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Donations Tax Credit Regime

Regulatory stewardship review

Phil Whittington and Talia Harvey, Policy

August 2024

Introduction

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Overall view

DTC regime performs adequately, but there are opportunities for reform

Current state

- DTC regime is well-established, and popular among donee organisations and donors who know about it
- Processes 350,000 claims for $309m credits annually (2022)
- Survey data collected during the review found:
  - Only 57% of those surveyed know about the DTC
  - 45% say the DTC makes them more likely to donate, and 22% say the DTC makes them donate more
  - Low uptake; one in five donors claim all their donations, almost a third don't claim at all.

Major opportunity: Structural reform to integrate with donee organisations and intermediaries…:

- Shift from receipt-based to payment-based verification
- Allow real-time payments of the credit
- Increase awareness and uptake of DTC by simplifying the process, increasing motivation to give

… or make more Incremental improvements:

- Modernise admin processes and use of technology
- Develop better and more targeted education materials
- Improve data sharing with Charities Services

Background and context

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History of the DTC

1962: Tax credit introduced

Tax rebate included in IR3/IR5

2000: Introduction of IR526

2008: Credit cap of $630 removed

2019: Online submissions through myIR

- Until 2000, donations were filed as part of IR3 and IR5 returns, with receipts filed alongside evidence of income for both INC and DTC purposes.

- Tax simplification, effective 1 April 1999, removed the need to file income tax returns and introduced Personal Tax Summaries (PTS) for taxpayers whose only income had tax deducted at source. From then, the donations information was separated from the income tax return and its own IR526 form was created, due 30 September each year.

- From April 2019 changes were made to simplify the donation tax credit claims process. Claims can now be made by submitting receipts through myIR, and removing the need to wait for the end of the year.

Purpose of the regime

DTC is for rewarding and reinforcing giving

- The donations tax credit regime has multiple justifications and objectives[1]. It:
  - Helps governments to further social objectives
  - Provides wider benefits to society over and above benefits to recipients
  - Supports people to use their knowledge for what extra goods and services are needed
  - Encourages efficient ways of providing social assistance
  - Supports organisations who may be more responsive to social needs than government programmes

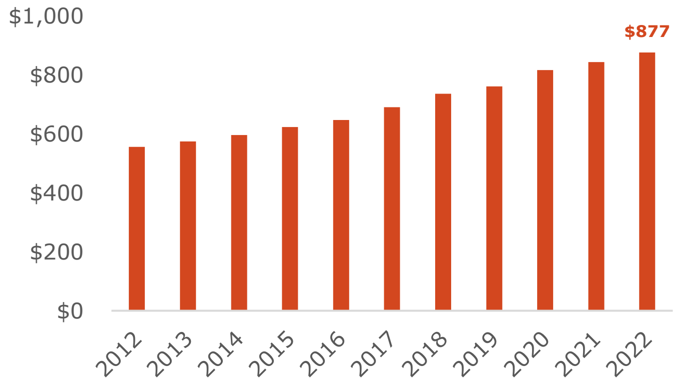
- There are many other regulatory regimes which interact with these justifications and objectives. This review looks only at the donations tax credit.

[1] *Source: Tax incentives for giving to charities and other non-profit organisations. A Government discussion document. October 2006*

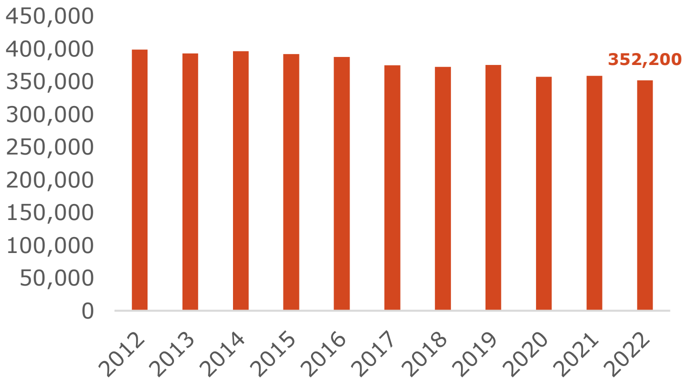
Recent trends in number and value of DTC

Total cost of DTC was $309m in 2022

The average donation tax credit has increased…



…while the number of donors claiming has decreased



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Review methodology

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Comprehensive approach

Review took an end-to-end view of the DTC regime

Review looked at the regime from multiple perspectives:

- Operational (day-to-day administrative functions)
- Customer (user experience)
- Policy (regulatory framework)
- Technical (technical specialists on DTC)
- Legal (solicitors and legal services)
- Data (information and statistics)
- Cultural (interaction with particular cultural communities)
- Technological (systems operations – START)

- The review tested the DTC regime asking whether it was effective and efficient; fit for purpose and the future, operating as intended, and achieving intended outcomes.

