
The Association of Banks in Malaysia

Memorandum on:

The Proposed Framework of Goods and Services Tax for the
Commercial Banking Industry

20 May 2005

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1. Executive Summary

1.1. Objective

The proposed introduction of Goods and Services Tax ("GST") in 2007 to replace the existing sales tax and service tax systems has potentially far-reaching implications for the nation.

This memorandum discusses the basis for the preferred Malaysian GST framework for commercial banks in Malaysia, as represented by The Association of Banks in Malaysia ("ABM")

1.2. Evaluation of an appropriate GST framework for commercial banking industry

The generally accepted notion is that imposing GST or Value Added Tax ("VAT") on financial services is problematic, as the added value in most financial transactions cannot be satisfactorily determined within the framework of a simple, invoice-based GST/VAT system.

As a result, most GST/VAT regimes adopt a mixed approach of exemptions and taxing certain fee-based income. Although there were theoretical and political grounds to exempt financial services, it is also widely acknowledged that exemptions give rise to a whole host of other issues.

Tax jurisdictions across the world are re-examining the GST treatment of financial services. The New Zealand GST model, once held as a prime example of how a GST system should work, has seen it fit to introduce zero rating in 2005. Also, there is evidence of growing concern in the European Union over the use of the exemption model in taxing financial services, we quote from the foreword to the case study in 1998 by Ernst & Young for the European Commission, entitled "Value Added Tax - A study of methods of taxing financial and insurance services":

"Such exemptions (without the right to deduction) are alien to the fundamental principles of a VAT system because they interfere with the neutrality of the tax and the cascading effect distorts competition."

In fact, the current thinking in the international arena presents a shift from the traditional exemption model. In the International Fiscal Association Congress Paper, "Consumption taxation and financial services" in 2003, Han A. Kogels, in the role of General Reporter, summarised the reports from 29 countries on the subject, and closed with the following comments:

"Whereas in the financial sector there seems to be support for exempting most financial services, both in the sector and wider business community the cumulative effects of the non-recovery of input VAT are generally felt as a distortion of the neutrality of the VAT system. Therefore, new approaches and suggestions like zero-rating and the cash flow method VAT deserve further study."

In light of the call to re-examine the use of the exemption model for financial services and to consider zero rating for the financial services sector, there is an opportunity for Malaysia to avoid the pitfalls of exemption and be in the forefront by embracing the zero rating approach at the outset.

To elaborate, the exemption model should not be adopted for the following reasons:

- Non-recoverability of input tax results in higher cost of providing financial services

The non-recoverability of input tax for exempt financial services inevitably increases the cost of doing business to the banks. The estimated unrecoverable input tax for commercial banks would be significant due to a major portion of the banks' services being exempt.

The exemption model casts the burden of GST on the banks as if they were end-consumers, because a substantial portion of input tax would not be recoverable. This is contrary to the basic principle and philosophy of GST being a consumption tax that should be borne by end-consumers.

In the context of Malaysia, the current Government policy for the Malaysian banking sector under the Financial Sector Masterplan ("FSMP"), makes it more imperative not to impose the burden of an exemption model on banks. The FSMP has the objective of strengthening the banking sector to face growing liberalization. This is to be achieved primarily by

increasing the efficiency of banks via reducing the cost of doing business to banks. With the chief attributes of a GST exemption model being significant unrecoverable input tax to banks (and high cost of administering 'mixed' supplies – see below), the objective of the FSMP may not be achieved if an exemption model is implemented for banks.

- High cost of administering 'mixed' supplies, both to banks and the tax authority

The existence of 'mixed' supplies of financial services (exempt or taxable) would result in increased administrative compliance cost to banks as well as the tax authority in ensuring only taxable supplies are charged to GST, input tax is directly attributed to taxable supplies, complex rules on adjustments on recoverable input tax and apportionment of common input tax between taxable and exempt supplies. ***Keeping the tax and relief schemes simple would enhance compliance and effectiveness of the tax for the Government and taxpayers alike.***

- Difficulty of defining scope of financial services

The dynamic nature of the financial services sector coupled with the common problem of ambiguities in identifying and specifying exempt financial services are acknowledged as causes of disputes between taxpayers and the tax authority. With each dispute more rules emerge and increases further the cost of compliance.

- Disincentive to outsourcing

The FSMP encourages banks to outsource their non-core functions in order to be efficient and competitive. With GST, the outsourcing company would likely be imposing GST on the outsourcing fee to banks, thereby increasing the input tax cost to the banks. The distortion caused by exemption and unrecoverable input tax would be a clear push factor for the financial services sector to 'insource' ('self-supply') services rather than outsource, to avoid incurring input tax.

