Regulatory Impact Statement: COVID-19: Tax relief for donations of trading stock

Coversheet

Purpose	
Decision Sought:	Introduce a temporary exclusion to the deemed income rule that applies to donated trading stock
Advising Agencies:	Inland Revenue
Proposing Ministers:	Minister of Revenue
Date:	18 January 2021

Problem Definition

Businesses are currently disincentivised from donating trading stock during COVID-19 (and more generally) due to an integrity rule in the Income Tax Act 2007 which deems a donation of trading stock to be a sale at market value.

Executive Summary

A deemed income rule in the Income Tax Act 2007 disincentivises businesses from donating trading stock during COVID-19 by imposing tax on the market value of the donated trading stock. This effectively reverses the deduction that was claimed when the trading stock was purchased and imposes tax on a deemed profit.

> Example – deemed income rule
>
> A supermarket donated canned food to a food bank which was purchased for $500 and had a market value of $750. Under the deemed income rule the supermarket would need to pay $70 of tax ($250 x 0.28, 28% being the company tax rate) on that donation despite also being out of pocket for the value of the canned food.

This rule was introduced as an anti-avoidance measure (for example, it prevents a person from donating trading stock to an associate to avoid the income tax that would otherwise be payable on the sale) but is over-reaching by imposing tax in situations where tax avoidance is not a concern.

Officials recommend turning off the deemed income rule in certain circumstances for donations of trading stock made on or after 17 March 2020 and before 17 March 2022, as a COVID-19 response measure.

The proposed amendment will provide that trading stock donated to:

(i) public authorities and donee organisations (the latter being organisations whose donors can claim a tax concession for donations made to the organisation) will not be subject to the deemed income rule and will be eligible for a tax deduction for the cost of the donated trading stock.

(ii) non-associated persons (that are not public authorities or donee organisations) will not be subject to the deemed income rule. However, the donor will only be able to claim a tax deduction for the cost of the donated trading stock where they can demonstrate the donation is made for business purposes.

This option will temporarily remove the disincentive to donate trading stock. It has an estimated fiscal cost of $10 million over two years.

The proposal has been consulted on and stakeholders are supportive of it, although they would also like a permanent solution.

Limitations or Constraints on Analysis

Timeline

Changes to the tax rules for donated trading stock need to be made by 31 March 2021 so that COVID-19 related donations made in the 2019-20 income year (i.e. between 17 and 31 March 2020) can be treated appropriately. This timeline has limited the options that officials could consider and the analysis of those options.

Data

Data related to fiscal cost estimates: Inland Revenue has no data on trading stock donations. Therefore, the estimated fiscal cost is based on several assumptions, such as using data on cash donations as a proxy for donations of trading stock.

Data related to effectiveness of the measure: Inland Revenue is unable to quantify the extent to which donations of trading stock would increase under the proposed measure and can rely only on anecdotal evidence from stakeholders.

Responsible Manager

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Policy & Strategy
Inland Revenue

18 January 2021

Quality Assurance

Reviewing Agency/Agencies:	Inland Revenue

Panel Assessment & Comment:	The Quality Assurance reviewer at Inland Revenue has reviewed *the COVID-19: Tax relief for donations of trading stock* RIA and considers that the information and analysis summarised in it **meets** the quality assurance criteria of the Regulatory Impact Analysis framework.

Section 1: Outlining the problem

Context/Background Information

The tax rules for donated trading stock disincentivise businesses donating goods during COVID-19

Since the COVID-19 pandemic began in New Zealand in March 2020, anecdotal evidence suggests that the amount of goods donated by businesses has increased.

Stakeholders have informed both officials and the Minister of Revenue's office that the Income Tax Act 2007 is disincentivising businesses from donating goods during COVID-19 by imposing tax on the market value of donated trading stock. For businesses that have already donated, but not yet filed a tax return, the tax treatment should be amended.

Stakeholders have requested that legislation resolving the issue be enacted "as soon as possible" as taxpayers will need to take positions in respect of the 2019-20 income year by 31 March 2021. They have also requested that work begins on a permanent solution.

Current law

Gift deductions are limited to gifts of money to donee organisations up to the level of the donor's income

Tax credits and deductions for donations are limited to gifts of money made to donee organisations, up to the level of the person or company's taxable income.