- The review looked at two important aspects in particular:
  - Public awareness, ease of use and take-up of the regime and its effect on charitable giving
  - Compliance by donors and donee organisations

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Review team and stakeholder engagement

Cross-disciplinary review team reached out to all relevant stakeholders

Review team networked across IR

- Phil Whittington, Policy
- Talia Harvey, Policy

s 9(2)(a)

[redacted]

Stakeholders consulted

- 13 frontline staff interviews
- 490 frontline staff survey responses (25% response rate)
- 2,876 customer survey responses (33% response rate)
- 25 donee organisations interviewed
- 3 online focus groups with 17 donors
- 10 accounting firms, 3 law firms
- 3 industry representative groups
- 2 DTC intermediaries interviewed

[1], Customer surveys and donee org and donor interviews and focus groups were conducted by Customer Voice and Measurement Donation Tax Credit Regulatory Stewardship Review - Donor and donee organisation research.pptx

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Key findings and recommendations

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Outline of review conclusions

Four key areas for improvement: structure, administration, cultural considerations, compliance issues

- The review suggests a range of improvements to be considered across four key areas:
  - **Restructuring the credit**: Consider **delinking from income tax** to allow real-time payments, s 9(2)(f)(iv) [redacted]
  - **Streamlining administration**: instead of IR to donor model, consider **change to IR to donation intermediary and/or donee organisations**. This is the widest reaching and most ambitious option for reform. Other more minor changes include introducing **mandatory receipt numbering** to make administration/detection easier and **improve compliance**
  - **Addressing cultural considerations**: Improve **education materials**, and reconsider **treatment of overseas giving to Pacific Island countries**
  - **Improving compliance measures:** Aside from issues already mentioned (receipts, cap, education), **increase targeted enforcement** and **publish and advertise IR's approach to DTC non-compliance**

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Structure of the credit

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Structure of the credit

Changing some structural elements could address key challenges and improve effectiveness

Current structure

- Linked to income tax system (capped only by taxable income)
- End-of-year processing
- Cash-only donations

Key challenges

- Low awareness (57% overall, 36% under 30)
- Delayed payments reduce motivation
- Operational inefficiencies
- Questionable cost-effectiveness

Current issues with income tax link

Delinking DTC from income tax could resolve existing issues and allow real-time payments

Awareness and timeliness

- 3.61 million customers have reduced interactions with IR because tax is automatically calculated
- No regular prompt to claim credit
- Only 57% aware of regime (36% for under 30)[1]

Delayed payments

- EOY process causes delay between donation and credit
- 4-year time bar increases time lag and confusion about claimable periods

Operational inefficiencies

- Income tax offsets: Not able to be offset against corresponding income tax
- Disputes process: Denying claims requires issuing a disputable decision letter just as with income tax disputes
- Payments can't be made until after EOY, despite year-round receipt uploads (since 2019)

Intermediary challenges

- Administrative/START issues due to the return-based model

[1] *Source: CVM survey*

Potential for real-time payments

Real-time payments would require significant changes but could substantially improve the regime

Increased donation motivation

- Immediate gratification could encourage more frequent or larger donations
- Real-time payments would match donation act with receipt of cash by donor
- Real-time system could provide greater incentive to make the credit claim

Operational efficiencies

- Reduce confusion around claimable periods (currently a top reason for declined receipts)
- May resolve issues with the 4-year time bar

Simplified reconciliation

- Both donors and IR could more easily track and reconcile credits throughout the year
- May reduce end-of-year administrative burden

s 9(2)(f)(iv)

Research raises questions about how effective the credit is in stimulating donations

Research on credit effectiveness

- Academic research has looked at how responsive donations are to New Zealand's Donations Tax Credit[1]
- Finds an elasticity of -0.4 to -0.7: For every **$1 in credit** given by government, reported **donations increase by $0.40 to $0.70** on average[2]
- Raises the question: is the DTC "**treasury inefficient**" – less bang for buck than just funding charities with the DTC budget?