- Cascading of tax – increase in pressure on prices

Apart from the potential increase in the pricing of exempt financial services, the non-recoverability of input tax could lead to a cascading of GST when the financial services flow into the supply chain of taxable goods and services.

- Insufficient lead time in preparing for the exemption model

The banks require time to prepare their systems to deal with GST. The task of gearing up systems to be GST compliant, consultation and agreement with the authorities on taxable and exempt services as well analysis of the actual legal requirements when the legislation is announced will take considerable time. With the intended start date on 1 January 2007, there is insufficient lead time for the banks to start and implement the business and systems changes, especially since the draft law is still currently not made public.

1.3. **Recommendations for Malaysian GST framework for commercial banks**

As a result of the above adverse consequences of exemption, ABM proposes the following framework for the commercial banking industry:

Zero rating of financial services provided by commercial banks

The only satisfactory method to prevent the higher cost of financial services and tax cascades, is, by *zero rating* financial services provided by commercial banks.

This is particularly crucial for a developing economy such as Malaysia's, where the adverse impact of the exemption model would likely bring about a situation of higher cost of financial services and over taxation of businesses, which would exert further pressure on the price of goods and services along the supply chain.

In the current climate where prices of goods and services are already under pressure, zero rating would be a measure that can assist the Government to relieve the pressure caused by tax cascading under an exemption model. The Government may wish to heed the observation by the New Zealand Government in its "GST & financial services – a government discussion document" (October 2002):

"Tax cascades arise when a supplier of a financial service cannot recover the GST paid on goods and services purchased. The non-creditable GST will then form part of the cost of production. To compensate, the financial intermediary [bank] either raises the price of the service or absorbs the GST cost. If the cost is passed on to businesses through higher prices, businesses face the same decision, to increase the prices charged for their products or absorb the additional tax cost. This may increase prices faced by final consumers.... Alternatively, if the non-creditable GST is absorbed, the GST is effectively being paid by the business through reduced profits rather than being shifted onto the price of goods and services supplied to final consumers."

To summarize, zero rating financial services provided by commercial banks would have the following benefits:

- Zero rating will be easy to administer for both the banks and the tax authority (avoiding the exemption model's massive systems change-requirements and complex tax audits).
- Zero-rating ensures that there is no incentive for end consumers to seek financial services from offshore.
- Zero-rating avoids tax cascades – businesses in Malaysia will not be affected by embedded ("cascading") GST associated with unrecovered GST on inputs to banks.
- Zero-rating will complement the FSMP's objective of reducing the cost of doing business to banks via increasing their efficiency. The FSMP provides an incentive for banks to outsource non-core functions, which would be adversely impacted by GST due to the bias inherent in the exemption model for banks to 'insource', rather than outsource and incur GST.
- Zero rating would be consistent with the basic principle of GST/VAT being a 'consumption' tax in that banks are not the final consumers in the chain of supply involving banking services and, as such, should not be made to bear the burden of unrecoverable GST.
- The cost to the Government and the banks of administering a zero-rating model for the commercial banks will be minimised and this encourages a high level of compliance.

ABM wishes to emphasise that the GST model to be implemented should avoid weakening the Government's strategy to develop the financial services sector, as set out in the FSMP.

The scope of zero rating the financial services of the commercial banking sector could be defined by the authorities by reference to the services provided by any "bank" and "banking and financing company", as defined under the Banking and Financial Institutions Act 1989 ("BAFIA"), which would fall within the definitions of "banking business" and "finance company business", as also defined under BAFIA.

If for some reason an alternative to zero rating needs to be looked at, then we would suggest the following:

- Fixed percentage of input tax recovery for commercial banks

The commercial banking industry should be given a **fixed percentage of input tax recovery**, regardless of whether supplies are exempt or taxable, **similar to the treatment in Singapore which is simple to understand and implement.**

In relation to rates of recovery of input tax credit, Singapore currently provides for a 74% recovery (on input tax incurred by a full bank in providing all financial services, whether exempt or taxable); whilst Australia provides for a 75% recovery (on input tax relating to certain 'direct' inputs for providing exempt financial services only).

Whilst there appears to be no transparent basis for the determination of the fixed rate of recovery in Singapore, ABM would request that the authorities consider according to commercial banks a fixed input tax recovery rate comparable, if not better than that adopted by Singapore for full banks (the equivalent to commercial banks in Malaysia), so as to not place banks in Malaysia at a disadvantage vis-à-vis the Singapore banks.

