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ASSESSMENT ON NATURAL AND PRODUCTION LOSSES FOR TAX PURPOSES

FINAL REPORT

USAID GOVERNING FOR GROWTH (G4G) IN GEORGIA

22 September 2016

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GEORGIA

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DATA

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ACRONYMS

AlkStG	“Alkoholsteuergesetz” = alcohol tax act
AO	“Abgabenordnung” = general tax code
BA	Business Associations
BAO	“Bundesabgabenordnung” = general tax code
BP	“Bundespräsident” = (federal) president
BrantwMonG	“Branntweinmonopolgesetz” = Spirits Monopoly Act
BrStV	“Branntweinsteuerverordnung” = Spirits Tax Decree
BR	“Bundesrat” = upper house of (federal) parliament
BT	“Bundestag” = lower house of (federal) parliament
BVerfG	“Bundesverfassungsgericht” = high court of justice
B-VG	“Bundes-Verfassungsgesetz”= federal constitution act
CIT	Corporate Income Tax (Act)
ESTg	“Einkommensteuergesetz” = income tax act
EU	European Union
FIFO	First In First Out
GG	“Grundgesetz” = German constitution
GoBD	Principles to ensure the due maintenance and preservation of books, records and documents in electronic form, as well as for data access
G4G	Governing for Growth in Georgia
HGB	“Handelsgesetzbuch” = commercial code
HZA	“Hauptzollamt” = main customs office
KET	“Knowledge and Experience Transfer”
KStG	“Körperschaftsteuergesetz” = corporate income tax act
LEPL	Legal Person of the Public Law
LIFO	Last In First Out
MoESD	Ministry of Economy and Sustainable Development
MOF	Ministry of Finance of Georgia
NGO	Non-Governmental Organization
OECD	The Organization for Economic Cooperation and Development
PIT	Personal Income Tax (Act)
RS	Revenue Service
SAF-T	Standard Audit File for Tax
SME	Small and Medium Enterprises
TabStV	“Tabaksteuerverordnung” = Tobacco Tax Decree
UGB	“Unternehmensgesetzbuch” = commercial code
USAID	United States Agency for International Development
UStG	“Umsatzsteuergesetz” = Value Added Tax Act
VAT	Value Added Tax
VfGH	“Verfassungsgerichtshof” = high court of justice
VwGH	“Verwaltungsgerichtshof” = higher administrative court
ZA	“Zollamt” = customs office

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1. EXECUTIVE SUMMARY

One of the more challenging areas for Georgian tax administration concerns the rules for the tax treatment of natural and production losses. The lack of clear guidelines or consistent practice for the calculation, documentation and deduction of these types of losses results in both increased tax liabilities and the possibility of tax avoidance. The magnitude of the problem is also evidenced by the increasing number of tax disputes and court cases related to loss deductions.

In an attempt to regulate the issue, an Intergovernmental Commission was established in 2009 to coordinate activities with relevant ministries to define allowable norms or thresholds of losses for different industries/sectors. The commission drafted and approved the norms for natural losses in the oil, oil products and wheat sectors. In 2011, this function was transferred to the Revenue Service (RS). The RS task force established for this purpose defined the norms for thirteen different sectors, which were approved by a Decree of the Head of the RS. For sectors where the RS did not have sufficient expertise, decisions were made with the involvement of the National Expertise Bureau. The RS task force is currently relatively inactive due to the RS leadership's decision to challenge the appropriateness of existing practice.

The objective of this project was to study the experience of several members of the European Union (EU) and analyze their existing rules, procedures and/or practice for defining the norms of natural and production losses for the purpose of tax deduction. Accordingly, Germany, Austria and Poland were selected for study and evaluation. The study on the experience of the selected countries concentrated on establishing the

- Responsible agency/government authority for setting up the norms of natural and production losses;
- Methodology used for setting up the norms of natural and production losses;
- Application of norms of natural and production losses for taxation purposes;
- Approaches and practice of the relevant tax administrations in calculating loss deductions;
- Responsible entities for calculations of natural and production losses for tax deduction purposes;
- Practice of using industry-specific standards for calculating natural and production losses for taxation purposes.

