Tax Pooling Review – Summary

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Inland Revenue

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Executive summary

Background

Tax pooling was first introduced in 2003 to allow taxpayers an avenue to mitigate the financial consequences that arise as a result of getting their provisional tax estimation wrong. This is done by allowing taxpayers to access better rates through approved intermediaries that arbitrage the low overpayment UOMI rate and high underpayment UOMI rate.

Tax pooling appears to be operating with efficiency and no significant issues have arisen to date. However, given the growth in the use of tax pooling by taxpayers as well as its continuing evolution, consideration should be given as to whether there are any potential risks that may not be well understood by key stakeholders.

This report considers the operation of tax pooling and provides a summary of the lifecycle of the various tax pooling transactions. It also identifies the key risks associated with tax pooling.

Overall finding of Phase One

Tax pooling is operating well and is a service and option that is valued and used extensively by taxpayers. Tax pooling appears to be achieving the policy objectives envisaged when it was developed.

Tax pooling has evolved beyond the sale and purchase of tax

Tax pooling continues to meet the policy objectives that it set out to achieve. That is, it allows taxpayers to mitigate their exposure to UOMI costs as a result of the uncertainty they faced in trying to estimate their provisional tax obligations. This is effectively delivered by the sale and purchase of tax in a tax pool.

However, additional transaction types have been developed including the provision of tax finance to taxpayers to allow them to manage cash flow issues. Tax finance was not anticipated by policy makers at the time tax pooling was first introduced. Further consideration should be given to tax finance to ensure it does not result in additional risks for Inland Revenue (IR) as well as other key stakeholders.

There is minimal regulatory oversight on tax pooling intermediaries

Tax pooling intermediaries are subject to scrutiny when they first apply to become an intermediary. However, following approval there is little regulatory oversight imposed on the intermediaries. In particular, no checks are done by IR to ensure that the tax pooling intermediary continues to meet the legislative requirements imposed under the tax legislation.

The only ongoing regulatory oversight would appear to be in relation to the anti-money laundering and countering financing of terrorism frameworks.

Consideration should be given to whether further checks should be performed to ensure the intermediaries are continuing to meet the standards set out in the legislation. For example, adequate records are being kept to provide confidence that taxpayers would be able to access their funds when required.

Further, IR should establish processes to ensure that if the legislative standards are not met, IR is aware and able to wind up the intermediary if required.

Consideration should also be given as to whether further regulatory oversight is necessary given the nature of the services that are provided.

The risk of something going wrong may be low but the consequences would likely be significant

The risk of significant issues arising from tax pooling appears to be low. This is in part due to the industry practices that have been adopted by the tax pooling intermediaries themselves, for example the use of independent trustees. However, the consequences should something go wrong would likely be significant for IR in terms of reputational risk and could extend to other government agencies. This is on the basis that there may be a potential perception that there has not been adequate government oversight over tax pooling to ensure taxpayers' funds are protected against things such as fraudulent activities. In addition, public perception may be that any issues that arise are the responsibility of IR to remedy.

IR should therefore be clear that it is comfortable with the level of regulatory scrutiny that is imposed on tax pooling intermediaries when balanced with the level of risk and the potential consequences.

There is a lack of transparency around tax pooling

There is very limited information publically available that comprehensively explains tax pooling and the various services that are provided. While tax pooling may be understood at a conceptual level, it is difficult to access the information required to fully understand the intricacy of the services provided.

There may be legitimate commercial reasons for the lack of transparency. However, care should be taken that IR is fully informed and understands all of the services that are provided by tax pooling intermediaries.

There are some operational risks within IR

There are some risks in the way IR currently operates tax pooling. These include manual calculations being performed, a heavy reliance on certain key personnel within IR to operate tax pooling, lack of reconciliations being performed on tax pooling balances with the tax pools, and the potential for policy decisions to be made by operational staff.

IR should ensure that adequate safeguards are in place to ensure that tax pooling operates as intended. This may include IR having more oversight of the tax pooling process as a whole, as well as developing reconciliation procedures with the tax pooling intermediaries.