- Reverse charge and group relief

We would further recommend that the reverse charge rule be deferred in its implementation, or, if implemented, related-party imported services for the banking sector in Malaysia be excluded from the reverse charge rule.

Current service tax group relief is applicable to certain taxable services provided within the same group provided certain conditions are met (including a key one whereby services must not be provided to outside the group). In law and practice, there is no restriction on foreign companies being within the "group".

Similarly, there should be a provision in the GST legislation to enable foreign companies within the same group to be treated as one entity for GST purposes, especially if related-party imported services for the banking sector are included in the reverse charge rule.

The complexity of the banks' service offerings far exceeds that in other industry sectors. The banks need to be distinguished from the other sectors, due to the unique features of the industry arising from mixed supplies and the need to segregate between taxable and exempt services under the exemption model. In the circumstances the banking sector would not have sufficient time to meet the Government's deadline of 1 January 2007.

Coupled with the distortions explained above, in the final analysis, zero rating gives Malaysia the best approach to deal with the commercial banking sector and ABM submits that the Government adopts this approach.

2. Preferred GST Framework for Commercial Banking Industry

2.1 Introduction

Scope of the commercial banking industry

ABM represents the Malaysian commercial banking sector including foreign commercial banks in Malaysia. A commercial bank could be either a "bank" or "banking and financing company" as defined in BAFIA. In this memorandum, the term "commercial banks" or "banks" is used to refer to a "bank" or "banking and financing company".

At present, ABM's members comprise 23 commercial banks.

A bank carries on "banking business" whilst a "banking and financing company" carries on both "banking business" and "finance company business". These terms are prescribed under BAFIA to mean:

banking business -

(a) the business of –

- (i) receiving deposits on current account, deposit account, savings account or other similar account;
- (ii) paying or collecting cheques drawn by or paid in by customers; and
- (iii) provision of finance; or

(b) such other business as (BNM), with the approval of the Minister (of Finance), may prescribe.

finance company business -

(a) the business of receiving deposits on deposit account, savings account or other similar account; and

(b) (i) giving of credit facilities;

(ii) leasing business;

(iii) business of hire-purchase, including that which is subject to the Hire-Purchase Act 1967; or

(iv) business of acquiring rights and interests in a hire-purchase, leasing or other similar transaction.

(c) such other business as (BNM), with the approval of the Minister (of Finance), may prescribe

A list of the services provided by the banks has been provided by ABM to BNM for submission to Customs and is attached as **Appendix 1**.

The problem of taxing financial services under an invoice-based GST/VAT system

It is an accepted notion that GST/VAT is a simple, invoice-based consumption tax system. Unfortunately, it is this very simplicity which does not translate well to the complexity of financial transactions, in particular determining the value added in financial transactions.

As succinctly stated by the New Zealand Government in its "GST Review - a tax policy discussion document" (March 1999):

"Applying GST to supplies of financial services is difficult because of the complexities involved in identifying and measuring the value that is added by the supply. This is because the added value is often not separately identifiable in the charges ... for the services.

"Amounts charged for ... financial services usually consist of a mixture of fees, commissions and interest rate margins. Interest rate margins may include pure interest (which represents the time value of money), ... and cost recovery and fees.

"The value added by a financial institution which should be subject to GST is in cost recovery and fees Identifying this component for specific transactions is difficult." (Emphasis added.)

Governments worldwide have traditionally dealt with the problem of taxing financial services by simply exempting the bulk of financial services (e.g. the provision of loans and credit), and taxing certain fee-based income (e.g. arranger fees for arranging syndicated loans and credit card subscription fees).

Table 1: Comparison of GST treatment of financial services in other countries

	New Zealand	Australia	Singapore	UK
Complexity of Law	Medium	High	Medium	High
GST standard rate	12.5%	10%	5%	17.5%
Significant regional financial services	No	No	Yes	Yes
Domestic Market	Small	Large	Small	Large
Regional Competition	Australia	Asia-Pacific	Asia-Pacific	Europe
Treatment of exported financial services	zero-rated	GST free (with input tax credit)	zero-rated	out-of-scope (with input tax credit)
Special rules for recovery of input tax to address effects of exemption	Yes – NZ has introduced "business-to-business zero-rating" of financial services and special deduction of input tax	Yes – reduced input tax cost recovery (RITC) system allows 75% recovery of GST on 'direct' inputs (specific "arranger services") for exempt supplies	Yes – administrative concession to allow high recovery rates for banks (74% for full bank)	No
Apportionment of input tax recovery for common business purchases used in making exempt and taxable financial services	Yes (for non-zero rated supplies)	Yes (for inputs not qualifying for RITC)	No	Yes
Administrative compliance costs	High	High	Low	High
Bias for domestic end users to seek services offshore	Yes	Yes	Yes	Yes
Flexibility	No	Yes - regulations define	Yes - administrative guidelines for	No

		services	industries	
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The current shift from the traditional exemption model

