend to charging GST in accordance with the industry agreement.

As the manager's services are exempt, no GST will be chargeable on the fee.

It is possible that a contract may set the fee by reference to irrecoverable GST of the unit trust manager. This would allow the irrecoverable GST to be quantified and added to the fee as additional consideration for the unit trust manager's (exempt) supply.

This approach is however more likely to require renegotiation of contracts as most contracts will not have an appropriate term for this to occur automatically. This will take time and effort.

3.5.2. Operation of law

Statutory ability to vary fees

Section 78 allows GST to be charged, despite a contract's terms, or provides transitional relief for certain GST law changes. This does not appear to apply. The change in the GST effect appears to be a change due to the application of the FMCA.

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From our brief review of the FMCA, there does not appear to be any explicit ability to vary contractual terms as a result of the effect of the FMCA.

We assume that no consideration was given to the GST effect of the FMCA.

The FSC would be interested in exploring with Inland Revenue whether the effect of a non-GST law change should be dealt with in the same way as a GST law change.

Reduced Input Tax Credit

The in source bias effect of GST is well known. In Australia, for financial services, this is dealt with through the Reduced Input Tax Credit (RITC). This allows a fixed percentage of GST charged to be recovered by a financial services provider. In Australia, this is not readily accessed by unit trusts as each trust must register to recover the GST.

Given the QWBAaa conclusion, New Zealand unit trusts would not be in the same position. It is the unit trust manager that would be entitled to a RITC deduction. This has a much more limited compliance and administration cost.

The FSC would be interested in exploring with Inland Revenue the potential for a RITC to be available for unit trust managers.

3.5.3. “Unbundling” of services - not necessary or incidental

The conclusion of QWBAaa is that the unit trust manager’s services are all exempt supplies. The potentially taxable supplies cannot be unbundled. QWBAaa states that activities (such as maintenance of a registry) which are reasonably incidental and necessary to the supply of financial services, are supplies which are reasonably incidental to the provision of the exempt supply. They are therefore also exempt financial services.

If these services were not necessary or incidental, a mixed exempt/taxable supply approach is possible.

If OCTC was to accept a mixed supply result, the unit trust manager would need to apportion the supplies between the exempt unit trust activity and the outsourced administration activity. Further, insourced administration activity would also need to be allocated an amount on which GST could be charged.

Aside from the compliance issues, the taxable percentage would vary from unit trust manager to manager. This may raise the prospect of competition on the GST effects of fees. To some extent, the on charge approach may be seen as having a GST competition element. However, an agreed position of principle would mean the GST effects would follow existing structures and costs.

3.6. Direct contract

In contrast to a sub-contract arrangement, there can be direct contracts between the unit trust and the outsource third party. In this case, the unit trust manager contracts for the unit trust. It does so in its capacity as manager of the unit trust. This form of contracting is required as the unit trust is not itself a legal entity.

(This may make it difficult to distinguish from a sub-contract. A sub-contract is also in a sense entered into “in the capacity of unit trust manager”. It is entered in that “capacity” to allow the unit trust manager’s duties to be discharged. However, a sub-contract is not entered into for the unit trust.)

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3.6.1. FMCA compliance

We note our discussion in section 1 and expand upon it.

The FSC agrees that a unit trust manager cannot contract out of obligations and responsibilities imposed by the FMCA. However, a unit trust manager does not breach the FMCA by contracting for the unit trust in this way.

The FSC view is that a unit trust manager cannot contract out of its responsibilities. However, that does not prevent it from having another party make the actual supplies to the unit trust.

The key distinction is activities can be delegated to outsource providers but the unit trust manager must retain oversight. Delegation is expressly allowed in trust deeds and is not precluded by the FMCA because there is no discharge of responsibility. In other words, having responsibility does not equate to or require the actual performance of the services.

FSC members operate on this basis. Further, there was no signal that the FMCA required a change to the historical approach. A change to contractual requirements to implement the FMCA was not identified as required. FSC members have continued to contract in this way.

3.6.2. GST effects of direct contracts

If the contract is a direct contract, GST is validly charged to the unit trust for those services.

However, unless the outsource provider and the unit trust manager agree (under the agency rules), the input and output tax would not be included in the unit trust manager's GST return. It would not have acquired the supplies or made them.

Further, these supplies would not be included in a unit trust manager's GST apportionment ratio.

3.7. Summary

3.7.1. Sub-contract

Inland Revenue's conclusion that a unit trust manager is unable to contract out of its obligations under the FMCA means that the unit trust manager is unable to take the position that outsource costs are supplies to the unit trust. The FSC acknowledges that unit trust managers may sub-contract but it is does not accept that a unit trust manager must sub-contract.

In any case, sub-contracted supplies are to the manager. Existing contractual arrangements are unlikely to allow the manager to add the irrecoverable GST to its fee (either as GST or as irrecoverable GST).

The unit trust manager will have to renegotiate its contract to deal with this change in position.

We have outlined a number of possible approaches which may assist the process of contract renegotiation. If none of those options are accepted by Inland Revenue, the FSC requests that additional time to implement Inland Revenue's view is given to allow contractual renegotiations to take place.

3.7.2. Direct contract

FSC consider that outsourcing does not mean that the unit trust manager is breaching its FMCA obligations. It is simply delegating the performance of certain activities but it retains responsibility and oversight. Responsibility and oversight is what the FMCA requires the unit trust manager to perform, not the actual delivery.

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A direct contract with the unit trust is therefore possible.

However, this characterisation may change existing GST processes. This may take some time to be given effect. The FSC asks that an appropriate period be provided to allow GST compliance with these effects.

4. Treatment of "out of fund" fees

This section specifically addresses paragraph 14 of OCTC's letter dated 14 March 2017.

We understand that OCTC agree with the FSC's conclusion that "out of fund" fees charged by the unit trust manager of an underlying fund to the unit trust manager of the investing fund is exempt from GST.

In addition, OCTC agree with the FSC that cash rebates would not be considered taxable supplies. It agrees with OCTC's conclusion that such rebates alter the consideration paid by the relevant parties (rather than constituting taxable supplies).

Prior to confirming, FSC members can walk through any example with OCTC.

5. General

Please contact Richard Klipin on +64 9 985 5762 or John Cantin +64 4 816 4518 on if you have any questions.

Yours sincerely

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