Difficulties in revenue forecast

Tax pooling provides challenges for revenue forecasting as funds deposited into a tax pool are not recognised as tax revenue under the current processes. As tax pooling continues to grow, the issue with revenue forecasting will only become more significant. However, it was recognised that revenue recognition for year-end purposes should not be skewed by tax pooling as all tax pooling transactions would need to have been completed before IR year end (30 June).

IR may wish to investigate whether additional information or data sharing, internally or with tax pooling intermediaries could eliminate some of the risks currently associated with how tax pooling interacts with revenue recognition.

Next steps

Phase 1 of the tax pooling review has identified that tax pooling is operating well and is a service and option that is valued and used extensively by taxpayers. Tax pooling appears to be achieving the policy objectives envisaged when it was developed.

Our review has identified certain risks that exist within the tax pooling framework. IR should consider these risks and determine whether further analysis should be undertaken in order to better understand how these risks are currently being managed, the consequences of the exposure to these risks and, if appropriate, how these risks may be mitigated.

In the event that IR considers further analysis should be undertaken, we would recommend the following approach:

- perform more in depth analysis to understand how these risks are currently being managed by the key stakeholders such as IR, tax pooling intermediaries and trustees
- identify the potential areas of risk exposure by highlighting the significant areas of unmitigated risk and understanding the consequences of this exposure
- consideration of opportunities that would enhance tax pooling to better meet stakeholder requirements and better manage risks.

Potential solutions

While Phase 1 of the review is focused on the identification of risks, we provide some high level comments on potential solutions that IR may wish to consider.

We note that these are merely observations we have made to date as part of the risk identification phase and therefore should not be taken as the complete suite of potential solutions. As referred to above, this may require IR to undertake a second phase of work.

- IR should consider expanding the regulatory oversight it has over tax pooling intermediaries. Our initial view is that IR is best placed to provide that oversight as tax pooling is fundamentally part of the tax system. This may include annual checks to be performed by the intermediaries that they continue to meet the legislative requirements, together with some form of quality assurance programme over systems and processes.
- Periodic reconciliation procedures should be adopted between IR and the tax pooling intermediaries/trustees to ensure the systems are operating as they should.
- IR should increase its understanding of the commercial aspects of tax pooling and the policy objective of tax pooling to ensure that there is a clear understanding within IR of how the various services offered by tax pooling intermediaries operate, and how that delivers the policy.
- IR, Treasury and the tax pooling intermediaries should hold a workshop to discuss the revenue forecasting issue and agree a process to resolve the forecasting challenges.
- IR should consider making the use of an independent trustee as a legislative requirement on the tax pooling intermediaries.
- Recognising that some tax pooling transactions have characteristics of financial instruments IR should hold further discussions with the Financial Markets Authority to explore any concerns that departments may have in relation to the services that are provided by the tax pooling intermediaries, for example, tax financing.
- IR should maintain regular interactions with other agencies that have a role in the regulation of tax pooling intermediaries, including the Department of Internal Affairs, to ensure there is a good general overview of the tax pooling industry.

Introduction

Background

New Zealand, in common with many other jurisdictions, has a regime in place which requires tax to be paid throughout the year as profits arise based on an estimation of total annual profit. Under this regime, provisional tax is required to be paid by taxpayers (including companies and individuals) if their residual tax liability for the income year is over a certain level.[1] The provisional tax is payable in three equal instalments throughout the year.

Given the volatility of business profits, IR allows three methods for taxpayers to calculate the amount of provisional tax that is payable for an income year. Taxpayers have the option to choose one of the methods outlined below.

- The "standard calculation" method is the default calculation method which bases the provisional tax payable for the year on a percentage uplift of the most recent residual income tax.
- Taxpayers may base payments on their own estimates of actual profit levels.
- Taxpayers may base payments on a percentage of their GST taxable supplies ("GST ratio method").

How to ensure taxpayers make accurate provisional tax payments throughout the year?