The model of exempting a broad range of financial services under GST/VAT has been seen by many as unsatisfactory as it creates numerous issues including higher cost of doing business to financial service-providers and tax-cascading (which in turn results in the over taxation of GST-registered businesses leading to higher prices of goods and services in the supply chain).

It should be noted that modern tax jurisdictions, including those surveyed in Table 1, have realised the distortions brought about by the exemption model, and have attempted to address these.

There have been suggested alternatives to exempting financial services, with the objective of bringing financial services back to the fold of a pure GST system i.e. full taxation on value added output and full recovery of input tax credit. However, none have been implemented by nation states so far.

As evidence of growing concern in the European Union over the use of the exemption model in taxing financial services, we quote from the foreword to the case study in 1998 by Ernst & Young for the European Commission, entitled "Value Added Tax - A study of methods of taxing financial and insurance services":

"Such exemptions (without the right to deduction) are alien to the fundamental principles of a VAT system because they interfere with the neutrality of the tax and the cascading effect distorts competition."

In fact, the current thinking in the international arena presents a shift from the traditional exemption model. *Han A. Kogels*, in the role of General Reporter for the International Fiscal Association Congress Paper, "Consumption taxation and financial services" in 2003 summarised the reports from 29 countries on the subject, and closed with the following comments:

"Whereas in the financial sector there seems to be support for exempting most financial services, both in the sector and wider business community the cumulative effects of the non-recovery of input VAT are generally felt as a distortion of the neutrality of the VAT system. Therefore, new approaches and suggestions like zero-rating and the cash flow method VAT deserve further study."

In New Zealand, the policy makers have seen it fit to adopt the zero rating model in 2005.

The effects of exempting financial services on Malaysia's developing economy

It is pertinent to note that the countries in Table 1 were already *developed nations by the time GST was implemented, unlike Malaysia*. Even for most of these "developed countries", it is also increasingly evident that tax authorities are reviewing whether the approach of exempting financial services in its present form should be maintained.

For a developing economy such as Malaysia's, the situation of higher cost of financial services and over taxation of businesses would exert further pressure on the price of goods and services along the supply chain and would certainly be detrimental to the well-being of the economy.

Further, the current Government policy for the Malaysian banking sector under the FSMP makes it more imperative not to impose the burden of an exemption model on banks. The FSMP has the objective of strengthening the banking sector to face growing liberalization. This is to be achieved primarily by increasing the efficiency of banks via reducing the cost of doing business to banks. With the chief attributes of a GST exemption model being significant unrecoverable input tax to banks (and high cost of administering 'mixed' supplies), the objective of the FSMP may not be achieved if an exemption model is implemented for banks.

Therefore, the only satisfactory method to prevent higher cost of financial services and tax cascades, especially in the context of a developing economy that is dependent on the banking sector, is, by **zero rating** financial services provided by commercial banks.

2.2 Recommended approach: zero rating of commercial banks' financial services

In the table below, we have attempted a summary to compare, the attributes of a GST system under the three options of applying GST to commercial banks' financial services (i.e. taxable, exempt or zero-rated) in the Malaysian context.

Table 2: Summary of attributes of a GST system under taxable, exempt and zero-rated treatment

Attributes to consider	Taxable	Exempt	Zero-rated
Simplicity	Complex	Complex	Simple
Efficiency (ease of administration)	Low	Low	High
Certainty of law	Medium	Low	High
Flexibility in coping with complex transactions	Low	Medium	High
Preserves or enhances global competitiveness	No	No	Yes

In our view, the analysis above strongly points towards zero-rating financial services, notwithstanding that to do so effectively excludes financial services from the tax net. This is further elaborated below:

- Zero-rating is the simplest model – it will be easy to implement and administer for both the banks and the tax authority (avoiding the massive systems costs and complexity of tax audits associated with treating financial services as exempt or taxable).
- Zero-rating ensures that there is no incentive for end consumers to seek financial services from offshore.
- Zero-rating avoids tax cascades– businesses in Malaysia will not be affected by embedded (“cascading”) GST associated with unrecovered GST on inputs to banks.
- Zero-rating will not distort the FSMP’s objective of providing an incentive for banks to outsource non-core functions. This in turn will help maintain an efficient financial services sector and promote a vibrant secondary financial services industry.
- Zero rating would be consistent with the basic principle of GST/VAT being a ‘consumption’ tax in that banks are not the final consumers in the chain of supply involving banking services and, as such, should not be made to bear the burden of unrecoverable GST.
- The cost to the Government of zero-rating financial services of commercial banks will not be significant as compared to the imperative to ensure equal footing of the banking sector with Singapore and other countries.

