Recommendations for improving the tax treatment of inventory write-offs

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Executive summary

- The current tax treatment of inventory write-offs due to natural and production losses heavily favours government over companies' interests
- At present, companies can often not write off losses that cannot be physically inspected or face large costs for storage until inspection while being subject to risks if the Revenue Service does not accept their declared losses
- A more balanced approach is needed that is more business-friendly while satisfying the government's interests, especially in combatting tax evasion
- We recommend transition to the international standard system, where companies can write off all losses according to accounting standards and the Revenue Service will conduct plausibility checks of declared losses
- This system carries some fiscal risks but would significantly improve the situation for businesses, especially in high-loss industries and hence the business climate
- Although fiscal risks especially exist during abrupt transition, no real alternative exists to an abrupt system change

Structure

1. Concepts: Inventory write-offs and their role in taxation
2. Current tax treatment in Georgia
3. Two alternative approaches
   I. Rigid quotas for inventory write-offs
   II. Full write-off
4. Recommendations for Georgia

1. Inventory write-offs due to natural and production losses

- Natural and production losses result in the sales of a company being less in weight or unit count than the purchases of inputs/raw material
  - Natural losses:
    - Losses due to natural processes or factors
    - Examples: Rotten fruit, evaporation of humidity
  - Production losses:
    - Loss of material (weight) during a production process in which inputs are transformed into a final product
    - Examples: Peeled fruit, wood carving, normal production errors
- Such losses need to be written off the inventory of the company to ensure that the inventory matches the physical stocks of the company
- **Challenge for taxation:** Ascertaining inventory write-offs occurred due to losses and not due to black sales or own consumption

Stakeholder interests

Stakeholder	Criteria	Explanation
Companies	Effective taxation	Taxes should reflect full extent of real losses (effective tax rate = statutory tax rate)
	Compliance costs	Tax procedures and administration should not be overtly complex and costly
Fiscal institutions of government	Fiscal revenues	Tax evasion should be limited as much as possible
	Capacity requirements	Capacity of the tax authority (Revenue Service, RS) should not be overstretched

- **Ideal tax treatment: Stakeholders' interests satisfied and balanced**
- **Importance of companies' concerns: Business-friendly tax treatment improves business climate, contributes to investment and growth**

2. Current tax treatment in Georgia

Corporate income tax (CIT)

- For 13 products, quotas exist determining maximum acceptable losses
- For all other products, RS must be notified (GEL 20 per notification) and consent, if taxpayer wants to write off losses from the inventory
- RS in most cases requires a physical inspection of the loss
- RS conducts official inventories during tax audits:
  i. If physical stocks differs from accounting ledgers or products were written off without RS consent: Difference is regarded as equated payment for CIT (a hidden profit distribution)
  ii. If in addition to i. the company's financial result is negative or 2 other tax violations have been discovered: RS can apply indirect methods (estimations) to define taxable base

Value added tax (VAT)

- VAT credit is received for purchased goods/materials
- If write-off is not accepted by RS, goods determined to be sold, VAT due on sales

➢ Issues closely related to CIT treatment

➢ For both taxes, actual practice sometimes deviates from rules described here

Current system: Effect on stakeholders‘ interests

Companies

Effective taxation

- Many losses cannot be inspected (e.g. evaporation), hence cannot be deducted
- Products subject to quotas: Losses above quota not deductible
- Higher effective CIT rate for companies with high natural/production losses

Compliance costs

- Costs of storage and inspections may exceed tax savings
- Risks of judicial consequences (indirect method for tax determination, criminal prosecution for offences exceeding GEL 100 thsd)

Fiscal institutions

Fiscal revenues

- Tax evasion minimised
- Scope for widespread application of indirect method increases tax revenue
- Impossibility to write off actual losses leads to exaggerated tax revenues

Capacity requirements

- Very little requirements due to quotas and emphasis on physical counting

Effects of current tax treatment

Stakeholder interests		Effect
Companies	Effective taxation	- -
	Compliance costs	- -
Fiscal institutions	Fiscal revenues	+ +
	Capacity requirements	+ +