Implications

- Credit may be greater than the increased donations it motivates
- Might suggest the government could help charities more by capping/reducing/abolishing the credit and using savings to give money directly
- However, this approach would lose bottom-up information about important causes
- Donee organisations are certain that not having the DTC would be detrimental, and think it has a small, positive effect on donations[3]

[1] Cruickshank, A. (2022). Elasticity of Reported Donations: Bunching Evidence from New Zealand. *Working Papers in Public Finance*, Victoria University Chair in Public Finance (21-2022)
[2] Since the elasticity may reflect both reporting effects and an actual donation response, the actual donation response could be anything between zero, or very small, "up to" the reported donation elasticity
[3] Customer Voice & Measurement survey and interviews with donee organisations, 2023

s 9(2)(f)(iv)

Non-cash donation rules

Calls for non-cash donations should be rejected due to integrity issues

Context

- Some countries (but not NZ) permit certain non-cash items as donations
- Stakeholders requested inclusion of crypto and shares in the DTC regime

Integrity and valuation concerns

- Thinly traded crypto assets can have very high, easily manipulated valuations
- Current regime has fewer checks and balances compared to other countries to protect regime integrity
- IR would have increased exposure to valuation issues related to liquidity

Operational and policy implications

- Non-cash donations complicate the currently relatively simple regime
- Maintaining cash-only policy preserves integrity and simplicity

Structural recommendations summary

Structural changes could significantly improve the DTC, with major reforms offering the biggest benefits

Minor structural issues

s 9(2)(f)(iv)

- **Maintaining cash-only donations**
  - Reject calls for including non-cash donations (e.g. crypto, shares)
  - Preserve system integrity and simplicity and avoid the complications of valuation issues

Major structural changes

- **Delinking from income tax**
  - Separate DTC from income tax system
  - Potential for significant operational efficiencies
  - Opens possibility of real-time processing

- **Implementing real-time payments**
  - Move from EOY to immediate credit payment
  - Could increase donation motivation and engagement by aligning time of donation with the credit payment

Administration of the credit

Administration of the credit

Major change to integrate with intermediaries or donee organisations, **or** some more minor admin adjustments could streamline processes

Current administration

- Labour-intensive processes for verification and processing
- Requires significant effort for IR and donors
- 18(3)
- DTC staff reviewed on average almost 8,000 receipts each

Key challenges

- High resource demands
- Dual admin (Charities Services and IR) creates confusion
- Compliance and verification difficulties
- Mixed signals and interactions with intermediaries

Proposed administrative changes

Major administrative changes

- Integrate with intermediaries or donee organisations – with current option for smaller charities
- Move away from receipts to a payment-based system

Minor administrative issues

- Optimise current processes
- Improve coordination with Charities Services
- Resolve issues with IR’s AML and authority to act rules

Current administrative challenges

The current system requires significant effort from IR and donors (in aggregate), leading to inefficiencies and low uptake

Resource and processing inefficiencies

- High IR effort in processing DTC receipts

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[redacted]

Compliance costs

- Uploading receipts to myIR is relatively straightforward
- But if keeping, finding, uploading receipts plus entering details of each receipt in myIR takes 20 minutes per claim, total compliance costs are ~117 000 hours per year
- At average ordinary time hourly earnings of $40.96[1] that is $4.8m per year in aggregate

Complexity and awareness issues

- Lack of awareness about credit and process for claiming
- Digital accessibility issues (87% file DTC digitally vs 99% for other tax types)

[1] *Source:* Statistics New Zealand. (2024). *Average hourly earnings up 5.2 percent annually*. Retrieved from https://www.stats.govt.nz/news/average-hourly-earnings-up-5-2-percent-annually/

Current DTC claim process

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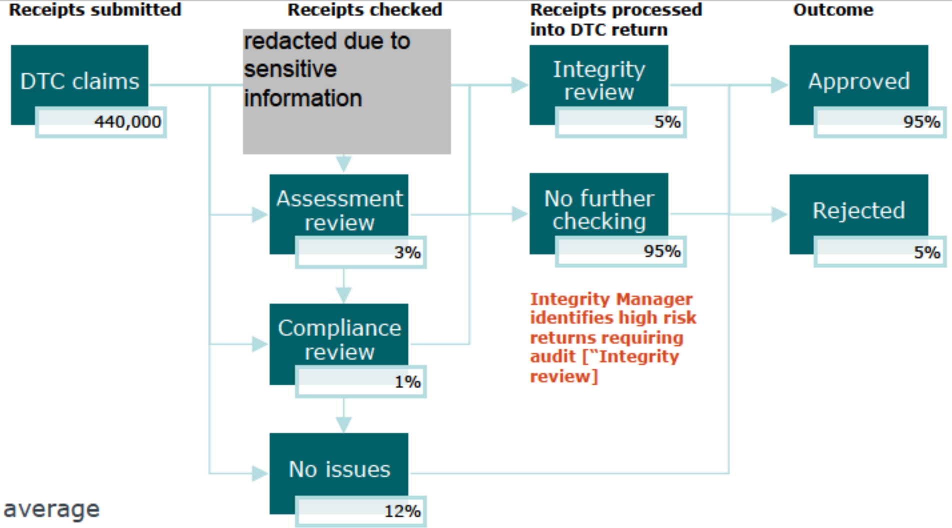
Two process stage of review