ABM suggests that weighing the cost-benefit of exemption versus zero rating, the zero rating model would best serve the objectives of the Government in implementing a GST system for a critical sector in the economy and would ensure that banks can continue to reduce their cost of doing business in accordance with the FSMP.

The scope of zero rating the financial services of the commercial banking sector could be defined by the authorities by reference to the services provided by any “bank” and “banking and financing company”, as defined under the BAFIA, which would fall within the definitions of “banking business” and “finance company business”, as also defined under BAFIA.

If for some reason zero rating is not adopted by the Government for the commercial banking sector, the exemption model would bring about issues and complications which are discussed further below.

2.3 Issues arising from exemption model

The issues below will help to highlight the cost of administering an exemption model of financial services far outweighs the benefits of exempting financial services.

As a yardstick of the input tax cost to the banks arising from exempting financial services, the statistics of revenue and expenditure for banks, as per Table 3, below, are used.

Table 3: Consolidated Income & Expenditure of commercial banks in 2004

	2004 calendar year ^P (RM million)
Gross interest income(a)	30,120
Fee-based income (b)	3,889
Total income(c) = (a) + (b)	34,009
Overheads (excluding staff cost).... (d)	5,042

^P Preliminary figures

Source: *BNM Annual Report 2004*

2.3.1 Higher cost of doing business to banks

Impact of unrecoverable input tax

GST/VAT is in principle a consumption tax which means that the burden of the tax should ultimately be borne by the consumers. An exemption model distorts the tax and results in the banks bearing the costs of GST/VAT. As the banks are not the final consumers, they should not be made to bear the unrecoverable GST/VAT costs.

The implementation of an exemption model of GST would certainly result in a higher cost of doing business to the banks. Table 4 below estimates the input tax cost to the banks under an exemption model of commercial banks' financial services.

Table 4: Computation of estimated net input tax cost to banks under exemption model (based on 2004 income & expenditure)

(Assumption: Standard GST rate in Malaysia of 5%)

	Exemption model
Output tax (e) = (b) x 5% (assuming all fee-based income is taxable and all interest income is exempt)	RM195 million
Input tax to banks ... (f) = (d) x 5% (assuming all overheads are subject to GST and used by banks to make both exempt and taxable supplies)	RM252 million
Percentage of recoverable input tax (apportioned to taxable supplies) (g) = ((b) / (c))	11.4%
Amount of recoverable input tax (apportioned to taxable supplies) (h) = (f) x (g)	RM29 million
Net input tax suffered by banks ... (i) = (f) - (h)	RM223 million

The analysis suggests that the unrecoverable input tax cost to banks under an exemption model could reach **RM223 million per annum**. This plus the increased compliance costs to the banks in terms of administering 'mixed' supplies under an exemption model (see below) would surely be detrimental to the healthy growth of the economy which is interconnected with the health of the financial sector.

The impact of higher cost of doing business to the banks is contrary to a key goal of the FSMP which is to strengthen the banking sector to face an increasingly liberalized environment. The primary focus of the FSMP to increase efficiency by reducing the cost of doing business to banks would be thwarted, as the prospect of unrecoverable input tax cost and increased administrative compliance cost would seriously impair the ability of banks to provide services at the lowest cost.

With input tax being unrecoverable, the banking sector would be facing a constraint in passing on the costs of doing business to consumers, as banks may be restricted from increasing bank charges in respect of basic accounts. The direct way for the banking sector to manage the constraint of increasing bank charges on basic accounts is by controlling internal costs. Unrecoverable GST would be a further burden to the banks in their effort to control costs.

On the other hand, and more importantly perhaps, lending interest rates have been deregulated via BNM's New Interest Rate Framework which was introduced in 2004. According to the new framework, the Base Lending Rate ("BLR") and lending spread is no longer regulated by BNM and is left to be determined by banks based on their respective cost structure and pricing strategies. Needless to say, the burden of unrecoverable input tax and administrative compliance cost would surely impact on the cost structure of banks in setting their respective BLR and lending margins.