A combined regime that imposes interest (referred to as use-of-money interest or "UOMI") and/or penalties is in place to ensure taxpayers are incentivised to make accurate provisional tax payments. Broadly, penalties are imposed if payments are made late[2] or if the amount of provisional tax paid is not a reasonable estimate of tax payable.[3]

UOMI is payable or receivable to the extent that actual taxable income is more or less than the estimated amount, therefore resulting in an underpayment or overpayment of provisional tax. The variability in business profits means that UOMI often arises even if detailed estimate calculations are undertaken by taxpayers.

The UOMI rate-setting framework is very much focused on ensuring the right incentives are in place to encourage taxpayers to pay the right amount of tax at the right time. The underpayment rate attempts to reflect the fact that the government is an involuntary and unsecured lender, and is unable to assess the actual credit-worthiness of each taxpayer. The overpayment rate is designed to discourage taxpayers from using IR as an investment opportunity.

The underpayment UOMI rate is set using the Reserve Bank of New Zealand (RBNZ) floating first mortgage new customer housing rate, plus 250 basis points.[4] The overpayment rate is based on the RBNZ 90-day bank bill rate, minus 100 basis points. Linking UOMI rates to RBNZ rates ensures that the UOMI rates reflect overall movements in market interest rates. The current UOMI rate for the underpayment of tax is 8.4% per annum, and for the overpayment of tax is 1.75% per annum. There is a significant differential between the underpayment and overpayment rates of 6.65%.

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1 The majority of individual taxpayers do not fall into the provisional tax regime as tax is fully withheld at source on income received by wage and salary earners and bank interest.

2 The late payment penalty has two components:

- Initial late payment penalty – 1% is added on the day after the due date then a further 4% is added to the unpaid tax and the late payment penalty already imposed at the end of the seventh day after the due date; and
- Incremental late payment penalty - 1% is added the day after the end of the month following the imposition of the initial late payment penalty. The incremental late payment penalty is calculated based on the unpaid tax and any late payment penalties already imposed.

3 Shortfall penalties that can apply can be between 20% to 150% of the unpaid tax.

4 The current method in setting the underpayment UOMI rate was introduced in 2009. Prior to that, the rate was set using the Reserve Bank of New Zealand 90-day bank rate plus 450 basis points.

This differential has remained relatively consistent over the years. The table below summarises the UOMI rates for the underpayment and overpayment of tax over the last 8 years.

Period	Underpayment rate (%)	Overpayment rate (%)	Differential between underpayment and overpayment
From 8 May 2012	8.40	1.75	6.65
From 16 January 2011	8.89	2.18	6.71
From 29 June 2009	8.91	1.82	7.09
From 1 March 2009	9.73	4.23	5.50
From 8 March 2007	14.24	6.66	7.58
From 8 March 2005	13.08	5.71	7.37

Why introduce tax pooling?

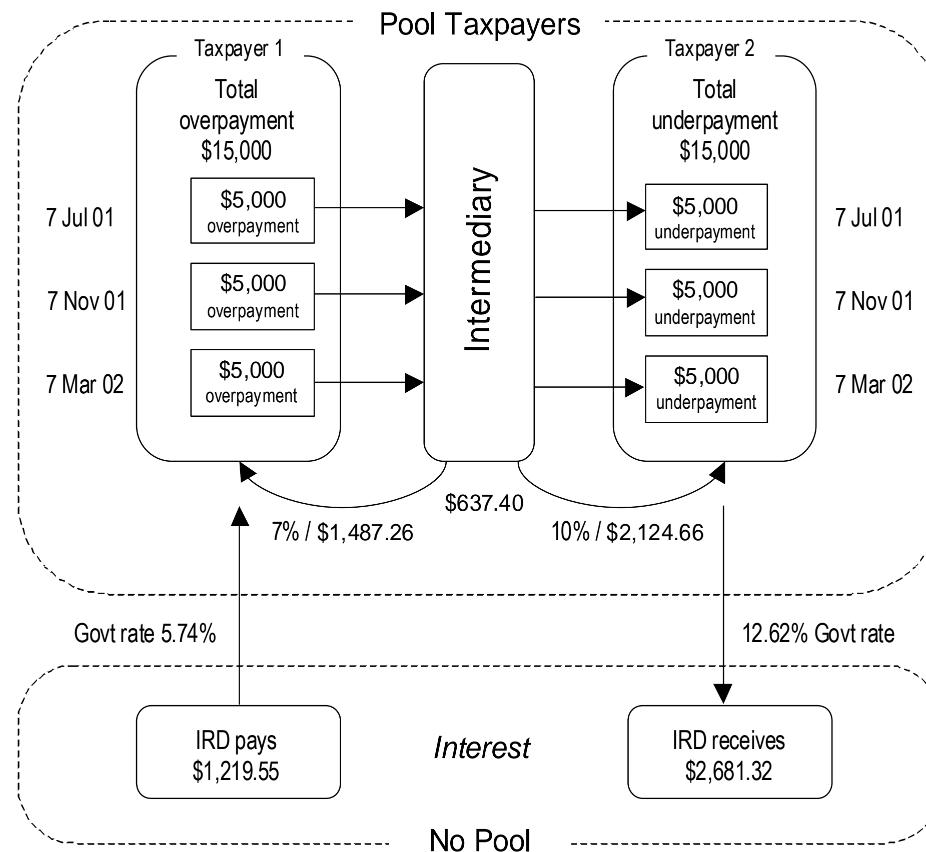
In 2001 the Government released a discussion document, "More time for business", which looked at tax simplification from the point of view of small businesses. The discussion document considered a number of options for simplifying the provisional tax rules to give taxpayers more certainty, and to minimise exposure to UOMI while still incentivising taxpayers to pay the correct amount of tax.