Tax concessions are not available for donations in kind due to the potential avoidance opportunities that would be created where there is no easily verifiable market value.

The deemed income rule imposes tax on the market value of donated trading stock

Trading stock is generally deductible in the income year it is purchased as a business expense. If it is not sold in the year of purchase, closing stock is included as income at the end of the year and then becomes deductible as opening stock the following year.

A deemed income rule applies when a person disposes of trading stock for less than market value, including when trading stock is donated for charitable purposes. The rule deems the market value of donated trading stock to be assessable income. This means businesses are effectively taxed on a deemed profit margin for the donated goods, (i.e., the difference between the deemed market value and the deduction obtained on purchase or in the opening stock adjustment).

Policy intent

The deemed income rule was introduced as an anti-avoidance measure intended to apply to non-arm's length transactions, but is drafted broadly and applies to all transactions

The deemed income rule was introduced in the late 1940s as an anti-avoidance measure. It was intended to combat situations such as where of a retiring farmer gifted stock to a relative who was also a farmer. Income tax was avoided by the retiring farmer on the gift. However, the succeeding farming business could revalue the stock brought onto its books at market value (even though it had paid nothing, or a nominal amount, for the trading stock). Another example of avoidance caught by the rule is where a business donates trading stock to an associate to avoid the tax that would otherwise be payable, but there is a linked transaction to ensure the business receives market value in return.

The provision was intended to treat the stock in the same way as if it were sold. It was not intended to apply to genuine arm's length transactions even where there appears to be inadequate consideration. However, the provision was drafted broadly, and still is today, so that it also applies to arm's length transactions.

Previous relevant decisions

There is precedent for turning off the deemed income rule in response to adverse events

A permanent provision allows relief from the rule when trading stock is donated to a person not associated with the donor for the use in a farming, agricultural or fishing business that is affected by a self-assessed adverse event.

An 18-month exclusion from the rule was introduced in response to the Canterbury earthquakes. This exclusion applied when trading stock was donated to a person not associated with the donor for the purpose of relief from the adverse effects of the earthquakes.

The previous Minister of Revenue agreed to progressing an amendment after the 2020 election and sent a letter to stakeholders to this effect.

What is the policy problem or opportunity?

Problem definition

The deemed income rule, an anti-avoidance provision, is imposing tax where tax avoidance is not a concern and disincentivising donations of trading stock during COVID-19

The deemed income rule was introduced to counter tax avoidance, however its application results in an over-reach that impacts on the fairness and equity of the tax system. In particular, the provision imposes tax where tax avoidance is not a concern. In the situation where trading stock is donated, the provision can act as a significant disincentive because it imposes tax on a deemed profit on the donor of the goods. For example, it will impose tax on goods donated during COVID-19 for public benefit, such as food donated to food banks or masks and medical equipment donated to hospitals. The rule is generally perceived to be unfair and as a result compliance with this rule is very low.

Currently some businesses incur compliance costs to structure around the deemed income rule – for example by entering into sponsorship arrangements with donees to formalise the value exchange (i.e., if the business is getting something of equal value for their donation then the deemed income rule does not apply).

How is the status quo expected to develop if no action is taken?

If no action is taken the deemed income rule will continue to disincentivise compliant businesses from donating trading stock.

What is the nature, scope, and scale of the loss or harm being experienced?

The rule imposes tax on a profit a business has not made, to be paid from funds it may not have as it has not sold the goods. Officials do not have any evidence relating to the scale of the loss being experienced, other than anecdotal evidence from stakeholders. The amount of loss will depend on the value of the donation, this is best illustrated through an example.

Example

Suppose a supermarket buys a supply of hand sanitiser for $10,000, which is normally sold in the store for $15,000. If the business donates that hand sanitiser to the local hospital, they will need to pay $1,400 of tax ($5,000 x 0.28) despite receiving no income. The donation has therefore cost the supermarket a total of $11,400. Donating the same amount in cash ($10,000) would have cost it $7,200 after allowing a $2,800 gift deduction. In addition, the supermarket would have to fund the amount of tax to pay as no funds arise from the donation.