The banking sector remains the primary source of funds to the developing Malaysian economy. According to the BNM Annual Report 2004, the banking sector contributed 78.1% of total loans and advances in 2004. In this context, low interest rates is particularly important for a developing economy like Malaysia's which relies on strong growth to turn the country into developed status.

In the present climate when keeping interest rates low is paramount in the minds of central banks worldwide and in Malaysia, in order to spur consumption and hence the growth of the economy, the negative consequence arising from the non-recoverability of input tax should be avoided at all cost.

Administrative compliance cost to banks

By having some supplies of financial services as exempt and some as taxable (either standard rated or zero rated - for exports), the administrative compliance cost to banks would increase due to the need to adhere to the following onerous requirements:

- a. ~~Distinguishing exempt and taxable supplies of financial services and ensuring GST is levied on taxable financial services only~~
- b. Directly attributing input tax in relation to exempt and taxable supplies in order to make sure that input tax is recovered in respect of taxable supplies only
- c. Apportioning residual input tax (i.e. input tax common to both exempt and taxable supplies) to taxable supplies only
- d. Adjusting recoverable input tax due to change in use of business purchases (this is where input tax earlier recovered in respect of a business purchase directly attributed to taxable supply has to be adjusted to cater for a "change-in-use" of the input to that of providing an exempt supply)

The above administrative compliance requirements require enormous system changes and record-keeping to banking operations which, if added to the input tax cost, could materially impair the ability of banks to be competitive.

Addressing non-recoverability of input tax

The exemption model has forced other countries, particularly Singapore, Australia and New Zealand to introduce special rules to address the issue of unrecoverable input tax. ABM

submits that the fixed input tax recovery scheme (for all supplies made by banks whether taxable or exempt), should then be given, as is currently being used in Singapore, which is the most simple and easiest to implement and administer. In contrast, the Australian and New Zealand models (see Table 1) would be administratively burdensome to comply with, due to the following factors:

- overly complex rules (attached are the Australian rules on RITC (**Appendix 2**) and New Zealand's guidelines on zero rating business-to-business financial services and special deduction of input tax (**Appendix 3**);
- stringent conditions to meet (for example, in New Zealand zero rating of financial services is only an option where financial services are provided to businesses with taxable supplies in the ratio of at least 75% of total supplies); and
- the need to still apportion residual input tax (input tax common to both exempt and taxable supplies) where such input tax would not be covered by the special relief schemes in Australia and New Zealand.

In Singapore, the fixed rates of GST recovery for financial institutions are as follows (the rates are fixed annually but are largely as below):

<u>Type of bank</u>	<u>Fixed input tax recovery rate</u>
Full Bank	74%
Merchant Bank	94%
Offshore Bank	98%
Finance Houses	58%

The fact that banks in Singapore do not get full recovery still creates inefficiency in the Singapore financial market, though the impact is mitigated due to the low GST rate (5%) and the high input tax recovery rate (74% for a 'full' bank which is the equivalent to a commercial bank in Malaysia).

The Singapore input tax recovery rates are determined by the Inland Revenue Authority of Singapore ("IRAS") for each category of financial institution, as above, based on loan statistics from the Monetary Authority of Singapore ("MAS"). Accordingly, the rates are uniform for all participants depending on their bank licence.

The Singapore scheme of input tax relief is administratively simple for both the taxpayer and the tax authority, and it avoids the substantial complexities and administrative costs associated with the general rules of recovery of input tax i.e. direct attribution of input tax to taxable revenue streams and apportionment of common input tax to taxable supplies only, and the special relief schemes of Australia and New Zealand (as explained above).

In order not to be disadvantaged, ABM would suggest that Malaysia needs to be at least on par with Singapore in terms of GST recovery rate for a full bank. The exact manner in which the IRAS arrive at the recovery rate is not a matter of public record and it is suggested that the rate includes an element of encouragement and support for the Singapore banking industry.

2.3.2 Cascading of tax

The cascading effect is introduced when the exempt supply of financial services becomes an intermediary component in business activities i.e. used as business inputs. When that happens, there will be an embedded GST cost (the unrecoverable input tax) in the value of the financial services provided to the business sector. The non-creditable input tax will be included in the price of non-financial goods and services. This will result in an over taxation of taxable goods and services that have used financial services as 'inputs'.

To remain competitive, banks would be under pressure not to pass on the unrecoverable GST, which will result in higher cost of doing business, hence going against the objective of the FSMP requiring banks to be more efficient.

