Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Accruals Variance for January 2008

Date:	22 February 2008	**Priority:**	**High**
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Action sought

	Action Sought	Deadline
Minister of Finance	Note contents	
Minister of Revenue	Note contents	

Contact for telephone discussion (if required)

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[1] Aspects of this report have been removed to protect privacy of individuals or because the information may be commercially sensitive

22 February 2008

Minister of Finance
Minister of Revenue

Implications of Accruals Variance for January 2008

Executive summary

For unconsolidated IRD taxes, cash outturns for the year to January are about $230 million below Treasury forecasts. Revenue figures, on the other hand, have shown a sudden large drop to be $940 million below forecast. In addition, we are aware of a further sum of roughly $[redacted] million that we had expected to be accrued later which has been included in revenue in January. This means that we are about $[redacted] million down on where we would have been if we had known that the $[redacted] million would accrue early.

Of this approximately $[redacted] million may be from growth in the pooling account and $170 million may be because some taxpayers have moved out of the provisional tax system through the PIE regime. Both of these amounts are likely to be largely reversed out later in the year. Thus, roughly $[redacted] million of the fall in the revenue figures can be explained by factors which are likely to be reversed later this year.

In addition part of the reason for the shortfall in revenue is lower terminal tax collections of $160 million, mostly attributable to the "other persons" tax type. Terminal tax for other persons is very volatile and so the lower figure for 2007 may not enter our base lines for future years.

Over and above these adjustments we are left with a revenue shortfall of $960 million dollars for the year to January 2008, which has the potential to affect baselines in future years. However uncertainties remain as to the nature of the current shortfall in revenue and another month of revenue figures will be needed to establish whether the January revenue shortfall is indicative of a trend. At this stage the adjustment to baselines could be anywhere between $500 million and $1 billion.

Our analysis to date on the nature of the $940 million variance is summarised in the following table.

Explanation of variance	Likely impact on baselines ($ million) timing	short term baselines	longer term baseline	uncertain (timing or baseline)	total
Increase in the use of tax pooling	-[redacted]				-[redacted]
PIE regime	-170				-170
Accrued income recognised early	+[redacted]				+[redacted]
Terminal tax		-160			-160
Provisional tax - larger taxpayers			-200		-200
GST			-310		-310
Other IRD taxes			70		70
Other taxpayers/unexplained				-520	-520
	180	-160	-440	-520	-940

Other non-IRD taxes, e.g. Customs GST, were above forecast for the seven months to January. This reduces the overall unconsolidated tax revenue variance to around $815 million below forecast.

This shortfall will be factored into our First Round Budget forecasts on 7 March. However, by the time that these forecasts are made, we will not have any further information on our revenue outturns. We will continue to monitor outturns closely, and the final Budget forecasts on 18 April will have an additional two months of data on revenue collections including March which is a high-tax month. This will help to clarify the implications in the shortfall to March for full year baselines.

The 2007 Half-Year Economic and Fiscal Update (2007 HYEFU) highlighted some downside risks to the economy, and hence tax revenue, including:

- recent international developments on world financial markets,
- the ongoing path of commodity prices,
- the impact of monetary policy tightening on the domestic economy, and
- climatic conditions.

Examining February and March data may give insights into which, if any, of these factors are affecting tax revenue. For instance, we may be able to tell how much the drought is affecting tax revenue from the agricultural sector or the extent to which international financial turmoil is affecting tax from the finance sector. We are also hopeful of getting further data on the extent to which the PIE regime has delayed recognition of tax, although this is far from certain.

The Treasury will keep the Minister of Finance updated with its assessment of the tax revenue outturn's implications for the fiscal position in the January 2008 Government Financial Statements report (due 28 February) and with further advice as the 2008 Budget forecasting round progresses.

This report is for your information only.

Recommended action

It is recommended that you **note** the contents of this report.

David Galt
for Secretary to the Treasury

Sandra Watson
Manager, Forecasting & Analysis, Policy
Inland Revenue

Hon Dr Michael Cullen
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. The figures discussed below relate to total IRD taxes – they do not include revenue from other agencies (for example Customs GST) and they are unconsolidated. The important information is as follows:

- Cash outturns for the year to January are $234 million below Treasury forecast. Most of the variance is in GST, Other Persons, and Company tax. The total variance continues a trend already seen in December; in other words there are no major new surprises in January; and early indications are that February cash outturns for company tax and other persons are arriving reasonably within expectations.

- Revenue figures, on the other hand, show a sudden, large variance in the month of January, with year-to-date figures being $941 million below Treasury forecast. The main contributors to the year to date revenue variance are (rounded):

- company tax	-$280 m
- other persons	-$360 m
- GST	-$310 m

  Note that the negative IRD GST variance was partially offset by a positive variance of $130 million in Customs GST.

- In addition we are aware of another $[redacted] million which we had expected to accrue in April which has been brought forward to January. This means that that this amount should be added to the shortfall in company tax. Company tax revenue is $[redacted] million lower and total collections are $[redacted] million lower than would have been forecast if we knew that the $[redacted] million would accrue in January.

Analysis for Company Tax

2. Looking through the $[redacted] million adjustment, year to date company tax revenue is $[redacted] million below Treasury forecast and $[redacted] million smaller than the prior year. At December, it was above forecast and only $218 million smaller than the prior year. So in one month we have seen a dramatic change in revenue, both relative to forecast and relative to the prior year.

3. The following analysis provides a comparison of year to date versus the prior year, as distinct from a direct comparison of actuals against Treasury forecast.

