New Zealand Law Society
Te Kāhui Ture o Aotearoa

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Re: Initial Policy think piece: Donated Trading Stock

1. The New Zealand Law Society | Te Kāhui Ture o Aotearoa (**Law Society**) welcomes the opportunity to comment on the consultation document entitled *Initial Policy think piece: Donated Trading Stock* (**think piece**).

2. The Law Society's Tax Law Committee has reviewed the think piece and has provided comments on:

   (a) addressing the broader issue of limiting donation tax credits and gift deductions (as relevant) to gifts of money; and

   (b) a targeted solution to the issue with respect to disposals of trading stock for less than market value in cases where the disposal was motivated by philanthropic considerations

   (c) the specific questions at [19].

3. Our understanding is that there is currently limited capacity for legislative change on the broader issue and that officials are only looking to implement a targeted solution at this point. In the event that a targeted solution is introduced, we would support the broader issue being revisited by officials as part of a public consultation document. This would be a similar approach as that taken with the temporary loss carry-back scheme that was introduced pending a more extensive review of the topic.

Issues with limiting donation tax credits and gift deductions to gifts of money

4. The Income Tax Act 2007 (Act) provides that a company is allowed a deduction for a "charitable or other public benefit gift", but only if the gift is in the form "of money": sections DB 41 and LD 13. A deduction is therefore not allowed for a gift in any form other than money. A disposal of trading stock at less than market value is treated as a disposal at market value: section GC 1. Therefore, a donation of trading stock to a charity is treated as a sale at market value. This is unsatisfactory for the reasons set out in paragraphs 5 to 8 below.

5. The policy intent behind section DB 41 is to encourage "charitable and other public benefit" gifts. That policy is satisfied not only by gifts of money, but by gifts of other forms of property

also, including trading stock. As a matter of policy, therefore, a gift of trading stock to a charity should be treated in the same manner as a gift of money. That is, it should entitle the donor to a deduction (or, at least, it should not be treated as a sale at market value).

6. As alluded to in the think piece, it appears that it might be common for taxpayers not to comply with section GC 1 when donating items of trading stock to charities (and, more importantly, when removing items of trading stock from their inventory for other purposes). That is, they might simply omit to account for the items that have been removed from their inventory.

7. Taxpayers might attempt to circumvent the effect of section CG 1 by contriving to donate trading stock to a charity not out of any genuinely charitable intent, but out of a self-interested desire to appear charitable as a marketing strategy. The think piece should clarify the tax consequences of donating trading stock to a charity as a marketing exercise.

8. An issue not identified in the think piece is that it is possible also that taxpayers wanting to make a gift of trading stock to a charity might attempt to circumvent section GC 1 by (a) making a gift of money to the charity and then (b) selling the trading stock to the charity at market value. The taxpayer would then claim to deduct the gift (being a gift of money) under section DB 41. It is unclear whether, having regard to the scheme of the Act, the Revenue would or should object to this; and it is also unclear whether, as a matter of law, the Revenue would or should have a remedy (under section BG 1 or otherwise).

Revenue base should be protected

9. Section CG 1 intends to protect Inland Revenue from taxpayers' attempts to extract profits from their businesses in the form of trading stock without paying tax on them. However, section GC 1 does not adequately protect the revenue from the problem at which it is aimed because taxpayers might simply remove items of trading stock from their inventory without accounting for them. When that happens as a result of an unrecorded gift to a charity, the problem is a technical one, rather than contrary to the scheme of the Act, because the taxpayer's failure to comply with the law has achieved the outcome that is desirable as a matter of policy. However it is also presumably common for taxpayers to remove items of trading stock from their inventory for purposes other than making a gift to charity – such as where a family company gives an item to a shareholder for his or her personal use, without recording it.

Section GC 1

10. Section GC 1 is a statutory version of the rule established by the House of Lords in *Sharkey v Wernher* [1956] AC 58. The rule in *Sharkey v Wernher*, as originally formulated, was that if a trader takes an item of trading stock for her own use, she is to be taxed as if she has sold it at market value. In other words, the rule is that (a) the taxpayer must account for the item removed from inventory and (b) the adjustment to the accounts must be on the basis of a notional sale at market value; she is not permitted to account for the removal of the item from her inventory by adding back in the deductions claimed in respect of it (that is, treating the removal as a sale at cost, rather than market value). The rule is a rule of interpretation, in that it is a necessary component of calculating the taxpayer's net income, as intended by the legislature.