The embedded GST cost will also result in goods and services exported outside of Malaysia becoming less competitive as there will always be an extra GST cost. As such an exemption model can distort a country's export of goods and services, which should be zero rated.

In Malaysia where bank lending is significant to businesses (according to the BNM Annual Report 2004, 45% of commercial bank lending in 2004 is to businesses), the effect of tax cascades would adversely impair the growth of the economy.

2.3.3 Self-supply bias ('insourcing')

Outsourcing of non-core, low skill processes by commercial banks is hardly a new concept but with the recommendation for outsourcing services by the Government through the FSMP, outsourcing became an issue banks could no longer afford to ignore. The non-core operations which the FSMP encouraged banks to outsource include back-office processes such as data entry, data conversion, transaction processes, payroll functions and certain ICT (information communication technology) processes such as network management. The consequences of the Government exempting financial services without providing input tax relief will create a bias towards self-supplying of non-core banking operations, meaning that the banking sector will now have to resort to providing these services in-house as it would be cheaper, minus the unrecoverable GST costs. This is because any services obtained by the banks through outsourcing arrangements would have to suffer GST and with the absence of input tax credit relief, GST paid on these services in providing exempted services, is not recoverable by the banks.

The relevant extract from the FSMP on the recommendation for outsourcing is attached as **Appendix 4**.

The result of the self-supply bias in an exemption model goes against the efforts of the Government in trying to cut banking costs and allowing the banks to access scale and skill improvements in core areas of their business. It can lead to inefficient production and delivery of financial services, obviously going against the vision and objective of the FSMP to strengthen domestic banking capacity to face a globalized market.

Without specific rules or mechanisms to off-set the self-supply bias, exemption will favour the larger banks as the chances of them affording in-house non-core services is more than the smaller banks. With limited funds and resources, smaller banks would have no choice but to outsource and this would inevitably increase their operation costs and reduce their competitiveness in the banking arena.

Again, because they adopted the exemption model, Australia (via the RITC) and New Zealand (via the special deduction of input tax credit) had to find ways to reduce the bias against outsourcing by providing partial input tax credits for purchases used in the provision of exempt financial services (in the case of New Zealand, to the extent the exempt financial services are used in providing banks' zero rated financial services). These reliefs however did not avoid the high administration costs in complying with these countries' respective rules in the matter.

2.3.4 Related party transactions and group relief

The non-availability of group relief would cause transactions within a group of companies to attract GST, which is a disadvantage as supplies between members of a group could generate unrecoverable input tax. This arises where members of the group are not fully taxable such as banks which are mainly exempt suppliers. In such a case some of the input tax costs generated within the group will be incurred by the recipient bank within the group. If there were group relief, there would be no such 'manufactured' input tax cost within the group. GST grouping is considered a business facilitation measure which is intended to reduce the administrative burden on businesses.

If the exemption model is adopted, Malaysia would have to consider a group relief provision which should be extended to cover cross-border transactions involving companies within a group. By disregarding supplies from companies located outside Malaysia, the supply of services by the overseas company e.g. support services from head office, would not be taxable under a reverse charge rule.

2.3.5 Reverse charge

Many GST systems require GST registered businesses to make self-assessments for GST on any imported services they purchase from outside the GST jurisdiction for the purpose of their business. If reverse charge is implemented in Malaysia, it would mean that exempt entities such as financial institutions, cannot avoid tax by purchasing services from non-resident suppliers. Although reverse charge is for the intention of protecting domestic service providers, it becomes complex in the case of common head office expenses obtained by foreign banks in Malaysia who would be largely suppliers of exempt services. In such cases, apportionment of the input tax would be required in respect of only taxable supplies made by the foreign banks. Even if Malaysia were to provide a fixed percentage reduced input tax relief scheme, the GST suffered and not recoverable in respect of the provision of exempt services gets passed on to consumers and reduces the competitiveness of these banks as compared to offshore financial institutions.

Currently, though Singapore has a reverse charge rule, it is only applicable to services which are prescribed under the law. And so far Singapore has not prescribed services which are subject to the reverse charge rule. This has given Singapore a further advantage in terms of promoting itself as the financial centre in Asia. If Malaysia is to be at par with the international financial centres in Asia, its reverse charge rules should not be operational, at least in the initial stage of GST implementation in this country.

2.3.6 Definition of exempt financial services

In GST/VAT systems, exempting financial services has normally been by way of specific identification. As is usually the case where any identification is made there are bound to be ambiguities, particularly so in the context of "financial services" which is a term that is fluid *per se*.