1. Receipts get visually checked that they are valid and eligible
2. Integrity manager then identifies DTC returns with risks of fraud requiring audit 'Integrity review'



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- Staff reviewed almost 8,000 receipts per person on average

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Audit results

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Historical challenges with DTC intermediaries

Past issues with our interactions with intermediaries[1] suggest the need for a more streamlined and consistent approach

System challenges

- Delays in gateway application decisions
- Unresolved questions about API connectivity
- Difficulties with automated interactions via myIR
- Manual workarounds previously required (e.g. spreadsheets, manual data entry)

IR policy inconsistencies

- Inconsistent advice on system-compliant business models
- IR enforce stricter AML requirements compared to Ministry of Justice requirements
- Authority to act issues leading to customer misunderstandings

Business model obstacles

- High AML compliance costs disproportionate to credit size
- IR requirement to view receipts when intermediaries can verify payments

Conclusion

- If we do decide to make further improvements to better accommodate intermediaries, we have to acknowledge these issues and not overpromise

[1] Intermediaries are third parties that interact with IR to administer the DTC claim on behalf of the donor, for a fee. These do not include traditional tax agents

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Major administrative change option

Integrating our system with intermediaries or donee orgs could address challenges and improve system integrity

Benefits of integration

- Direct access to payment information
- Expected lower overall compliance costs
- Improved accuracy and reduced fraud risk
- Ability to risk-target compliance activity to organisations rather than individuals
- Potential for real-time processing and increased uptake
- Overcome perception that "it's not worth it" to claim

Issues with implementation

- Major legal and system changes required
- Resistance from some stakeholders likely to require some de minimis that allows individuals to claim for cash donations and donations to small orgs

Options to consider

- **Intermediary model** - IR interacts with 2 or 3 DTC intermediaries, who deal with donee organisations
- **Donee organisation model** – IR interacts with all donee organisations
- **Hybrid –** interact with intermediaries and donee orgs[1]

[1] Under a hybrid model, not all donee orgs would interact with IR, this could be optional or dependent on size and capacity of the donee org. Donors could continue to make their own DTC claims made to those donee orgs.

Charities Services and Inland Revenue split

Division of responsibilities creates administrative inefficiencies and some customer confusion

Limited monitoring and data sharing issues

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- Data is received sporadically or requested monthly from Charities Services - IR's end-to-end process for deregistrations relies on this information

Customer confusion

- Navigating between two monitoring agencies is challenging for customers
- Particular confusion between **charitable** status and **donee organisation** status

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Better collaboration with Charities Services

Improvements in information sharing and processes could address some administrative challenges

Improve information management and dissemination

- Include donee organisation status or link on charities register
- Collect comprehensive data on overseas spending
- Improve B2B processes for regular, automated data exchange for near real-time charity or donee status changes

Improve regulatory flexibility and oversight

- Introduce 3-month grace period for reregistration - Donations are ineligible if a charity becomes deregistered but then reregisters and regains donee status
- A grace period of 3 months would resolve unfortunate technical timing issues

Improving current processes and awareness

Targeted improvements could significantly reduce human effort, increase efficiency, and raise awareness

Optimise digital receipt processing

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- Staff review over 350,000 receipts during peak periods – main complaint: **eye strain**

Optimise decision-maker tool to auto-decline claims

- Most declined receipts (by value) are due to **duplicate claims** or **invalid receipts**
- Could be done in MyIR in **real-time** as receipts are being uploaded

Address paper receipt handling with two options

- Optimise the OCR (optical character recognition) tool for paper receipts, or
- Require electronic receipts (noting DTC has lower digital uptake than other tax types)

Implement receipt numbering system

- Described earlier
- Pattern recognition could better direct staff resources

Improve public engagement

- Collaborate with Philanthropy NZ for broader outreach

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Administrative recommendations summary

Administrative changes could be a major system overhaul, or more targeted improvements to improve efficiency

Minor administrative changes

- **Optimise current processes**
  - Automate digital receipt processing 18(3)
  - Paper receipts: decline or improve OCR
- **Implement receipt numbering system**
- **Improve collaboration with charities services**
  - Data collection and sharing on registration status and overseas spending