The proposals were developed in response to sustained concerns about the penal impact of UOMI from organisations such as the Institute of Chartered Accountants of New Zealand (as it was then).

Tax pooling was one of the options proposed in the discussion document. Tax pooling was expected to allow businesses to pool their provisional tax payments together so that underpayments by some in the pool could be offset against overpayments by others in the same pool.

The intended result of tax pooling was summarised as follows:

HOW POOLING WOULD WORK



In the example, Taxpayer 1 who overpays would have received $1,219 of UOMI for their overpayment from IR, but instead receives $1,487 from the Intermediary by paying their provisional tax through the Intermediary.

Taxpayer 1 is better off by $268. Taxpayer 2 who underpays would have had to pay $2,681 of UOMI to IR, but instead pays $2,124 to the Intermediary. Taxpayer 2 is better off by $557.

The Intermediary would gain $637 from the opportunity to manage the arbitrage between those in a pool who overpay and those who underpay.

Tax pooling was implemented as part of the tax simplification measures undertaken in 2002.

Policy rationale for tax pooling

Officials acknowledged that the provisional tax rules often resulted in uncertainty for businesses as they operate on the premise that businesses are able to correctly estimate their income for the year. The result of not getting the estimation right will mean the taxpayer overpays or underpays their tax for the year both of which have financial consequences for the business.

Overpayment of provisional tax results in money that a business could use in their business to be "deposited" with IR at a cost to the business. Underpayment of provisional tax means businesses have to face an unexpected interest charge (UOMI). This issue is further exacerbated in that many taxpayers consider that the UOMI rate for overpayment is too low (i.e. does not adequately compensate the business) and the rate it charges on underpayment is too high.

Changing the UOMI was not a feasible option…

It is likely that reducing the UOMI rate differential (for example reducing the underpayment rate) would have alleviated some of the concerns raised by taxpayers in respect of the application of UOMI.

However, in the 2001 discussion document dismissed a change to the UOMI rates as it was considered to be unworkable. In particular, it emphasised that the underpayment rate needs to be set high enough so that there are appropriate incentives in place to ensure taxpayers pay the right amount of tax at the right time. It was further suggested that if the underpayment rate was reduced, an additional penalty may be required to apply to underpayments to ensure the right incentives are in place to encourage compliance from taxpayers.

Although a change of UOMI was swiftly dismissed by IR, the Treasury has subsequently questioned the efficiency of using tax pooling as a way to address the perception of high UOMI underpayment rates and uncertainty in determining provisional tax obligations. It instead favoured a review of the UOMI and provisional tax regimes with a view to making it more certain and acceptable to taxpayers thereby removing the need for a tax pooling regime.