- **The current tax treatment puts too much emphasis on inspection and focuses exclusively on fiscal objectives, neglecting business interests**
- We see two key reasons for this practice
  - Legacy: Historic Soviet practice prescribed very limited amounts of natural or production losses due to widespread theft of personnel
  - Limited technical capacities of the RS to understand a multiplicity of complex production processes of companies
- Likely to have negative effect on business climate & investment, especially in industries with large natural and production losses
- **Is there a more balanced approach with better balance of stakeholder interests?**

3. Two alternative approaches

i. **Rigid quotas for inventory write-offs**
   - RS sets quota limits for a wide range, if not all, specific products
   - Companies can write off losses up to quota limits without further justification
   - In operation in Georgia right now for few selected products
   - This approach was pursued in Georgia since 2009 but is effectively suspended
   - In Germany, such quotas exist for selected excisable goods

ii. **Full write-off: Companies write off full losses, plausibility checks by RS**
   - System is based on cooperation between RS and companies
   - Companies write off natural and production losses based on international accounting standards, provide a sound documentation of losses
   - RS checks plausibility (cameral check) of these losses based on database allowing comparison of write-offs for each product and sector of industry
   - If plausibility check indicates high declared losses: Tax audit on site checking respective documentation concerning write-offs (substance over form!)
   - This approach is used by most EU countries, exceptions exist for excisable goods

i. Rigid quotas: Effect on stakeholder interests

Effect on stakeholder interests

Companies

Effective taxation

- Does not allow write-off of losses if they exceed quota
- Still not a “normal” approach to CIT as a profit tax

Compliance costs

- Very low, as no documentation/storage of losses is needed, no further risks for companies

Fiscal institutions

Fiscal revenues

- Fiscal risks would be limited and highly controllable

Capacity requirements

- Very easy to operate, no more need for physical inspections (easy supervision)
- Quotas for many more products would make excessive demands on capacity
  - Requires technical expertise not present at the RS, lobbyism must be avoided
  - Loss rates change over time and across countries

i. Rigid quotas: Summary

Effect on stakeholder interests, summary

Stakeholder interests		Effect
Companies	Effective taxation	-
	Compliance costs	+ +
Fiscal institutions	Fiscal revenues	+
	Capacity requirements	- -

- Would entail extension of quotas approach from 12 products to all or most products
- Would improve compliance costs for companies
- Easy to operate for companies and the RS
- Limited and controllable fiscal risks
- However, even with well-defined quotas, the system cannot take into account specific circumstances of companies leading to higher losses and write-offs
- **Crucial: Definition and continuous revision of a vast number of product-specific quotas would exceed the capacities of the RS**

ii. Full write-off: Effect on stakeholder interests

Companies

Effective taxation

- As all losses can be written off, effective tax rate will be the same as statutory rate
- No discrimination against companies with higher/not countable losses

Compliance costs

- Moderate, companies must continuously document losses and explain them to RS
- Documentation partly required by new accounting standards anyway

Fiscal institutions

Fiscal revenues

- Some decrease: Legitimate write-offs, less use of indirect method, some tax evasion
- First calculation: Revenue decrease due to more legitimate write-offs in 2018 probably below GEL 24 m (0.06% of GDP) => Total effect on fiscal revenues probably limited

Capacity requirements

- Moderate, RS must be able to evaluate plausibility of stated losses through
  - Internal experience and expertise on industry sectors/products and/or
  - An up-to-date database allowing cross-company checks of loss rates

ii. Full write-off: Summary

Stakeholder	Criteria	Effect
Companies	Effective taxation	+ +
	Compliance costs	+
Fiscal institutions	Fiscal revenues	-
	Capacity requirements	+

- Significant system change from a control philosophy to a system involving trust and cooperation between companies and the RS
- Better for companies: In line with standard interpretation of sensible CIT, moderate compliance costs
- Lower fiscal revenues likely, but will probably remain limited
- Capacity requirements on RS are standard for a tax administration
- **Better balancing of interests of companies and fiscal institutions of government**
- **International standard approach likely to have positive effect on business climate**

4. Comparison of systems

Stakeholder	Criteria	Present system	Quotas	Full write-off
Companies	Effective taxation	- -	-	+ +
	Compliance costs	- -	+ +	+
Fiscal institutions	Fiscal revenues	+ +	+	-
	Capacity requirements	+ +	- -	+

