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Uncertainty in corporate tax

Tax Forecast for 2016 to 2020 (comparison with previous forecast from February 2016 and General Government budget for 2017 -2019)

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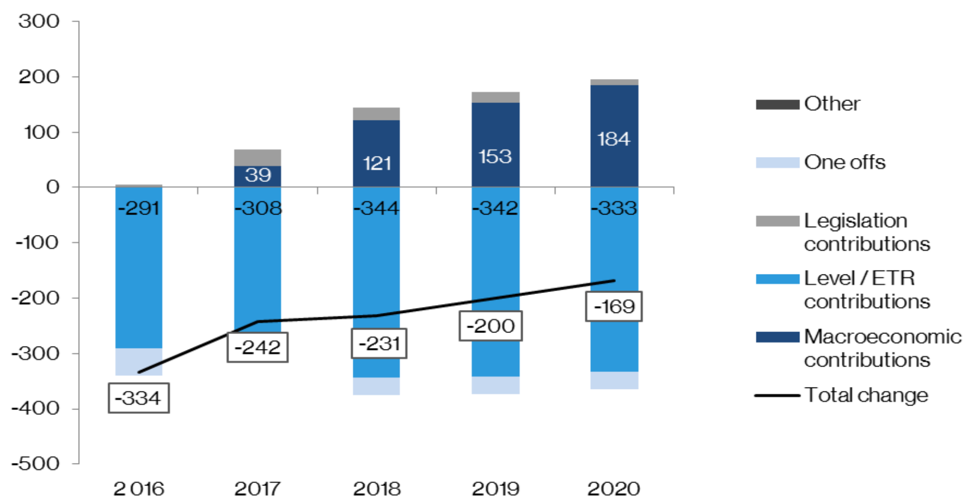
Strong pace of economic expansion, robust labour market and stable effectiveness of VAT collection are offset by negative development of corporate income tax (CIT). Therefore we decrease tax revenues forecast by EUR -242 million for 2017 (-0.3 % GDP), EUR -231 million for 2018 (-0.3 % GDP), EUR -200 million for 2019 (-0.2 % GDP), EUR -169 million for 2020 (-0.2 % GDP) compared to our prediction from February. Two main reasons caused deterioration of CIT revenues. First explains the decline in profitability of companies according to individual tax returns. Secondly unobserved one-offs in 2015 misled forecast of CIT revenues for 2016.

Lower tax revenues for 2017 to 2020

Based on actual collection of tax revenues we **decrease expected general government (GG) revenue[1] by EUR 169 to 242 million for 2017 to 2020.** The update of tax revenues by EUR -334 million[2] for 2016 is based on recent information received from processed individual CIT tax returns. Significant amount of corporations postponed submission of tax return until June and September which creates uncertainty for estimate of CIT revenues. Unexpected development of CIT is partly offset by positive macroeconomic development, mainly by labour market and domestic demand.

Figure 1: Change of GG tax revenue forecast compared to February 2017[3] (EUR million)



Source: IFP, UloziskoIFP

Labour market and domestic demand as main drivers of tax revenues

The revised macroeconomic forecast increases tax revenues in 2017 – 2020. Ongoing improvements in labour market will increase PIT revenues and SSC. Robust household consumption, and improved development of investment and general government

[1] Decrease relates only to tax revenues.
[2] The difference compared to EDP Notification Tables from April 2017 corresponds to the level of EUR 299 million (0.37 % GDP), of which the CIT is EUR 285 million (0.35 % GDP).
[3] Including social security contributions (SSC) – sum of social insurance contributions (SIC) and health insurance contributions (HIC). Taxes are categorized as follows: PIT = Personal income tax, CIT=corporate income tax, VAT=Value added tax , ED = excise duty, ED MO = excise duty on mineral oil.

intermediate consumption (at the end of forecasted period) explain higher VAT revenues. Lower interest rate and slower growth of deposits negatively affects withholding tax and special levy in financial sector.