11. In later cases, the English courts elaborated upon the rule to the effect that it applies not only where the taxpayer takes an item of trading stock for her own use but also (in particular) where she (a) effects a notional sale of the item to herself at an undervalue or (b) gives it or sells it at an undervalue to an associate. These refinements of the rule are obviously necessary to protect the Revenue.

12. Whilst section GC 1 was clearly intended as a statutory version of the rule in *Sharkey v Wernher*, the rule as provided for by the section is not exactly the same as the rule as formulated by the English courts. In particular, it is not clear that the rule formulated by the English courts would require a gift to charity to be treated as a sale at market value. It seems to be sometimes assumed that section GC 1 excludes the operation of *Sharkey v Wernher* in New Zealand, but it is possible that that assumption is unsound; see *Rangatira Limited v Commissioner of Inland Revenue* [1996] NZPC 7; [1996] UKPC 54; [1997] 1 NZLR 129 at [17], where the Privy Council seems to have assumed that the rule continues to apply in New Zealand.

Solutions

Broader issue

13. The think piece suggests at [18] that the problems it discusses could be ameliorated by a reporting requirement. It does not elaborate, but the idea would presumably be that a taxpayer who disposes of an item of trading stock other than at market value would be required to report that fact to the Revenue, together with other relevant facts – in particular, to whom the item was transferred and at what price (if any). This would assist in preventing taxpayers from extracting profits from their businesses without paying tax on them.

14. Gifts in kind to charities should be afforded the same benign tax treatment as gifts in cash. It would appear that that could be achieved by simply deleting the words "of money" as they appear in section LD 3(1)(a).

15. The consequence of deleting the words "of money" in section LD 3(1)(a) would be that the section would no longer be confined to gifts of money, so a taxpayer making a gift in kind would be entitled to a deduction under section DB 41. Section GC 1 would still apply, so the deduction provided for by section DB 41 would effectively negate the sale at market value deemed to have taken place under section GC 1.

Targeted solution

16. Our comments below are focused on dealing with the narrower issue of donations (or disposals at less than market value) of trading stock. If officials were to take this narrower approach, but with a view to addressing the broader issue at a later date, any legislative change providing a targeted solution may need to be reconsidered at that time.

17. Generally, we consider that a targeted solution should apply more directly to goods donated to donee organisations. The problem that section GC 1 is aimed at does not appear to be relevant where goods have been donated to a donee organisation. Therefore, a carve-out to section GC 1 in cases where goods are donated or disposed of for less than market value to a donee organisation is warranted.

18. The think piece suggests at [11] that “there could be a general provision to provide relief from section GC 1 during times of adverse events”. We support a broader carve-out to section GC 1 that would apply for the current income year, where the recipient of the goods is not required to be a donee organisation – i.e. the carve-out to section GC 1 could also apply in the 2020-2021 income year if the disposal was motivated by philanthropic considerations. This is on the basis that such gifts ought not to be restricted by tax policy settings given the challenges that COVID-19 has brought about.

19. The proposed carve-outs to section GC 1 could be included as two new paragraphs in subsection (5) as follows:

    (c) to a donee organisation;

    (d) by the person to another person who is not associated with them, in circumstances where the disposal is motivated by philanthropic considerations and is not part of a tax avoidance arrangement [during the approved period, could be extended by Order in Council].

20. A deduction should be allowed for the cost of the trading stock in order to provide an economically neutral result for the donor.

21. Under the current Act, the better view would appear to be that if the proposed carve-out to section GC 1 was to apply, the deduction for the cost of the trading stock would still be available under section DB 49 (which allows a deduction for the opening value of trading stock) as the trading stock would have been acquired by the donor for the purpose of deriving assessable income.