Who are the stakeholders in this issue, what is the nature of their interest, and how are they affected?

Both donors and donees are affected:

- **Donors:** Any business that donates trading stock is affected as tax is imposed on a deemed profit – an amount the business has not received. This increases the cost of the donation to the business.

- **Donees:** Any charity/person that receives donated trading stock is also affected. Officials spoke to Auckland City Mission staff and advisors who mentioned that the deemed income rule encourages businesses to donate obsolescent stock as the market value of this would be zero or close to zero, and thus no/little adjustment would be required. Auckland City Mission's policy is to take all donations, even if near expiry, but noted that receiving food close to expiry is problematic for them as they need to distribute it immediately or it is wasted. They want the tax system to encourage the donation of good quality food, rather than discourage it. Removing the disincentive should achieve this.

What are the key assumptions underlying this policy problem?

There is a high level of non-compliance with the rule. For those that would comply with the rule, it is disincentivising donations of trading stock. Not all businesses that donate trading stock would be prepared to donate cash instead.

What objectives are you seeking in relation to this policy problem or opportunity?

There are two objectives:

- **Objective one:** remove a tax impediment to donating trading stock, particularly during COVID-19 where there is an increased need in the community.

- **Objective two:** ensure the provision is robust and there are limited opportunities for tax avoidance.

There are trade-offs between these two objectives (i.e., the more relief that is provided from the deemed income rule the greater the removal of the disincentive to donate, but more tax avoidance opportunities may arise).

Section 2: Option identification and impact analysis

What criteria will be used to evaluate options against the status quo?

The options will be assessed against the objectives previously mentioned, as well as the criteria of fiscal cost and fairness.

What scope are you considering options within?

The status quo is a less viable option as the previous Minister of Revenue wrote to a select group of stakeholders committing to a temporary solution.

Because legislation needs to be enacted by 31 March 2021 to ensure that donations made between 17 and 31 March 2020 are treated appropriately, there was not sufficient time to consider a permanent solution to the deemed income rule. Targeted consultation to date has shown that stakeholders hold differing views on the best approach to a permanent solution, so any permanent change would warrant wider public consultation as part of the Generic Tax Policy Process. Officials propose beginning work on a permanent solution, subject to prioritisation on the tax policy work programme.

Describe and analyse the options

Option one – status quo

The current law – tax must be returned on a deemed profit for any donations of trading stock. However, if the status quo is not amended, the unfairness and disincentive to donate will continue to exist.

Option two (preferred) – targeted temporary exclusion from the deemed income rule

An exclusion from the deemed income rule (with the ability to modify the application period by Order in Council) for donations of trading stock made on or after 17 March 2020 and before 17 March 2022.

The proposed amendment will provide that trading stock donated to:

(i) public authorities and donee organisations will not be subject to the deemed income rule and will be eligible for a tax deduction for the cost of the donated trading stock.

(ii) non-associated persons (which are not public authorities or donee organisations) will not be subject to the deemed income rule. However, the donor will only be able to claim a tax deduction for the cost of the donated trading stock where they can demonstrate the donation is made for business purposes.

Option three – more limited temporary exclusion from the deemed income rule

Same as option 2 above, except a deduction for the cost of the donated trading stock would not be allowed where the donation was made for a business purpose (i.e., the deemed income rule would be turned off, but the deduction would be added back, effectively only turning off the deemed profit aspect of the rule).

Key features of option two (the preferred option)

Donations to public authorities and donee organisations:

- This allows the business a deduction for the cost of the donated trading stock with no corresponding income arising.
- This would ensure 'gifts' of trading stock qualify for a tax deduction in a similar way to a gift of money, with the exception that the deduction is not limited to the net income of the donor. The limitation to net income has not been proposed on the basis that many donating businesses may be in loss as a result of COVID-19, so any such limitation would cause the amendment to be of limited benefit.
- This includes donations to associated parties that are donee organisation or public authorities (i.e., a business that donates something to its own donee organisation). Donee organisations and public authorities are subject to regulation and are publicly transparent so there are no specific integrity concerns even where the parties are associated.
- This approach is broadly consistent with the government's donations framework where donations of money to donee organisations are eligible for a deduction.
- Unlike the policy solution implemented in response to the Canterbury earthquakes, there is no requirement that the donations must be made specifically to people or organisations who have suffered as a result of COVID-19. The rationale is that it could be argued that almost everyone in NZ suffered as a result of COVID-19. To minimise the risk of abuse, the concession is restricted to donee organisations and public authorities.