Table 1: Update of main macro indicators, June 2017 vs. February 201 7

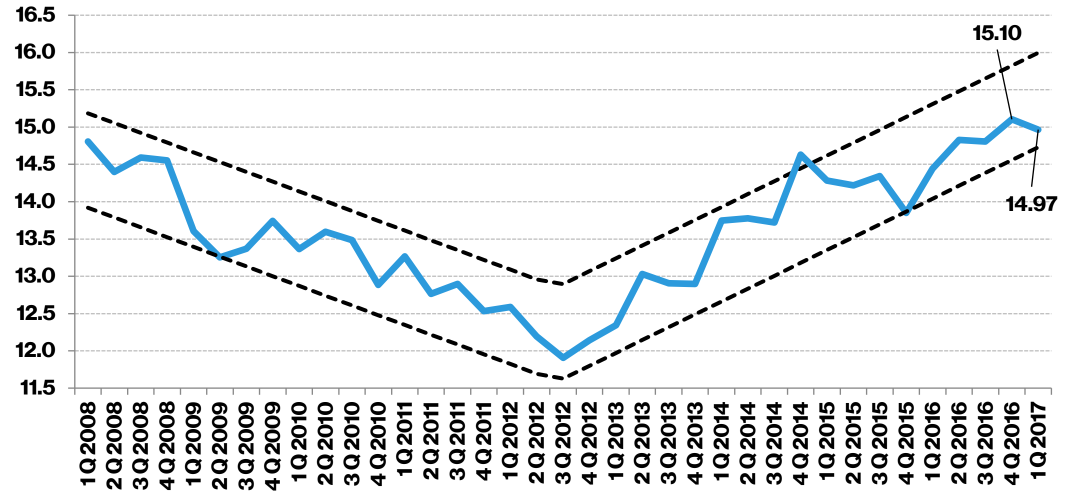
	growth in %					change compared to Februrary (in pp)				
	2016	2017	2018	2019	2020	2016	2017	2018	2019	2020
GDP, real	3.3	3.3	4.2	4.4	3.9	-0.1	0.0	0.2	0.0	0.1
GDP, nominal	2.9	4.5	5.8	6.4	6.0	-0.1	0.1	0.2	0.0	0.1
Real household consumption	2.9	3.1	2.8	2.9	2.9	0.2	0.7	0.0	0.0	0.0
Nominal household consumption,	2.5	4.5	4.5	4.8	5.1	0.3	0.9	0.0	0.0	-0.1
Adjusted base for VAT	-1.0	4.1	4.1	4.7	4.8	-0.3	0.7	0.6	0.3	0.1
Wage base	5.8	5.5	5.8	5.8	6.3	0.3	0.0	0.3	0.1	0.2
Stock of deposit	7.6	5.0	5.9	6.0	6.1	-0.2	-1.7	0.0	-0.7	0.0

Source: IFP, ***UloziskoIFP***

Effectiveness of tax collection

Tax collection is negatively affected by unexpected lower revenue from CIT (for more information see below or BOX 1). We expect improved PIT and SSC collection. Effectiveness of VAT collection, measured by effective tax rate, will remain stable during 2017 - 2020.

Figure 2.: VAT Effective Tax Rate[4]