22. However, there is an alternative view that the donor may not be allowed a deduction for the cost of the trading stock because section DB 49 does not override the general permission in section DA 1(1) and in cases where the goods have been disposed of for nil consideration there is arguably no nexus between the expenditure incurred and assessable income.

23. Further, it may be arguable that (in cases where the disposal is to a donee organisation) section DB 41 only allows a deduction in cases where the definition of “charitable or other public benefit gift” has been met and gifts of trading stock would not satisfy section DB 41.

24. Given the scope for argument, we would encourage officials to consider including wording to:

    (a) amend section DB 49 to clarify that the general permission does not operate to prevent a deduction under section DB 49 in circumstances where the proposed carve-out to section GC 1 applies; and

    (b) clarify that section DB 41 does not override the availability of a deduction under section DB 49.

Specific Questions at [19]

25. The think piece invites at [19] feedback on a series of specific questions. The Law Society’s feedback on questions 1 to 5 is set out below.

Question 1: "Is there a policy problem? Why are existing options such as writing down the value of donated trading stock or donating trading stock as part of deductible sponsorship/marketing arrangements not sufficient?"

26. The policy problem is essentially that the law should not discourage "charitable or other public benefit" gifts of trading stock by not affording them the same treatment as gifts of money. The existing options are not sufficient because they do not provide for gifts of trading stock to be treated in the same manner as gifts of money. It is inappropriate for the tax system to encourage taxpayers to disguise genuine charity as marketing and this approach to taking a deduction may still be problematic as the amount of deductible "expenditure" is likely to be equal to the cost of the goods rather than the market value of the goods donated and therefore may not fully offset the amount of deemed income under section GC 1.

27. In cases where there has been no reduction in the market value of the trading stock, a write-down is not likely to be in compliance with the trading stock valuation methods as set out in section EB 4 of the Act.

Question 2: "What exactly is the policy problem that needs to be solved? For example, is it the application of section GC 1 during adverse events, or is it wider? Is the problem limited to trading stock gifted to donee organisations, or trading stock gifted to a range of recipients?"

28. The problem, as indicated above, is that "charitable or other public benefit" gifts of trading stock should be afforded the same treatment as gifts of money. This problem is not confined to times of "adverse events"; "charitable or other public benefit" gifts of trading stock should be treated in the same manner as gifts of money, irrespective of whether there has been an "adverse event".

29. However, we have proposed a targeted solution in the form of a carve-out to section GC 1 that could introduced pending a more detailed review of the broader issue.

Question 3: "How wide-spread is the problem and who is affected?"

30. It is difficult to answer this question because it seems probable, or at least possible, that the current tax treatment of gifts of trading stock to charities has discouraged taxpayers from making such gifts.

Question 4: "Is Inland Revenue's view that the current legislation is often ignored a valid assessment (i.e., that many businesses simply do not include donated goods as stock on hand at the end of the year)? If that is the case, is a policy response by itself sufficient, given that there seems little point in providing legislative relief to a section GC 1 market value adjustment if many businesses are already going further and claiming a full deduction for donated trading stock?"

31. It might well be the case that some taxpayers fail to comply with their legal obligations, and that they consequently achieve a result that is appropriate as a matter of policy. However, that cannot be regarded as a satisfactory state of affairs. Taxpayers breaking the law cannot be condoned. In addition, while it may be the case that some taxpayers break the law, many do not; and the tax system should not discriminate against those who comply. Nor, as indicated above, should the law discourage charitable gifts of trading stock.

Question 5: "If there is a policy response, should it be temporary and targeted, or should it be wider? What would the most appropriate response measure look like?"

32. The Tax Law Committee's view is that the law should be amended and that the amendment should be general and permanent, not temporary and targeted. Specifically, section LD 3(1)(a) should be amended by deleting the words "of money". However, we have also proposed a targeted solution to the narrower issue of donated trading stock in the form of a carve-out to section GC 1.

Further Assistance

We trust Inland Revenue will find these comments helpful. If you wish to discuss them, please do not hesitate to contact the Tax Law Committee convenor Neil Russ, through the Law Society's Law Reform Adviser, Emily Sutton (Emily.Sutton@lawsociety.org.nz).

Yours faithfully

Arti Chand
Vice President