In the first stage of the project, a report on the existing system of production losses was developed. This report is presented in the *Background* section and reviews regulations relating to natural and production losses. Some key problems are highlighted by examples.

In the second stage, initial working meetings on natural and production losses were planned and subsequently conducted from April 2016. Interested persons were supplied with information about the project, the implementation stages and envisaged results. Potential participants were asked to present projects initiated by their organizations associated with the issues of natural and production losses. The project team and tax experts were actively involved in the facilitation of the meetings. During the meetings, they proposed several approaches to solving the issue and discussed the possible benefits of each for the stakeholders.

In the third stage, Lutz Reichelt, the project's German expert, with the active involvement of Georgian experts, obtained information on the Georgian tax treatment of production and natural losses, and



performed a comparative study of the experience of two old and one new member of the EU: Germany, Austria and Poland. He also developed some recommendations for Georgia.

These case studies represent an important source of understanding the tax treatment of natural and production losses in EU member states. The transfer of the experiences of selected EU member states to Georgia must take into account the overall evolution of tax policy, taxation practices, taxpayer's culture, and relations between tax administrations and taxpayers. The experience of Germany, Austria and Poland will help policy makers, experts and tax administration specialists in finding solutions to the longstanding problem in Georgia. The knowledge acquired will assist the Georgian Ministry of Finance and Revenue Service in developing strategic cooperation with the relevant institutions of the three EU member states and in obtaining more information based on the experience of their experts. The key findings of the report are included in the *Findings* section. The full version of this report is an annex to the main document.

In the next stage of the project, a preliminary reform roadmap was designed. This was based on:

- Evaluation of Georgia's legislation and procedures on natural and production losses for taxation purposes;
- The results of the discussions regarding the current tax treatment of production and natural losses that were held with various business associations, the RS and other stakeholders;
- Description of the tax treatment of production and natural losses of the selected EU member states (Germany, Austria and Poland), which may be adapted to the needs of Georgia.

Project experts underlined the basic principles to be followed in the reform process and advised on the necessary steps for the implementation of the recommendations.

In the following stage, all interested parties were supplied with the full version of the report on production and natural losses taxation in the selected EU member states, the executive summary of the document with key findings and a preliminary version of the reform roadmap as elaborated by Georgian experts. Working meetings for discussion of the findings were organized with beneficiaries and stakeholders. Governmental institutions expressed their willingness to reform the existing system. Active interest was generated towards the Standard Audit File for Tax (SAF-T), developed by the Organization for Economic Cooperation and Development (OECD), which became known as a result of the Polish experience study. Based on the results of these meetings and discussions, the reform roadmap was amended (this can be found in the *Recommendations* section) and was presented to the stakeholders at an event held on 8 September 2016. The meeting was attended by representatives of the Ministry of Finance (MoF), RS, Ministry of Economy and Sustainable Development (MoESD), Office of the Business Ombudsman, Office of the Economic Council, Business Associations, Governing for Growth (G4G) project of The United States Agency for International Development (USAID), and also representatives of those private organizations for which the topic of losses represents an important problem.

The event consisted of two parts. In the first part, the project implementation team presented a summary of previous activities and the recommendations of tax experts. The second part of the event was dedicated to facilitating a dialogue in which participants discussed models of tax treatment and deductions of production and natural losses in the selected EU member states that may be reflected in the Georgian tax system and the reform roadmap developed by Georgian experts.



2. BACKGROUND

STATUS QUO

The status quo with respect to the tax treatment of production and natural losses in Georgia is interesting in terms of (i) current regulations; (ii) perception of the problem by the business community; and (iii) perception of the same subject by key public bodies, including the RS and the MoF.

Current regulations and their implementation carry inherent risks for honest taxpayers who may fall victim to additional taxes and tax sanctions. Although some taxpayers manage to avoid making such payments, this usually happens following prolonged tax dispute procedures that are usually very costly for taxpayers in terms of time and money. During the meetings conducted by project experts, a large number of these taxpayers named production and natural losses among their top tax risks.