Growth in the use of tax pooling. (timing, -$[redacted]m)

4. Revenue recognises assessments plus any credit balances from payments exceeding assessments. However payments to the tax pool are not recognised to avoid double counting with assessments held in client accounts. This is the right outcome provided the assessments have been raised. If clients do not yet have an assessment, any of their payments into tax pooling will not be recognised as tax revenue. Revenue hence understates the true picture until the assessments are raised. Growth in the use of tax pooling exacerbates this problem, and has not been incorporated into the forecasts. For the seven months to January 2008, compared to the same period in the prior year, deposits into the pool by clients without assessments grew by $[redacted] million.

5. Revenue recognition associated with tax pooling is largely a timing issue. Thus, this shortfall is likely to be reversed later in the year.

6. As part of a wider review of revenue recognition policies, Inland Revenue and The Treasury will consider whether changes are required to the recognition of funds held in the pooling account, to address these timing issues.

A drop in the value of terminal tax assessments for 2007[2]

(current year -$40 million)

7. Company tax net square ups[3] for 2007 at $260 million are approximately $40m below the prior year. This drop indicates less terminal tax will be collected in April this year.

An $890 million drop in the value of provisional assessments for 2008

(Timing due to PIE regime -$170 million)
(Larger taxpayers – drop in tax liability -$200 million)
(Residual: smaller taxpayers *and/or* timing of provisional assessments -$520 million)

8. Provisional tax assessments affect revenue where they exceed cash payments. Company net provisional assessments for 2008 at $3 billion in the year to January are approximately $890m below assessments in the prior year, even though similar volumes of returns have been processed year to date.

9. Some taxpayers have moved out of provisional tax because of the new Portfolio Investment Entity (PIE) regime, and will in future pay their tax annually. Their new tax liability under the PIE regime will not be known until PIE returns are received after April 2008. Previous provisional tax for taxpayers who have elected to become PIEs, who are using the same IRD number, and who will be filing annually under the PIE regime is approximately $170m. The total effect of the PIE regime may be larger because many PIEs are new taxpayers who cannot be directly matched to previous payment or filing behaviour. To get a feel for the size of the sector, unit trusts and super funds previously paid approximately $560m income tax per annum.

10. Excluding PIEs, larger[4] taxpayers with provisional tax assessments in both years have reduced their assessments by $200 million. This represents a risk to revenue in both the current year and across the forecast period.

11. No inferences on tax growth can be made for taxpayers who had filed provisional assessments by January 2007, but who have not yet filed by January 2008. The remaining $520 million drop in assessments will be partly due to such timing issues (for example an analysis of the larger assessments from January 2007 showed that $330 million was assessed to taxpayers who have not yet filed in 2008), and partly due to a drop in income for smaller taxpayers.

[2] This analysis has looked at assessments generated in the July-January period, and has ignored any early returns
[3] A net square up refers to an assessment of terminal tax for the prior year, which also reverses the provisional assessment from the prior year. The "net effect" has been compared to the "net effect" from the previous season of processing.
[4] The analysis included the top twenty assessments from each of 2007 and 2008, from a total of 33 different large taxpayers.

Other Taxes

12. Other Persons net terminal tax assessments are approximately $120m below the prior year, indicating less terminal tax will be collected in April this year. Terminal tax for other persons is very volatile and so the lower figure for 2007 may not enter our base lines for future years. Provisional assessments for Other Persons are very similar to the prior year so the remainder of the $360 million other persons variance against forecast is likely to be due to the "credit balance" aspect of the revenue figures, with lighter than expected payments from the farming sector also evident in cash receipts. This variance is possibly due to the drought, and hence will only affect the forecasts in the short term, although it may be a bit early yet for drought effects to be evident in tax revenues.

13. A further $310 million variance is attributed to GST. Much of this variance is also apparent in the cash, with GST refunds tracking higher than expected. The $130 million positive variance in Customs-collected GST partially offsets this IRD GST variance.

Summary of Analysis

14. Interpreting the analysis against the prior year as indicative of variance against forecast, the $1.47 billion year to date variance against forecast can be broadly categorised as follows:

Timing – expected to unwind in the current year – about $[redacted] million through:
Growth in the use of tax pooling
Introduction of PIE regime

Short term impact only – about $160 million through:
Terminal tax for 2007

Potential to affect baseline forecasts through to 2009 – about $440 million through:
A -$200m drop in company provisional tax assessments for 2008, larger taxpayers
GST -$310 million – mainly refunds
Other IRD taxes (for example PAYE) +$70m

Unclear whether timing or ongoing impact - the residual year to date variance of $520 million
Possibly less provisional tax for 2008 from smaller company taxpayers
Lower than expected payments from farmers in February
Possibly due to timing of assessments
Possibly not all of the effects of the PIE regime have been captured above

Why the sudden surprise in January?

15. Most of the big drop in assessments occurred in the month of January. Of the $890m year to date drop in provisional tax assessments for companies, $630 million was in January. Net square ups for companies also dropped by over $180 million in January.

16. Further, most of the $360 million variance in Other Persons reported in January is attributable to a timing adjustment that should have been recognised in December. In other words, this particular variance should have been apparent a month earlier.

Is the variance likely to get bigger over the next few months?

17. The answer to this question depends on the extent to which the drop in assessments is genuinely due to a drop in income rather than to timing. One more month of assessments will be needed to establish if there is a new trend. Baseline forecasts could be affected by between $500million and $1 billion.

18. The first round of Budget tax forecasts is due to be completed on 7 March, but with no further data than is currently available. Final Budget tax forecasts are due for completion on 18 April, by which time February and March data will be available, which we hope will shed further light on the tax revenue situation.