Donations made to non-associates:

For a business purpose:

- This allows the business a deduction for the cost of the donated trading stock with no corresponding income arising.
- Because the donation has been made to promote the taxpayer's business (i.e., increased customer loyalty/brand awareness, even if there is a charitable element to it), the deduction should not be reversed by the deemed income rule.

Not for a business purpose:

- This ensures the business does not have to pay tax on a deemed profit.
- This applies to pure gifts made by business where there is no material benefit or advantage to the donor.
- This ensures there is identical treatment to a business donating money to an organisation that is not a donee organisation or public authority. For example, if a

business donates either food or money directly to an individual person (not to a donee organisation) they receive no tax deduction, and they do not have to pay tax on a deemed profit on the donated food.

Analysis of options against objectives

Option one - status quo

Objective one – removing the tax impediment to donating trading stock

This option does not achieve this objective as businesses are required to pay tax on a deemed profit when donating trading stock which creates the tax impediment.

Objective two – ensure the provision is robust and avoidance opportunities are minimised

This objective is achieved at the expense of also capturing genuine donations of trading stock that are not a concern.

Option two – targeted temporary exemption from the deemed income rule (preferred option)

Objective one – removing the tax impediment to donating trading stock

This option achieves this objective as a business will no longer have to pay tax on an assumed profit when donating trading stock on or after 17 March 2020 and before 17 March 2022 (unless the donation is to an associated party that is not a donee organisation or public authority in which case the deemed income rule is appropriate to prevent tax avoidance).

Objective two – ensure the provision is robust and avoidance opportunities are minimised

Avoidance opportunities are limited since relief from the deemed income rule is only provided when:

- Donations are made to donee organisations and public authorities. These organisations are subject to regulation and are publicly transparent.
- Donations are made for a business purpose to non-associates that are not donee organisations or public authorities. There is likely to be minimal mischief in these cases as the donation results from a commercial decision to receive a benefit or advantage such as enhancing the business's brand. The fact the donation must be made to a non-associate reduces the chance of any artificial transaction. Existing tax rules – such as the deemed dividend rules, fringe benefit tax, and the general anti-avoidance rule, also limit the scope for abuse.
- Donations are made for a non-business (charitable) purpose to non-associates that are not donee organisations or public authorities. There is likely to be minimal mischief in these cases as the donation is made to a non-associated entity. The proposed amendment does not allow a deduction in these situations, it simply removes the requirement to report the market value as deemed income, so the risk to the tax base is minimal.

What is the level of stakeholder support for this option?

Stakeholders fully support this option although they prefer a permanent solution.

Will there be an increase or decrease in the benefit to society compared with the status quo?

Because there is a high level of non-compliance with the deemed income rule, the change will mainly align the law with commercial practice. At the margins there should be some increase in donations of trading stock (and the quality of those donations) which will have a social benefit, but will also result in slightly less tax collected.

Option three –more limited temporary exemption from the deemed income rule

Objective one – removing the tax impediment to donating trading stock

This option achieves this objective but to a lesser extent than option two, as a business donating trading stock for a business purpose will be disallowed a deduction under this option.

Objective two – ensure the provision is robust and avoidance opportunities are minimised

Avoidance opportunities are limited – same rationale as option two.

What is the level of stakeholder support for this option?

Stakeholders prefer this option to the status quo as it would remove the deemed income arising on the donation of trading stock but believe it does not go far enough. In particular, they do not think it appropriate to disallow a deduction for the cost of the donated trading stock where trading stock is donated for a business purpose. It is not uncommon for businesses to donate trading stock as a way of promoting their business (i.e., increased customer loyalty and brand awareness, even if there is a philanthropic element to it). This is currently deductible under general tax rules and this option would reverse that position. The proposal to not permit a deduction for the cost of the donated trading stock should only apply where there is no business reason for making the donation – such as pure gifts where there is no material benefit or advantage to the donor. Donating trading stock for a commercial outcome is a genuine business expense and should be treated as such.