Key governmental institutions, including the RS and the MoF, have also acknowledged the existence of certain problems in current tax practice with respect to production and natural losses. Certain legislative changes have been introduced at various times to mitigate risks in this area. However, it was also confirmed that these changes have not totally resolved the problem and have merely addressed certain aspects of production and natural losses. The public authorities also expressed interest in the possibility of introducing a new system to ensure an equitable balance between private and public interest. One of the key factors that has historically hindered reforms in this area was also noted: the risk of dishonest taxpayers abusing the new system and the concern that such abuse might occur on a large scale.

LEGISLATIVE FRAMEWORK

In order to achieve the project goals, the legislative framework of Georgia with respect to the tax treatment of production and natural losses (both generally taxable and/or sanctionable “deficiencies”) was considered. The project experts reviewed all relevant Georgian laws and decrees of the Government, MoF and RS.

INTRODUCTION

For the purposes of Corporate Income Tax (CIT), Personal Income Tax (PIT) and Value Added tax (VAT), the tax code does not differentiate between production losses and natural losses. Therefore, the term “deficiencies” covers both forms of losses. For the purposes of customs regulations, however, the tax code only makes reference to natural losses. This matter is considered in more detail below.

The two major legal instruments that set the framework for the treatment of deficiencies are (i) the Tax Code of Georgia (the “Tax Code” dated 17 September 2010) and (ii) Decree № 994 of the MoF of Georgia about endorsement of the rules on Regular (Current) Control Procedures, Write-Offs of Inventories, Payment of Admitted Tax Arrears, Enforcement actions on Tax Arrears, and Procedures for Dealing with Tax Irregularities (dated 31 December 2010). In addition to this, the RS has issued a number of decrees setting the allowable amount of deficiencies (these are listed under the subsection *Relevant Legislation and Decrees*).

The Tax Code is the major legal instrument setting out the definition of deficiencies for tax purposes and their tax treatment. Additionally, the Tax Code sets out the framework for the audit, monitoring and control of compliance with regulations on deficiencies, while Decree № 994 provides procedural rules on the audit, monitoring and control of the fulfillment of these obligations by taxpayers. The Tax Code is thus the primary document that emphasizes policy makers’ approaches towards the tax treatment for deficiencies.



DEFINITION OF DEFICIENCIES

The Tax Code provides a definition¹ of deficiencies, and identifies three separate groups:

- The difference between the inventory and/or fixed assets possessed by the taxpayer at a given time (usually at the time of the tax audit or inventory count conducted by the RS) and the amount/number of the inventory and/or fixed assets recorded on the books of the company at the same time;
- With respect to inventory that may not be stored (electricity, heat, gas, and water), the deficiency is the difference between the purchased (according to the purchase documentation) and sold (the factual output) inventory, if the purchaser and/or appropriator of these goods cannot be established;
- The authorized body (currently the RS) may establish the threshold for allowable losses. In this case, only the loss of the inventory and/or fixed assets in excess of the thresholds established by the competent body will qualify as the deficiency.

The Tax Code provides favorable treatment with respect to certain losses arising in the course of production of goods subject to mandatory markings. Specifically, excise goods and some non-excisable beverages in Georgia are subject to mandatory markings. Some markings use paper marks that are firmly attached to the products with glue (or similar adhesive materials); while other products subject to mandatory marking are marked electronically by special equipment installed at production lines. Given that the electronic marking process is entirely automated with a computer automatically recording how many products had been marked, the risk of a taxpayer manipulating the inventory count of such products is remote. Therefore, according to the Tax Code, the loss of products subject to electronic marking shall not qualify as a deficiency if such a deficiency is uncovered in the production process.

UNCOVERING THE DEFICIENCY

As noted above, the deficiency is the difference between the inventory and/or fixed assets possessed by a taxpayer (usually at the time of the tax audit or inventory count conducted by the RS) and the amount/number of the inventory and/or fixed assets recorded in the books of the taxpayer at the same time.

For the above definition, the inventory count and book records of the company are key. The inventory count herein refers to a control procedure under which the RS together with the taxpayer conducts an inventory count at a specific time and compares the results of this count to the book records of the taxpayer.

The following tax regulations relating to the accounting of the inventory are worth noting:

- The taxpayer is required to record transactions so that the beginning, progress and end of the transaction (including, purchase and sale of inventory and fixed assets) is easily identifiable;
- Inventory may be recorded on the basis of the following methods;²
 - (a) The individual or perpetual method, implying record of the sale and receipt of each item of the inventory;
 - (b) Weighted average; and

¹ Article 8.11, Tax Code



(c) FIFO (first in first out).

