Tax treatment of inventory write-offs: Building a database and expertise at the tax authority

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Introduction

- In PB/07/2017, GET Georgia has made recommendations for reforming the tax treatment of inventory write-offs towards a more business-friendly approach
- Proposed reforms:
  - Generally accepting self-reported write-offs of companies
  - Plausibility checks of reported write-offs using a database and industry-specific experience at the Revenue Service of Georgia (RS)
- Here: A deeper look at how to build the database and experience at the RS

<u>Structure</u>

1. Inventory write-offs and their tax treatment
2. Requirements and use of a database
3. Information sources for a database
4. Building expertise at the tax authority

1. Inventory write-offs

- 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

Current tax treatment and GET recommendations

- Currently, inventory write-offs due to natural or production losses are only accepted by the RS (for VAT and CIT alike) if:
  - They satisfy regulatory quotas on the losses, established for 13 products only
  - Losses have been physically inspected by RS inspectors
- GET has recommended to move to internationally common system (PB/07/2017)
  - Allow full write-off by companies in principle
  - Only companies with implausibly high write-offs get audited

- Challenge: How can the RS gather experience and data in determining what are implausibly high write-offs?
- GET recommendations
  - i. Building a company database for comparison of loss rates within sectors
  - ii. Gradual building up of industry-specific expertise at the RS
  - iii. Development of a solid practice of documentation of losses by companies
- This PB focuses on recommendations for the RS on i. and ii.

2. Requirements of a database

- Database should satisfy two main requirements
  - Adequate content: Enable plausibility checks of self-reported inventory write-offs between similar companies through the RS
  - Ease of administration: No unnecessary burdens on companies, compatibility with future architecture of tax administration

Adequate content	Ease of administration

• Companies sorted by very specific sub-sector or main output produced
  • RS internal classification, if applicable
  • NACE (write-offs per company)
  • HS (write offs per good produced)
• Inventory write-offs due to natural & production losses
  • Per company (simple)
  • Per product (better plausibility checks, but more reporting burden)
• At discretion of companies: Explanation of loss processes
	• Avoid unnecessary, additional and complex reporting requirements for companiea (also relevant for business climate rankings)
	• Possibility to integrate database and usage into a holistic risk-based tax administration and auditing approach along with a single case management system at the RS

Use of database in the short run

Determine audit needs based on plausibility of inventory write-offs

- There is presently no fully integrated process of audit decisions
- Hence, database only informs those audit decisions made for establishing plausibility of inventory write-offs

Companies

Information on inventory write-offs

➢ *Key issue: Reporting requirements*

Database

Comparison of write-off magnitudes across comparable companies

Outliers with high write-offs are **audited according to decision rules**

➢ *Need appropriate decision rules for audits*

Audits

Verification whether write-offs are justified or not

➢ Substance over form: Checking company own documentation, applying logical thinking to verify plausibility of losses

Feedback

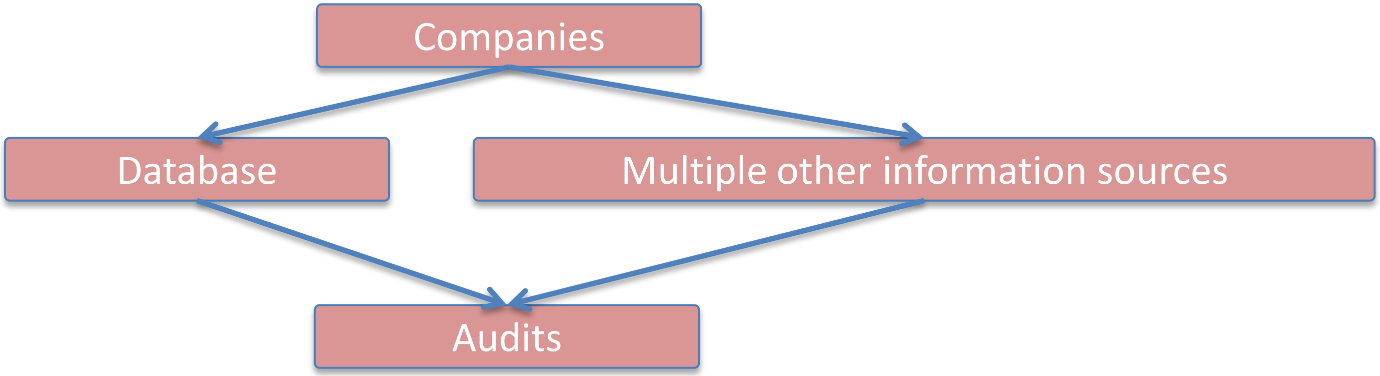
- Established loss processes
- Compliance

Use of database in long run

Comprehensive risk-based tax administration should govern all audit decisions

- Risk-based auditing generally involves complex decision rules involving criteria and data from multiple sources
- Database of inventory write-off information should constitute one of many sources in the integrated process

Complex decision rules using all available information



- Unitary case management required (TA towards this objective is in process)
- Data mining techniques ensure general compatibility of a purpose-built database with comprehensive risk-based tax administration of the future

➢ Long term aim is to ensure low audit, low evasion equilibrium through using optimal decision rules and rich data

Decision rules for audits

- Decision rules for audits can be
  - Discretionary: Taken by RS staff at their discretion
  - Simple rules: E.g. thresholds for deviation of write-offs from industry average
  - Algorithm-based (more complex, computer based decisions)