Major administrative changes

- **Integrate with intermediaries or donee organisations**
  - Shift from receipt-based to payment-based verification
  - Implement real-time payments
  - Address historical challenges with intermediaries

Cultural considerations

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Cultural considerations

Policies could be changed or adapted to be more culturally inclusive, with targeted education and compliance activity to resolve issues

Distinct cultural practices

- Māori and Pacific peoples have distinct cultural giving practices
- Current DTC regime does not fully accommodate these practices

Key issues

- Non-cash and collective giving common in both cultures
- Pacific churches often send funds to home countries
- Limited guidance and support on DTC for these communities

Cultural giving practices and DTC challenges

Pacific giving practices can conflict with current rules, potentially leading to non-compliance

Overseas giving and schedule 32 issues

- 39% of Pacific churches send funds to home countries
- Regulatory limit: Over 25% overseas spending requires schedule 32 status
- Only 5 out of 200 Pacific churches have Schedule 32 status

Additional challenges

- Lack of recognition for household and collective giving in current DTC rules
- Māori landing page lacks DTC information
- No dedicated Pacific Island community landing page

Schedule 32

- Allows donations to certain international charities to be eligible for DTC
- Charities must apply and demonstrate their purposes align with specific criteria
- Cabinet approves additions to schedule 32

Policy recommendations

Policy changes could make the DTC regime more inclusive of cultural giving practices

Expand DTC law to accommodate:

- Spousal giving (giving by both spouses jointly, when the DTC is based on individual giving)
- Household/family giving

Reconsider overseas funding rules for Pacific countries

- Potential relaxation of 25% overseas spending rule
- Align with NZ's Official Development Assistance to the Pacific
  - New Zealand's Official Development Assistance to the Pacific is ~750m a year, at 65% of the total Official Development Assistance budget[1]

[1] Source: New Zealand Ministry of Foreign Affairs and Trade. (n.d.). *Where our funding goes*. Retrieved August 11, 2024, from https://www.mfat.govt.nz/en/aid-and-development/where-our-funding-goes/

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Education and support recommendations

Targeted education and support can improve understanding and compliance

Create culture specific education materials:

- Fact sheets and cultural scenarios
- Particular guidance on overseas giving

Improve distribution of material and upskill frontline staff:

- Workshops through Pacific Island churches
- Update Māori and NFP (not-for-profit) landing pages

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Cultural recommendations summary

Policy changes would be the most far reaching, but education and support for current rules would improve understanding

Minor cultural consideration changes

- **Education and support**
  - Develop targeted materials for Māori and Pacific customers
  - Improve distribution through multiple channels (online and in person workshops)

Major cultural consideration changes

- **Policy changes**
  - Expand law for spousal and household giving
  - Reconsider overseas funding rules for Pacific countries

Compliance with the credit

Compliance in the DTC regime

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Types of non-compliance

Errors, structuring, and fraud

Errors

Top 7 errors:

- Duplicate receipt
- Invalid receipt
- No donee status
- Not in claimant’s name
- Not a gift
- Not paid
- Outside time bar

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[1] E.g. Revenue Alert *RA 11/01* sets out examples where arrangements were structured in a failed attempt to qualify for the DTC

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Compliance challenges

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[redacted]

Improving compliance

Major change: move compliance away from individuals and toward intermediaries/donee orgs, or look at more minor changes

Minor compliance changes

- **Consider DTC cap to mitigate structured arrangements**
- **Targeted enforcement and/or education campaigns to address known fraud areas/organisations**
- **Introduce consequences where donee org facilitates fraud, e.g. lose donee org status**
- **Publish and advertise IR's approach to DTC non-compliance**
- **Introduce numbered receipts**
    - Discussed earlier

Major compliance changes

- **Shift compliance to intermediary or donee organisation-based administration**

Implementation considerations

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DTC improvements from the review

Packages of options based on level of ambition

Incremental improvements

- Improve OCR and decision maker tool for receipt processing
- Look at paper receipts (decline, or improve OCR tool to read)
- Include donee status on charities register
- Develop culturally specific education materials for Māori and Pacific communities
- Implement 3-month grace period for charity reregistration

Significant enhancements

- Make **Incremental improvements**, and
- Improve collaboration with Charities Services through improved data sharing protocols
- Introduce receipt numbering system
- s 9(2)(f)(iv)
- Look at overseas funding rules for Pacific countries

Structural reform

- Fully integrate with intermediaries and donee organisations
- Delink DTC from income tax system
- Make real-time payments

Conclusion

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Improving the DTC regime

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