…therefore tax pooling was introduced

Tax pooling was introduced as a way to provide some relief of the financial impact UOMI rules have on businesses as a result of the uncertainty they face in trying to estimate their provisional tax liability without changing the UOMI rates. The UOMI costs faced by taxpayers who participate in tax pooling was expected to more readily reflect the true commercial cost of borrowing or lending by the taxpayer concerned.

In short, tax pooling was intended to provide an opportunity for taxpayers to manage their tax payment risks. It would do so by allowing businesses to pool their provisional tax payments with those of other businesses, with the result that underpayments would be offset by overpayments within the same pool.

The Government also expected to benefit from the introduction of tax pooling. In particular, the government would be seen to have taken a concrete step to address concerns over the UOMI interest rate setting process, by opening up an opportunity for taxpayers to reduce their costs. The sustainability of the then UOMI rate setting processes would also be strengthened.

Tax pooling has evolved over time

While the policy rationale for tax pooling has remained the same, a number of changes have been made to the regime since its introduction in 2003. In particular, a review of the legislation applying to tax pooling intermediaries was undertaken to ensure the rules were working as intended. As a result of the review a number of amendments were made to the tax pooling legislation in 2009 and in 2011.

The changes include:

- extending tax pooling to reassessments (including reassessment that arise as a result of a voluntary disclosure or the resolution of a dispute)
- extending tax pooling to voluntary disclosures for certain non-income tax obligations (i.e. GST, PAYE or FBT) where no previous assessment has been made
- providing discretion for IR (i.e. the Commissioner) to allow taxpayers to use tax pooling for certain income tax or RWT voluntary disclosures where no return has previously been filed

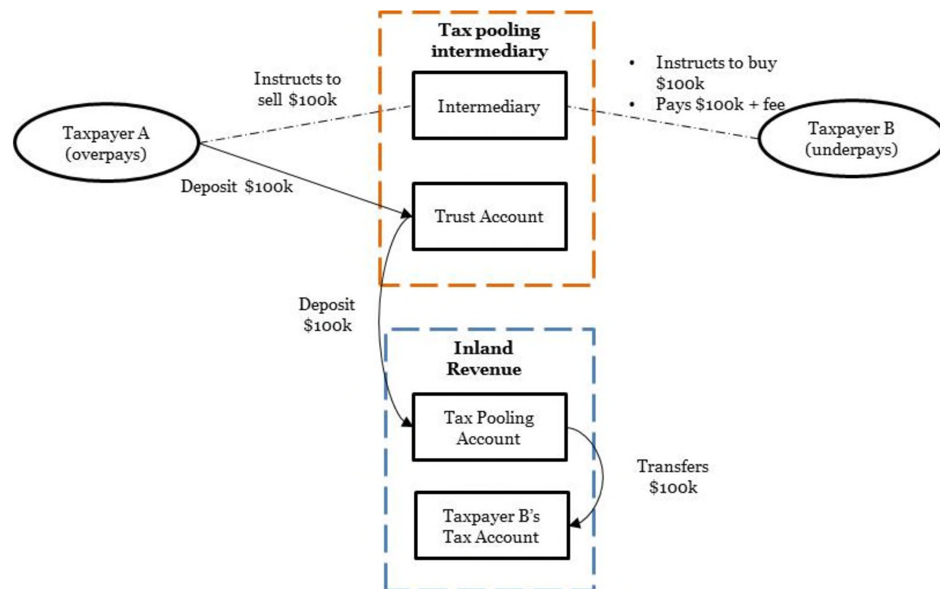
- enabling pooling funds to be transferred between intermediaries
- allowing all taxpayers to make deposits into tax pooling accounts
- extending the time limit available to satisfy an obligation to pay provisional or terminal tax to 75 days (note that for reassessments the time limit remains at 60 days from the date of the reassessment)
- removing this time limit for meeting provisional or terminal tax obligations when taxpayers use their own deposited funds, provided the return was filed on time.

In addition to this general review of the tax pooling legislation, IR also conducted a specific review of the operation of the Commissioner's discretion to allow the use of tax pooling funds for certain income tax or RWT voluntary disclosures where no return has previously been filed. The review concluded that the discretion is operating as intended and should be retained.