The ambiguity of definitions has led to unproductive disputes in other countries, for example in relation to whether outsourcing is an exempt "arranger" type service (in the United Kingdom) or what service would be incidental to a core exempt financial service and thus falling into the latter category.

The adoption of an exemption model would require extensive deliberation on clear definitions of what are and are not financial services and a mechanism must be put in place for these definitions to be updated in a timely manner.

2.3.7 Insufficient lead time for implementation of the exemption model

If the authorities were to opt for the exemption model for the banking sector, sufficient lead time would be required for discussions and consultations to be carried out between the authorities and the banking sector in finalising the draft law which will include various issues such as input tax recovery schemes and the list of taxable / exempt services. Banks would have to go through the education process in respect of the new tax system and modification of their current systems to suit GST. With the proposal that GST be implemented with effect from 1 January 2007, there is insufficient lead time for banks to undertake the massive systems changes and education necessitated by the complexity of an exemption model, especially in light of the fact that the draft law is not yet available.

2.4

Conclusion – zero rating the way forward especially for a developing economy

Looking at the host of issues an exemption model would bring about, it is without doubt that zero rating is the best option for the commercial banking sector, especially for a developing economy such as Malaysia's. Otherwise, the authorities would have to consider the following special rules to alleviate the burden of the exemption model on banks:

2.4.1 Fixed percentage of input tax recovery

The fixed percentage of input tax recovery is the method currently adopted by Singapore, regardless of whether supplies by banks are exempt or taxable.

Whilst there appears to be no transparent basis for the determination of the fixed rate of recovery in Singapore, the Malaysian authorities should consider the same fixed input tax recovery rate of 74% as applied by Singapore for full banks (the equivalent to commercial banks in Malaysia), if not better, so as to not place banks in Malaysia at a disadvantage vis-à-vis Singapore banks.

The Singapore treatment is the most preferred as compared with the special input tax recovery schemes in Australia and New Zealand, as it is relatively easier from an administrative compliance perspective, in the sense the recovery is allowed regardless whether supplies by the commercial banks are exempt or taxable, unlike the Australian and New Zealand schemes. This would alleviate 3 out of the 4 administrative compliance matters mentioned above, namely:

- (i) directly attributing input tax in relation to exempt and taxable supplies in order to make sure that input tax is recovered in respect of taxable supplies only;
- (ii) apportioning residual input tax (i.e. input tax common to both exempt and taxable supplies) to taxable supplies only;
- (iii) adjusting input tax due to change in use of business inputs.

It is noted that Singapore is already an established regional financial centre with international financial standing. Unless Malaysia is prepared to level the playing field in terms of input tax recovery with Singapore banks, the goals of the FSMP in preparing the Malaysian financial sector to progress towards a more competitive environment and finally greater international integration, would be that much more difficult to achieve.

2.4.2 Reverse charge to be deferred in implementation

A reverse charge regime is generally applied in most GST/VAT jurisdictions for the purpose of imposing GST on foreign services imported as business inputs.

Usually there are special rules to deal with services between related entities to reduce the impact of GST on overseas head office and regional office services provided to related businesses in Malaysia. There is precedence for this in the Australian model, which was designed to ensure foreign corporations would not be disadvantaged by the introduction of GST.

We recommend that such related-party imported services for the banking sector in Malaysia be excluded from reverse charge rules.

We further propose that the reverse charge rule, if introduced, be deferred in its application to the commercial banking sector so as not to place the Malaysian banks at a disadvantage compared to Singapore (which has not activated the reverse charge rule).

~~2.4.3 Group relief to extend to related companies outside Malaysia~~

Broadly, the provisions should allow a GST return to be submitted by a representative member of a group on behalf of the entire business group. The GST return should ignore intra-group transactions and only capture GST on transactions with non-group entities.

The authorities should consider implementing group relief rules which permit companies located outside of Malaysia to be included in the group, to avoid the adverse effect of taxing head office charges by overseas companies to related foreign banks in Malaysia.

Where a group has constituent members with different fixed rates of recovery, or using the general rules of input tax recovery (as explained above), the proposed treatment for input tax credit should be as follows:

- first, the input tax should be calculated for each entity in the group based on the rate of recovery (or general rules) applicable to each entity; and
- thereafter, the input tax as above calculated for each entity should be aggregated for the purpose of the group return.

By zero rating commercial banks' services, the measures of fixed percentage of input tax recovery, deferment of reverse charge and group relief would obviously not be necessary for banks. It is reiterated that zero rating should be the preferred approach for commercial banks' financial services.

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