- The taxpayer has the right to write off deficient or out of fashion goods, which are impossible to sell at a price exceeding their purchase/production price;²
- The taxpayer may write off expired and/or useless goods or goods that are impossible to sell, only if;³
 - (d) The taxpayer notifies the RS in advance about such a write off; and
 - (e) The RS consents to such a write off.

The abovementioned rules are mostly reasonable. However, the rule restricting the write off of expired or useless goods is rather strict because it restricts the write off of such goods without confirmation from the RS. Given the limited resources of the RS, the taxpayer (acting in good faith) may not be able to obtain such consent in time or the RS may not be in a position to give such consent for various reasons. In such instances, the taxpayer faces the risk of tax sanctions.

The majority of problems with losses are caused by the usage of the so-called indirect method by the RS. Under this rule, the RS establishes the tax liability of the taxpayer on the basis of indirect information instead of the taxpayer's books and documents. Using this method, the RS may try to determine the tax liability of the taxpayer on the basis of:⁴

- (f) The amount/number of the taxpayer's assets;
- (g) The taxpayer's operational costs and income;
- (h) A comparison of the taxpayer's performance at various times;
- (i) A comparison of the taxpayer's results to the results of similar taxpayers.

The Tax Code authorizes the RS to use the indirect method only if certain preconditions are satisfied. These preconditions have often been changed by the legislators. Currently, the RS is authorized to use the indirect method if:⁵

- The taxpayer does not have accounting documentation or it is impossible to correctly establish the tax liability of the taxpayer on the basis of the accounting information;
- At least two of these conditions are met:
 - (j) The taxpayer's assets increase unjustifiably;
 - (k) The taxpayer's expenses relating to his/her own or business activities exceed the income of the same taxpayer;
 - (l) The RS has uncovered two or more tax offences in the course of regular tax control measures;
 - (m) The RS uncovers material differences between the information the taxpayer submitted to the RS and the information obtained by the RS in the course of regular tax control measures.

² Article 145.5, Tax Code

³ Article 145.6, Tax Code

⁴ Article 73.5, Tax Code

⁵ Article 73.5, Tax Code



The above preconditions for the use of indirect methods are usually broadly interpreted. For instance, even a minor violation committed a number of years ago and the lack of some documents may be sufficient for the application of the indirect method. Furthermore, the tax authorities sometimes challenge the appropriateness of the application of certain methods for inventory measurement. For example, some relatively small-size businesses prefer to use the weighted average method for inventory measurement, while the RS requires application of the individual/perpetual method. The application of the latter method is, however, very difficult for taxpayers who trade in goods that are each of relatively small value but are large in numbers (e.g. small household shops trading in household items).

Moreover, the indirect method, by its very nature, is not an exact science. It merely endeavors to establish the approximate amount of the tax base. When approximate figures for the inventory are used, it usually leads to differences between the current inventory stock the taxpayer has at hand and the inventory that the taxpayer is supposed to have under the indirect method.

DEFICIENCY THRESHOLDS

As noted above, the Tax Code authorizes the competent body to establish allowable losses. The losses taxpayers sustain within the limits set by the competent body may be deducted from the gross income of the taxpayer. However, losses in excess of the allowable limits are required to be recognized as taxable sales.

Based on the Tax Code, the Government of Georgia issued Decree № 845 (dated 14 April 2011) regarding the creation of a commission for the determination of the thresholds for deductions of natural losses. This decree lists 10 high-level public officials as members of the commission: the Minister of Finance, Deputy Minister of Interior Affairs, Deputy Minister of the Environmental Protection of Georgia, Deputy Minister of Economy and Sustainable Development, etc. The same decree authorized this commission to determine natural losses only; it authorized the RS to establish production losses.

Further to Decree № 845, the commission established thresholds for oil products and cereal products on 24 May 2011. However, soon thereafter, on 29 December 2011, the thresholds for allowable natural losses of oil products were abolished.