How tax pooling operates

Tax pooling generally involves a taxpayer depositing money with a tax pooling intermediary. The deposits earn interest. The intermediary deposits that money in its tax pooling account with IR. The taxpayer may use the funds (deposits) in the future to satisfy their outstanding tax liabilities or may sell the funds to another taxpayer who is also a client of that tax pooling intermediary. The funds remain in the tax pool until the taxpayer directs the intermediary to transfer the funds to the taxpayer's own IR account or to another taxpayer's IR account. The taxpayer may also request for the funds to be refunded. If the taxpayer sells the funds, the intermediary will facilitate the sale for a fee. On the payment of the fee, the intermediary transfers the funds to the other taxpayer's IR account, as at the date the money was originally deposited with the intermediary.

The diagram below provides a simplified view of the tax pooling regime:



In this example, Taxpayer A has deposited $100k into the tax pooling intermediary's trust account. The intermediary (through the use of a trustee) deposits the money into the intermediary's tax pooling account set up with IR. Taxpayer A then instructs the intermediary to sell its excess tax as it has overpaid.

Taxpayer B, who has underpaid its tax, instructs the intermediary to purchase tax in order to meet its obligation with IR. The intermediary facilitates the transaction. Once the transaction is completed (i.e. Taxpayer B pays the $100k and fee) the $100k in the tax pooling account is transferred to Taxpayer B's IR account as at the date that Taxpayer A deposited the money with the intermediary.

There are a number of specific rules and provisions that limit the use of the tax pooling funds. One of the key restrictions is that taxpayers must access funds within 75 days of their terminal tax date in order to apply tax pooling funds against their provisional or income tax liabilities as at the effective date of the original deposit. The time limit is reduced to 60 days if the income tax liability relates to a reassessment. Note that there is no time restriction if the taxpayer is using their own deposited funds and they have filed a tax return.

How to become a tax pooling intermediary

A person that wants to act as a tax pooling intermediary must first get IR's approval. The person may only apply to be a tax pooling intermediary if they are fit to apply. This means the person (or officer or principal) must not be a discharged or un-discharged bankrupt; nor have been convicted of an offence involving dishonesty; and must be eligible to be a company director.[5]

[5] Tax Administration Act 1994, section 15R.

Although IR is required to approve tax pooling intermediaries, it is under no obligation to oversee or audit the operation of tax pooling accounts and is not liable for any loss suffered by the taxpayer if the account is not properly operated.[6]

In approving tax pooling intermediaries IR must be satisfied that the applicant can operate the tax pooling account correctly and will operate systems that will allow it to make payments and provide information in the format required by IR.[7] This means IR must be satisfied that the applicant has the requisite systems in place to protect personal information and payment details, which are obtained in the course of running the tax pooling account, and to keep a record of each taxpayer's balance in the account.[8]

In their application the prospective intermediary must undertake to inform the taxpayer, before acting as intermediary for a taxpayer, of IR's role in relation to tax pooling and that it is fit to operate the tax pooling account using the appropriate system, outlined above.[9]

The intermediary must also confirm to IR that it will establish a trust account into which it will pay the amounts received in its role as intermediary. The amounts paid by taxpayers are held on trust by the intermediary until they are transferred out of the pool, whether this is to another IR account or refunded to the taxpayer.

Ceasing to be a tax pooling intermediary

Although the intermediary may wind up the account at their discretion at any time, IR only has the power to require an intermediary to wind up their tax pooling account if the intermediary does not meet certain conditions.

IR may require the intermediary to wind up its tax pooling account if:

- The tax pooling account has gone into deficit
- The intermediary's actions are preventing a taxpayer from effectively managing their liabilities to pay provisional tax and UOMI
- The intermediary has been put into liquidation or receivership
- Fewer than 100 taxpayers are using the pooling account or are likely to be using the pooling account
- The intermediary has breached any of their obligations to establish and maintain a tax pooling or no longer meet the requirements to be fit to operate a tax pooling account (as outlined above).

IR may require the pooling intermediary to be wound up immediately or may set a future date for the wind up.