Recommendation

- **The full write-off approach appears to best balance stakeholder interests**
- This approach is internationally common and applied e.g. by most EU countries
- It is based on balance of cooperation between RS and companies and plausibility checks / audits where indicated
- Positive effects on business climate and investments should outweigh fiscal risks
- **The main challenge will be to master the transition to the new system, as RS experience and a database will take time to develop**
- **For selected excisable products, quotas can be retained or drawn up if necessary**

Recommendations for the transition to the new system

Problem:

- Full write-off system creates possibility of tax evasion if RS lacks capacity to properly validate the plausibility of declared losses
- Capacity buildup (expertise of staff in different industries and a database of losses allowing intra-industry company comparisons) can only occur if full write-off is possible and not under the current, inspection-based system

Possible approach

- In theory, a mixed system of product-specific quotas and full write-off is possible for the transition period
- Such a system was recommended by USAID/G4G report
- RS only checks plausibility of losses above the quotas, reduced number of cases
- However, the effort to define a vast number of quotas would outweigh any benefit

Conclusion

- **No possibility for gradual „phasing in“ of the new system. Hence, some loss of tax revenue due to evasion must be accepted and planned for in the transition phase**

Implementing a system of full write-off

Key steps towards the new system:

- Legislation change of the relevant passages in the Tax Code of Georgia
- RS must change philosophy concerning inventory-write-offs:
  - Away from assuming tax evasion whenever the situation is not fully clear
  - Towards generally accepting statements by companies, trying to understand the specific situations/processes of companies
- Building up a dynamically evolving database allowing comparison of loss rates across companies in similar industries or producing the same products, ideally automatically fed from electronic tax declarations
  - This database would serve as the primary tool for determining whether companies *possibly* declared too much losses
- Gradual building up of industry specific expertise by RS staff (experts for specific sectors/industries), necessary especially for tax audits
- Development of a solid practice of documentation of losses by companies wherever possible (e.g. a loss book for products thrown away, with photos or solid explanation of how production losses arise)

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Annex: Significance of potential tax revenue losses (I)

- CIT revenues in Georgia in 2018 (2018 budget):
  - GEL 630 m; 1.6% of GDP
- Recommended change can reduce tax revenues in three ways:
  1. More (legitimate) **inventory write-offs** due to natural and production losses
  2. Less application of **indirect method** for tax burden determination
  3. Scope for more **tax evasion**

- A full estimation of the fiscal effect of the proposed change is not possible now
  - Data for increased tax take due to indirect method application necessary
  - Possible tax evasion depends on buildup of capacity at the RS
- Estimate is possible for legitimate inventory write-offs after the proposed change
  - Does not take into account how many inventory write-offs occur already
  - Hence a very high estimate, see next slide for calculation

➢ **2018 CIT revenue decrease due to legitimate inventory write-offs probably below GEL 24.3 m, 0.06% of GDP**

➢ **Total effect on CIT revenues will probably be very limited**

Annex: Significance of potential tax revenue losses (II)

Total possible CIT revenue loss due to additional inventory write-offs, 2018*

Line #	Formula	Item	Company type: Producers	Company type: Traders
1		CIT revenues (2018 budget), GEL m	630.0	
2		Rate of inventory write-offs*	4.0%	
3		Ratio profits/turnover	25.0%	
4		Ratio input/turnover	30.0%	80.0%
5		Share of producers/traders in CIT revenues**	35%	17%
6	2*4	Ratio inventory write-offs/turnover	1.2%	3.2%
7	6/3	Ratio inventory write-offs/profits	4.8%	12.8%
8	1*5*7	Possible CIT revenue loss per company type, GEL m	10.6	13.7
9		**Total possible CIT revenue loss, GEL m**	**24.3**	
10		***... % of GDP***	***0.06%***	
11		*2018 GDP forecast used in budget, GEL bn*	*40.4*	

*Source: Own calculation, * Inventory write-offs due to natural or production losses*

***Estimated from shares of industry + 50% of agriculture and trading services in 2016 private sector GVA*

- Rough estimate using expert‘s estimation of average industry values (lines 2-5)
- Important: Counterfactual assumption that currently no inventory write-offs accepted

- **Result: Possible decrease of CIT revenues by GEL 24.3 m, 0.06% of GDP in 2018**
- **Minor effect on budget balance likely even with evasion/indirect method channels**