Decree № 845 was repealed on 27 December 2011 by Governmental Decree № 2547 (the “Decree on Allowable Deficiencies”). The latter decree authorized the RS to establish a commission on the determination of allowable amounts of deficiencies (including production and natural losses). Currently, taxpayers are authorized to apply to the RS for the determination of production losses with respect to the specific type of production⁶, and the RS is authorized to consider such applications. These applications are subject to a fee of GEL 5,000 and the RS has three months to make a decision on the application.

The above regulation gives some certainty to the taxpayer and is definitely a positive development. However, the same approach is not without its difficulties:

- The RS has limited resources to determine specific and allowable losses for all industries or sectors of the economy;
- Given variations in human resources, access to superior means of production, and other economic factors, various businesses have different levels of production losses; therefore,

⁶ Decree № 96 of the Government of Georgia on the endorsement of Fees for the Services of the LEPL RS of Georgia, dated 30 March 2010.



determination of the same allowable amount of production losses may be an arbitrary exercise.

RELEVANT LEGISLATION AND DECREES

According to the official webpage of the RS,⁷ the RS has issued a number of decrees for the determination of various allowable losses with respect to various products: oil products, egg production, cereals, glass production, etc.

The list of legislation and decrees that were reviewed is as follows:

i. Laws of Georgia

1. Tax Code of Georgia, dated 17 September 2010; and
2. Law of Georgia on Financial Accounting and Audit of Financial Reporting, 29 June 2012.

ii. Decrees of the Government of Georgia

1. Decree № 845 of the Government of Georgia on Creation of a Commission for the Determination of Thresholds for the Deduction of Natural Losses, dated 14 April 2011;
2. Decree № 223 of the Government of Georgia on Determination of Allowable Natural Losses with respect to Oil Products, dated 24 May 2011;
3. Decree № 502 of the Government of Georgia on the Repeal of the Governmental Decree on the Determination of Allowable Natural Losses with respect to Oil Products, dated 29 December 2011;
4. Decree № 2547 of the Government of Georgia on Determination of the Body Authorized to Establish Allowable Deficiencies, dated 27 December 2011; and
5. Decree № 96 of the Government of Georgia on endorsement of the Fees for the Services of the LEPL RS of Georgia, dated 30 March 2010.

iii. Decrees of the MoF

1. Decree № 303 of the Minister of Finance of Georgia on endorsement of the Charter of the LEPL RS of Georgia, dated 23 May 2011; and
2. Decree № 994 of the Minister of Finance of Georgia on endorsement of the Rules on Regular (Current) Control Procedures, Write Off of Inventories, Payment of Admitted Tax Arrears, Enforcement Actions on the Tax Arrears, and Procedures for Dealing with Tax Irregularities, dated 31 December 2010.

iv. Decrees of the RS

1. Decree № 7188 of the RS on endorsement of Allowable Production Losses with respect to Cereals, dated 30 August 2011;
2. Decree № 2119 of the RS on endorsement of Allowable Production Losses with respect to Processing of Ore Containing Manganese, dated 29 April 2011;
3. Decree № 2293 of the RS on endorsement of Allowable Production Losses with respect to the Processing of Cotton Products, dated 11 May 2011;

⁷ Official webpage of the RS: <http://www.rs.ge/6151>



4. Decree № 12439 of the RS on endorsement of Allowable Production Losses with respect to the Production of Calcium Oxide, dated 30 December 2011;
5. Decree № 2439 of the RS on endorsement of Allowable Production Losses with respect to Excise Marks damaged in the Production or Import of the Alcoholic Beverages, dated 3 May 2011;
6. Decree № 23022 of the RS on endorsement of Allowable Natural Losses with respect to Oil Products, dated 29 June 2015;
7. Decree № 11321 of the RS on endorsement of Allowable Production Losses with respect to Glass Products, dated 10 July 2012;
8. Decree № 3374 of the RS on endorsement of Allowable Production Losses with respect to Sugar Products, dated 29 June 2011;
9. Decree № 3375 of the RS on endorsement of Allowable Production Losses with respect to Egg Production, dated 29 June 2011;
10. Decree № 6339 of the RS on endorsement of Allowable Production Losses with respect to Scrap (Black) Metal, dated 18 April 2012;
11. Decree № 12051 of the RS on endorsement of Allowable Production Losses with respect to Fruit Concentrates, dated 23 December 2011;
12. Decree № 12002 of the RS on endorsement of Allowable Production Losses with respect to the Drying of Nuts, dated 15 June 2015;
13. Decree № 2140 of the RS on endorsement of Allowable Production Losses with respect to Excise Marks Damaged in the Production and/or Import of Cigars, Cigarettes and Cigarillos, dated 3 May 2011; and
14. Decree № 12500 of the RS on endorsement of Allowable Production Losses with respect to the Production of Gypsum Cardboard during the Thermal Processing of Gypsum Stones, dated 30 December 2012.