Source: IFP, ***UloziskoIFP***

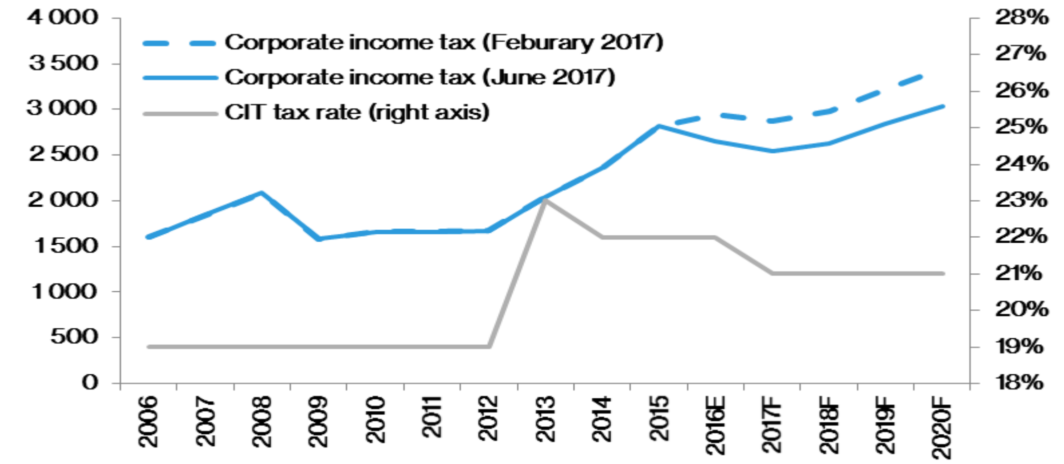
Accumulation of unexpected factors decreases CIT revenue

Growth of corporate profitability for 2016 (6 %) reported by Statistical office of Slovak Republic (SO SR) is above our expectation (5 %)[5] from February. This would imply further growth of CIT revenue for 2016. However, actual CIT settlement from January 2017 to May 2017, which belongs to accrual year 2016, is lower by EUR 155 million compared to previous forecast. Contradiction between corporate profit condition reported by SO SR and tax liability was analysed using processed CIT returns. They indicate counterintuitive decline of profitability of companies for 2016 (BOX 1).

[4] Effective Tax Rate is a “simplified measure” of effectiveness of tax collection. It is calculated as share of adjusted revenues from tax returns to corresponding modified macro tax base. VAT revenues are adjusted for one-offs and legislative changes. Modified macro tax base consist of final consumption liable to VAT, intermediate consumption and gross fixed capital formation of general government subject to VAT. ETR is calculated on quarterly basis, seasonally adjusted.

[5] We expected profitability of companies (adjusted by one-offs which are irrelevant for final tax liability) to be 10.1 % in February 2017. Real adjusted profitability of companies is 11.2 % in June 2017.

Figure 3: CIT revenues (ESA2010, EUR million)



Source: IFP, UloziskoIFP

Significant amount of postponed tax returns creates uncertainty about CIT revenues. Many corporations extended submitting their tax returns to June and September[6] and we have no information about their tax liability for 2016 (in September when almost all tax returns for 2016 are submitted our forecast would be more reliable). Based on already processed tax returns, tax liability of Selected Big Corporations[7] (information from Financial Administration) and our expectation about positive settlements of companies with extended tax returns, we decrease CIT revenues by EUR 285 million for 2016. This decline has negative consequences on CIT forecast for following years.

BOX 1: What factors misled forecast of corporate income tax?

The forecast of CIT has been misguided by several factors. The first one explains contradictory development of corporate profit when comparing the figures from processed tax returns with data reported by Statistical Office of the Slovak republic. Next, part of a tax liability paid in 2015 can be considered as one-off due to increased drawdown of the EU funds and legislation changes focused to improve payment discipline of corporations. Furthermore, data of industry sector implies increased investment activity which is considered as a positive risk for future CIT revenues.

The reduction (EUR 285 million) of accrued CIT revenue for 2016 is a negative surprise considering the current economy growth (3.3 %) and growing corporate profitability. In particular, Statistical office of Slovak republic (SO SR) reported 6 %[8] corporate profit growth (36.6 % in financial and 1.1 % in non-financial sector) for 2016[9]. The final corporate profitability for 2016 will be reported at the end of June 2017[10] and might be further revised.