Will there be an increase or decrease in the benefit to society compared with the status quo?

Same as option two – but slightly less of an increase in donations given this option is less generous.

Multi-Criteria Analysis

	Option One – Status Quo / Counterfactual	Option Two – targeted temporary exemption from the deemed income rule	Option three – more limited temporary exemption from

			the deemed income rule
Fiscal cost	0	Cost of $10 million over two years	Similar to option two, but slightly less given the option is not as generous.
Fairness	The status quo is unfair as a business is required to pay tax when donating trading stock in circumstances where there is no concern. Tax is normally payable on profit – not when giving something away for free. If a business donated cash it would receive a tax concession in certain circumstances, but if it donates trading stock it must pay tax on a profit that has not eventuated.	Removes the disincentive to donate trading stock and ensures that trading stock that has already been donated on or after March 17 2020 is treated appropriately.	Same as option two, although the disincentive still exists to some extent where the donation is made for a business purpose to an organisation that is not a donee organisation or public authority.
Overall assessment	0	Cost of 10 million over two years. Improved fairness	Cost of this option is similar, but slightly less than option two. Improved fairness, but not to the same extent as option two.

Conclusions

Option 2 is the preferred option as it reduces the disincentive to donate trading stock whilst still ensuring that tax avoidance opportunities are limited.

Summarise the costs and benefits of your preferred option

Affected groups *(identify)*	**Comment**: nature of cost or benefit (e.g. ongoing, one-off), evidence and assumption (e.g. compliance rates), risks	**Impact** *$m present value where appropriate, for monetised impacts;*

		high, medium or low for non-monetised impacts
Additional costs of the preferred option compared to taking no action		
Regulated groups	No costs on businesses as a result of the proposed approach.	
Regulators	There is not expected to be any significant administration costs for Inland Revenue	Very low
Wider government	Fiscal cost in the form of reduced revenue in the future. Small risk of additional tax avoidance. Unlikely as: -The rule has been designed in a way to prevent abuse as mentioned previously. -Commercial considerations and existing tax rules (dividend rules, fringe benefit tax and the anti-avoidance rule) are likely to prevent abuse anyway. -There is no evidence of tax avoidance occurring when an amendment was made to the rule in response to the Canterbury earthquakes. Most donations are motivated by benevolence or brand awareness, not tax avoidance.	$10 million over a 2-year period. This estimate is based on limited data and is approximate only. Anecdotal evidence from stakeholders suggests significant non-compliance with the deemed income rule. Therefore, the proposed amendment may just align the law with commercial practice, rather than have a negative fiscal effect.
Other groups	N/A	
Total monetised costs	Fiscal cost	$10m over 2 years
Non-monetised costs	Tax avoidance risk	*Very low/nil*
Additional benefits of the preferred option compared to taking no action		
Regulated groups	Compliance costs for businesses will reduce as a result of the proposed approach. Currently some businesses incur compliance costs to structure around the deemed income rule.	Decrease in compliance costs – unable to quantify

Regulators		
Other groups (e.g., wider government, consumers etc.)	Donees are likely to see an increase in donations of trading stock as a result of the proposed option as well as an increase in quality (i.e. less obsolescent stock).	Increase in donations (and quality of those donations) – unable to quantify.
Total monetised benefits		Increase
Non-monetised benefits		Increase

Section 3: Implementing the preferred option

How will it be implemented?

If approved by Cabinet, an amendment will be included as a Supplementary Order Paper to the Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill.

The changes will apply for donations of trading stock made on or after 17 March 2020 and before 17 March 2022.

Inland Revenue will be responsible for administering the changes.

The public will be notified of the changes through the Tax Information Bulletin, which will be published on the Inland Revenue website once the legislation is enacted.

Monitoring, Evaluation, and Review

Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process ("GTTP") to confirm that they match the policy objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995.

Policy officials are exploring the possibility of surveying stakeholders (such as Chartered Accountants Australia and New Zealand) post-implementation to establish the impact of this temporary change. This will inform options regarding the development of longer-term and more enduring solution to the tax treatment of donated trading stock.