On the winding up of a tax pooling account, IR may refund the balance of the account to the former holder of the account (i.e. the tax pooling intermediary) or apply to the courts for directions on the disposal of the balance of the account.[10]

[6] Tax Administration Act 1994, section 15P.

[7] Tax Administration Act 1994, section 15S(2).

[8] Tax Administration Act 1994, section 15S(1)(b).

[9] Tax Administration Act 1994, section 15S(1)(d).

[10] Tax Administration Act 1994, section 15T(4).

Key players in the tax pooling industry

The number of intermediaries has grown since tax pooling was first introduced. It is expected that further players will continue to enter the market.

Currently, there are six tax pooling intermediaries approved by the IR. They are:

- Tax Management New Zealand Ltd (TMNZ)
- Tax Pooling Solutions Ltd (TPS)
- Provisional Tax Finance Ltd (PTF)
- Electronic Tax Exchange Ltd (ETX)
- The New Zealand Tax Trading Company Ltd (NZTTC)
- Bailey Ingham.

Five of the intermediaries operate as companies and they appear to only provide tax pooling services. The majority of the intermediaries have executive team members that have had previous experience in tax or in banking and finance.

Transactions offered by the pooling intermediaries

The following table outlines the transactions provided by each intermediary:

Service	TMNZ	NZTTC	PTF	TPS	ETX
Deposit	Yes	Yes	Yes*	Yes *	Yes*
Sale/Purchase	Yes	Yes	Yes	Yes	Yes
Finance	Yes	Yes	Yes	Yes	"Coming soon"
Swap	Yes	No	Yes	No	No

* These intermediaries offer this service but do not separately market it.

The transactions provided are briefly explained below.

Tax Deposit

Tax deposit, while marketed as a separate service by some of the intermediaries, is the key initial step that taxpayers must undertake if they wish to sell their excess tax payments, as only funds deposited with an intermediary may be sold.

In effect tax deposits are tax payments made into an intermediary's tax pool account instead of to IR directly. The taxpayer can then request these funds to be transferred from the tax pooling account to their own IR accounts and sell any surplus funds through the tax pool.

The benefit of the deposit scheme is the flexibility the taxpayer has over their provisional tax obligations, and the access to more preferential interest rates as compared with UOMI. An additional benefit of depositing funds with an intermediary is that the taxpayer is able to request a refund of their overpayment at any time, compared to having to file a tax return before obtaining a refund of any overpaid tax from IR.

Tax Sale / Purchase

Tax sales and purchases were the key transaction types envisaged by IR when tax pooling was first introduced. That is, the ability for a taxpayer who has underpaid their tax for the year to purchase the tax from a taxpayer who has overpaid.

In summary, a purchase will occur when the taxpayer has underpaid their provisional tax liability as the taxpayer benefits through reducing the interest payable on the underpaid tax liability. Taxpayers may also purchase tax if they have underpaid other types of tax (including income tax, GST, FBT and PAYE) under certain circumstances.

A sale will occur when the taxpayer has overpaid their provisional tax liability as the taxpayer benefits by receiving a higher rate of interest on their overpayment compared to 1.75% offered by IR.

Tax Finance

When a tax pooling intermediary finances a tax payment, it effectively allows a taxpayer to select a date (or period) after the provisional tax due date to pay their provisional tax instalment. The taxpayer pays a finance charge upfront and the intermediary makes a deposit equal to the amount financed into the tax pooling account. That deposit is funded from intermediaries own funds or via lines of credit established with other financiers for that purposes. On the agreed date the taxpayer pays the intermediary the final tax due and the intermediary transfers the tax deposit into the taxpayers IR account.

Tax Swap

Where a taxpayer has overpaid at one provisional tax date and underpaid at another, the tax pool will allow them to swap the payments between provisional tax dates or with another taxpayer in order to even the payments out across the different dates. This enables the taxpayer to offset interest charges and either increase or reduce the amount of interest payable/receivable.

The ability to use tax swap depends on whether the taxpayer has been depositing their tax payments into a tax pooling account, and whether there is tax available at those dates. This is essentially a combination of a sale and a purchase.