The CIT forecast for current year uses the aggregated corporate profit reported by SO SR as main driver of the current year tax revenue. The rationale is simple, as CIT is paid from profit. Furthermore, reported profit data already include potential attempts of tax payers to reduce their tax liability. However, this approach has the following weaknesses:

[6] 71 thousands of corporations extended their tax return for the tax period for 2014, 83 thousands for 2015 and 86 thousands for 2016.
[7] Include corporations with turnover higher than EUR 40 million (circa 770 companies).
[8] Profitability growth 6 % is unadjusted by one-offs. Adjusted profitability growth reaches 11 % from which nonfinancial corporations rises by 6.8 % and financial sector by 36.6 %.
[9] Data are reported by Statistical office of Slovak republic. Available at National bank of Slovakia website.
[10] National accounts data are revised according to ESA2010 methodology.

- **One can observe the growth of profit due to a loss reduction.** However, tax is paid only from the profit. For example, there is no tax to be paid by corporation, which reduced its loss from EUR 1 000 to EUR 100. However, we can observe this improvement in aggregated profit growth.

- Corporate profit or loss is for the purpose of setting tax base further **modified by additions and deductions according** to current tax legislation (accounting profit or loss is modified with non-taxable income and expenses).

- **Tax base is modified by carry-forward losses.** This fact is crucial in periods when significant amount of corporations „switch“ from loss to profit. This „switch“ is fully incorporated in the growth of profit. However, tax revenue is lower due to employment of carry-forward losses from previous tax periods.

Due to carry-forward loss effect we regularly monitor volume of profits and losses at the level of the largest corporations in the economy according to the data reported by SO SR.

Profitability is the main cause that misled CIT forecast:

Annual reduction of tax revenue was analysed via data sample of 138 140[11] corporations (Table 1). Profitability in this data sample decreased by 4.4 % annually. Contrariwise, reported profitability by SO SR shows 6 % growth. The growth of profitability reported by SO SR serves as a main input for CIT forecast. Currently, it is not specifically clear what causes these profit discrepancies.

Tax is paid from corporate profit (not loss). There is the 2.2 % annual reduction of profit (profit-making corporations only) while related tax revenue decreased by 10.4 % (EUR 142 million, Table 1).

Year-on-year switch of loss-making corporations to profit reduces tax revenue by EUR 31 million due to employment of carry-forward loss.

Table 2: Corporate profit/loss and tax revenue (EUR million)

Tax Period	Profit	Tax	Loss	Tax	Loss 2015 Profit 2016	Tax	Profit 2015 Loss 2016	Tax	Profit &Loss	Tax
2015	6 733	1 360	-1 288	28	-572	**26**	605	**82**	5 478	1 496
2016	6 588	1 218	-1 372	26	598	**55**	-579	**22**	5 235	1 321
y-o-y	**-2,2 %**	**-10,4 %**	6,4 %	-6,5 %	204 %	129 %	-196 %	-73,4 %	-4,4 %	-11,6 %
Number of firms	69 532		33 882		18 166		16 560		138 140	

Source: individual tax returns, IFP calculations

CIT forecast was partially misled by one-off factors increasing tax revenue in 2015 but reducing tax liability in 2016:

Discrepancy (Table 1) between reduction in tax liability (-10.4 %) and profit (-2.2 %) is given by combination of one-off additions and deductions when setting the tax base (Table 2). During 2015, the profit of 138 thousands corporations in analysed sample was increased by EUR 782 million. On the contrary, their profit was decreased by EUR 12 million (-102 %) in 2016.

[11] Corporations, that issued tax returns for 2016 tax period before 16th of June 2017 and issued tax returns in 2015 as well. Analysed sample includes approximately 60 % of corporations that are expected to issue tax returns for 2016 tax period.

Table 3: Additions and deductions[12] (EUR million)

Tax period	Sum of additions	Sum of deductions	Difference (+/-)
2015	11 373	10 591	782
2016	11 632	11 645	-12
y-o-y	2,3 %	10 %	-102 %

Source: individual tax returns, IFP calculations

One-off additions in 2015 that switched to deductions in 2016 can be attributed especially to:

1) **Selected expenses** (agency services, advisory or legal services, costs for lease of tangible and intangible assets) **are considered as taxable expense only when settled (paid) as of 2015.** This legislation change pursues the improvement of payment discipline. In 2015, these (not paid) expenses were considered as non-taxable expense for the first time. When reimbursed in 2016, they became taxable expenses. One can observe EUR 145 million (353 %) increase of these expenses across the whole economy.