CUSTOMS REGULATIONS

The problem of deficiencies is also relevant for customs regulations. For instance, in principle, goods brought into Georgia under the transit customs regime should leave Georgia in the same quantity as they were brought into the country. The same approach applies in other instances too. In this respect, the following customs regulations are notable:

- Goods are allowed for export if the goods are in the same condition at the time of export as they were at the date of the submission of the export declaration, save for alterations caused by natural losses;⁸
- Goods transported under the transit regime through Georgia must remain without any alteration, save for alterations caused by natural wear and tear, transportation and natural losses characteristic of normal terms of storage;⁹

⁸ Article 229.1, Tax Code

⁹ Article 230.5, Tax Code



- Goods stored at customs warehouses must remain without any alterations, except for alterations caused by natural wear and tear, transportation and natural losses characteristic of normal terms of storage;¹⁰
- Goods declared under the re-export customs regime must remain without any alterations, except of alterations caused by natural wear and tear, transportation and natural losses characteristic of normal terms of storage.¹¹

The Tax Code has a similar approaches to goods declared in the domestic and foreign processing regime and temporary imports.¹²

It should also be noted that goods stored at free trade points¹³ must be kept without any alterations, save for alterations caused by natural wear and tear, and natural losses characteristic of normal terms of storage.

PENALTIES ON DEFICIENCIES

Under the Tax Code, upon the discovery of a deficiency of an asset, the assumption is that it has been sold at the market price of such assets at the time of discovery. If the deficiency was discovered in the course of the inventory count conducted by the RS, then the taxpayer shall be penalized with an additional 10% (ten percent) of the market price of the deficient assets.

Discovery of goods not supported by the books of the taxpayer and the required documentation (so-called “Excessive Products”), is also subject to penalty to the amount of 50% (fifty percent) of the market price of such goods.

However, the above penalties do not apply if:¹⁴

- The deficiency or excessive products do not exceed 2% (two percent) of similar products recorded in the books of the taxpayer;
- The taxpayer reflected the deficiency or excessive products in its tax returns and/or supplied the relevant information to the RS before commencement of the inventory count or the audit by the RS, and, according to this information, the deficiency is declared as income and the excessive products as a taxable gain.

On 13 May, the Parliament of Georgian voted into law a bill on a new CIT for Georgia. This was executed and published in the official legislative gazette of Georgia shortly afterwards. Under this bill, a new corporate tax will take effect for most entities from 1 January 2017. However, the new law does not simplify or clarify the tax treatment of losses. Under the new corporate tax rules, upon discovery, a deficiency shall immediately be taxable with CIT (of 15%). All other provisions of the Tax Code relating to deficiencies remain in force.

Importantly, under the Tax Code, as it now stands, a deficiency does not result in the cancelation of the VAT credit the taxpayer has claimed/received on the deficient inventory.

¹⁰ Article 231.9(b), Tax Code

¹¹ Article 233.5, Tax Code

¹² Article 234.7, Tax Code

¹³ Article 226.5, Tax Code

¹⁴ Article 286.10, Tax Code



CONTROLS

Some of the controls related to deficiencies have been set out above. Specifically, reference is made to the regulations under which taxpayers have the right to notify the RS about their intent to write off inventory and get confirmation from the RS to this effect. If taxpayers do not follow this procedure, then the written-off inventory may qualify as a deficiency. Notwithstanding its drawbacks, this procedure was designed specifically to address problems relating to deficiencies. This is certainly a positive development, because many taxpayers have used this mechanism to resolve their problems relating to deficiencies. However, administration of this mechanism is very difficult in light of the growing population of taxpayers and increasing demand on the RS for the confirmation of write-offs.