- Developing algorithm-based decisions is complex and works best if the information sources are much richer than just inventory write-offs

➢ Implement in future as part of a comprehensive risk-based tax audit approach

- Discretion problematic: Corruption risks, experience requirements of tax officials

➢ Short-run: Combine discretion and simple rules (limited discretion)

➢ Relevant cases should be identified by
  - Relative magnitude of inventory write-offs vs. comparable companies
  - Absolute magnitude of write-offs (focus on cases with higher value)
  - Ensuring adequate audit probability also for smaller companies in initial period to ensure compliance while first data is gathered

3. Information sources for the database

- Information source should satisfy objectives identified previously
  - Adequate content
  - Ease of administration (no unnecessary burden for companies)
- Feasible information sources would be:
  - Audited financial accounts (as electronically submitted to SARAS as per the new accounting rules)
  - A separate report to the RS submitted by all companies
  - Implementation of the OECD‘s „Standard Audit File for Tax“ (SAF-T)

➢ We will look at these options individually

➢ It is crucial to ensure that the information sources contain properly structured information to permit the required plausibility checks

➢ Data must be collected from *all* companies that produce goods, not just those with high losses, to facilitate cross-company checks

Audited financial accounts

- As per new rules, from 2018, medium to large companies have to electronically submit audited IFRS accounting to SARAS agency
- Small and micro enterprises: Submit accounts from 2020, not audited
- Information to be submitted to SARAS in the new, mandatory reporting forms includes relevant components of inventory write-offs:
  - "Net Gains/(losses) from revaluation and disposal of biological assets"
  - "(Allowance for) / recovery of impairment of other assets"

<u>Conclusions</u>

- ➢ No additional reporting required
- ➢ Sufficient information for comparison across companies possible
- ➢ Insufficient information for comparing losses per type of product
- ➢ It should be ensured that the IFRS-IAS2 standard (concept of „*net realizable value*") is used for determining the magnitude of write-offs
- ➢ As for all information sources, company classification by industry type (e.g. NACE at highest possible detail level) must be added to the database

Separate reporting to the RS

- The RS has already developed a draft form for companies to declare their natural and production losses

Information about natural and production losses

N	produced good		input spent on final product	raw material used for producing 1 unit of final product		actual amount of input spent for producing 1 unit of final product		type of loss generated on input spent during production process: 1.natural 2.production	maximum amount of loss (%)	the basis for determining loss	activiy period of losses	cause of loss
	name	*measurement unit*		*quantity*	*measurement unit*	*quantity*	*measurement unit*					
	1	2	3	4	5	6	7	8	9	10	11	12
1	whire bread	piece	flour	800	gram	795	gram	1	1.5	production practice	during the whole year	*free text: company's explanation*
			yeast	5	gram	5	gram	2				
			water	500	litre	500	litre	2				

- Information by type of product, more detail than in accounting documents
- However, form focuses on general loss processes rather than realised losses
- Additionally, information on the absolute, realised level of production and losses is required for complete plausibility checks

<u>Conclusions</u>

- ➢ Well designed, easy to implement, limited extra burden for companies
- ➢ Some additional information required, could be gathered from tax declarations
- ➢ Should focus on realised losses, not general loss processes (empirical database)

Standard Audit File for Tax

- The OECD has developed the Standard Audit File for Tax (SAF-T) as an e-government tool for easier tax administration
- SAF-T is a comprehensive, structured information exchange from companies electronic accounting to tax authorities
- Includes information far in excess of that required for assessing plausibility of inventory write-offs under analysis here
- Requires that companies use electronic accounting systems
- Widening international use for comprehensive tax administration purposes, e.g. in France, Austria, Poland

Conclusions

- May be an option for a future, comprehensive approach to risk-based auditing, but not a quick fix for improving tax treatment of inventory write-offs
- Demands on companies (extensive electronic accounting) could be too high for smaller Georgian companies in the short run
- However, could only be required for larger companies

Which information source to use?

- SAF-T introduction would be a larger undertaking that needs to be discussed in much wider context
- Both the audited financial accounts (SARAS) and the separate reporting document under construction at the RS are feasible sources for the database

Advantages and disadvantages of the two applicable information sources

	Audited financial accounts (SARAS)	Separate reporting to the RS
+	• No further requirement on companies • Audited information	• Information per product type possible

-	• Only comparison across companies possible
	• Information available only for medium and large companies (unaudited information for small & micro enterprises from 2020)
		• Additional reporting required from companies
		• Need to adapt forms to reflect
		  • Realised values, not general process
		  • Total level of losses and production

➢ Need to decide whether more comprehensive (per product) plausibility check needed (RS reporting) or less burden for companies desired (SARAS documents)

4. Building expertise at the tax authority

- RS staff must build expertise in two key areas
  i. Decision on audits using the new database
  ii. Conducting audits with regard to establishing plausibility of larger inventory write-offs

- Audit decisions
  – Decision rules should help reduce discretion and expertise requirement
  – Should be elaborated in collaboration with TA providers

- Conducting audits
  – Cultural shift: From inspection approach to trust/critical understanding
  – Limit the caseload of audits through adequate decisions/decision rules
  – Auditors should specialise in specific industry branches
  – Need sufficient time to understanding companies, put „substance over form“
  – TA from partner organisations (e.g. Tax Inspectors Without borders, GIZ) should be sought in training auditors for this new approach

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