Table 4: Taxable and non-taxable expenses due to settlement (EUR million)

Tax period	Sum of unsettled transactions in given tax period	Sum of settled transactions in given tax period	Sum considered as taxable expenses
2014	60	36	**60**
2015	174	32	**32**
2016	211	145	**145**

Source: individual tax returns, IFP calculations

2) Similarly, as of 2015, non-taxable expenses are also creation of reserves for unpaid supplies or services, and legal services related to processing of tax return or financial statement.

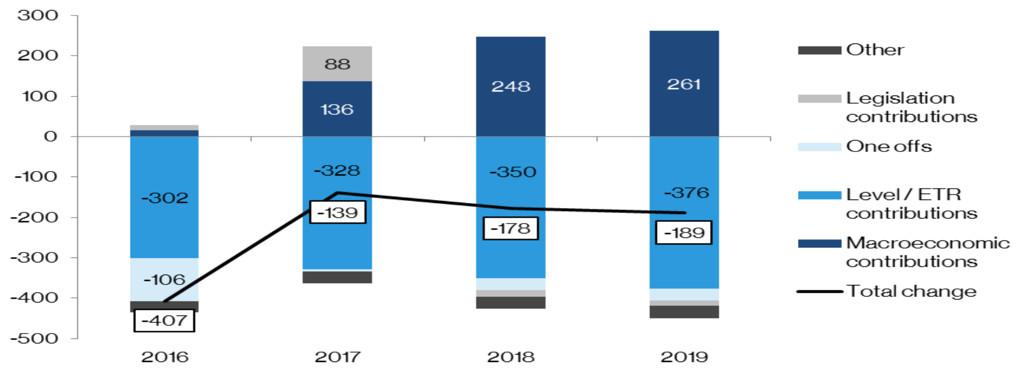
3) Annual growth of received dividends in banking sector. Received dividends at the level of legal entity increases the accounting profit. However, for tax purposes they are considered as income that is not subject to CIT.

Moreover, industry sector records EUR 73 million increase of difference between tax and accounting depreciation. Faster growth of tax depreciation can be attributed only to growing investments within the sector that might positively influence tax revenue in future.

Comparison with GG budget for 2017 - 2019

We decrease expected GG revenues by EUR 407 to 139 million compared to approved GG budget for 2017-2019.

Figure 4: Comparison of actual forecast with to GG budget for 2017 - 2019 (Eur million)



zdroj: IFP, UloziskoIFP

[12] Adjusted for selected companies whose additions and deductions contain "unusual" values "deforming" observed developments at the level of the economy.

The Ministry of Finance (MoF) prepares and publishes forecasts of tax and social contribution revenues in accordance with the constitutional Fiscal Responsibility Act. The forecast of tax and social contributions revenues was discussed at the meeting of **The Tax Revenue Forecast Committee on 26th June 2017. The forecast was evaluated as realistic by every member of the Committee (KRRZ, NBS, Infostat, ČSOB, SLSP, Tatrabanka a UniCreditBank)[13].**

More about tax forecast, including materials and relevant documents can be found on the IFP website in the section "Economic forecasts ⇨ tax forecast".

This documents presents the views of its authors and of the Institute for Financial Policy which do not necessarily reflects the official views of the Ministry of Finance of the Slovak republic. The analyses prepared by Institute for Financial Policy (IFP) are published to stimulate and enhance professional and general discussion on various economic topics. Therefore, any quotations of this text should refer to the IFP (and not the MFSR) as to the authors of these views.

Detailed information about tax forecast, decomposition of contributions and source data to each figure and table in this policy brief can be found on UloziskoIFP

[13] NBS=National Bank of Slovakia, KRRZ=Council for Budget Responsibility and Infostat are public organizations. SLSP, Tatrabanka, UnicreditBank and ČSOB are private banks.