In addition to this, the RS has a number of other legal instruments to control taxpayer compliance with the regulations on deficiencies. Three of these are particularly noteworthy: tax audits, monitoring and inventory counts.

Tax audits usually check taxpayers' overall compliance with tax regulations, including those relating to deficiencies. Where necessary, the auditing team may request the conduct of an inventory count. Monitoring implies the physical attendance of a representative of the RS at the taxpayer's location so that the monitor can observe processes conducted by the taxpayer. One purpose (among others) of the monitoring is to observe purchases, expenditure, and the formation of deficiencies of the major elements of the inventory. Information collected by such monitoring may be used in the course of the tax audit and ultimately for the determination of the tax liability of the taxpayer.

However, the RS most commonly employs inventory counts to determine taxpayers' compliance with the regulations for the accounting of their inventories. The purpose of the inventory count is to compare the inventory the taxpayer has at the time of the inventory count with the amount the taxpayer should have at such a time according to the taxpayer's books. If the inventory count results in the discovery of some irregularities, the taxpayer may be penalized. In addition to this, information obtained in the course of an inventory count may trigger a wider tax audit of the taxpayer.



3. METHODOLOGY

The project team developed and followed the following work plan:

- Research of the existing system of production losses and drafting a relevant report;
- Meeting/workshops with representatives of business associations, the RS and MoF, Business Ombudsman Office, MoESD and other stakeholders and preparing the respective report;
- Obtaining a report from the German expert on production and natural losses in the taxation of selected EU member states, and his recommendations in this regard;
- Producing the preliminary reform roadmap based on all of the above activities;
- Meeting, presenting and discussing the preliminary reform roadmap with interested parties, including business associations, the Business Ombudsman Office, RS and the MoF;
- Updating the preliminary reform roadmap according to the results of meetings and discussions with various stakeholders;
- Presentation of the final reform roadmap to the stakeholders;
- Finalizing/submitting the reform roadmap.

The project was implemented with the engagement of Georgian and German experts. Georgian experts conducted research on the existing tax treatment of production and natural losses, held meetings with stakeholders, guided the work of the German expert on the case studies, contributed to the organization and running of the workshop, and developed relevant reports.

The German expert, Lutz Reichelt, developed the report on the taxation practice of production and natural losses in Germany, Austria and Poland and provided advice on the reform of the Georgian model.

The project leader and the project manager were engaged in the daily management of the project, planning and organizing relevant meetings and workshops, supplying materials and progress reports to the stakeholders, communicating with G4G and developing project reports.

The positions, opinions and suggestions of stakeholders that were heard in the meetings and workshops were reflected in the relevant reports and were considered in the reform roadmap.



4. FINDINGS

KEY FINDINGS FROM THE STUDY OF FOREIGN PRACTICES

Three EU countries were selected for the study of tax treatments of production and natural losses. Two of these countries (Germany and Austria) have long been EU member states, whereas the third country, Poland, was deliberately chosen as it is a former member of the communist bloc of countries that joined the EU relatively recently.

This study discovered that the Georgian tax treatment of production and natural losses is very similar to specific regulations that can be found in the field of excise taxes in the selected EU member states. Such treatments, however, are limited to a specific (limited) group of products and are not generally applied to other products. With respect to other products, no special regulations exist on production and natural losses. Tax authorities thus rely on general principles and regulations to combat tax evasion practices in this area.

GERMANY

1. GENERAL TAX TREATMENT

With the exception of specific rules for excisable goods/products, in Germany there are no comparable (to Georgia) tax treatments with respect to production and natural losses. In particular, no thresholds for allowable production and natural losses are set.

The German tax authority accepts such kinds of losses in general. The full costs are deductible from the taxable base if they are caused by business activities. If there is no evidence of dishonest or criminal action, the tax authority will not estimate higher sales or income.

In the German tax system, the principles of net income and protection of private property are applicable.

The general principle of equality is protected at the level of the constitution. In terms of tax law, this principle is interpreted as follows:

- Comparable tax issues have to be taxed equally and consistently;
- Every sort of income is equal (very general, in effect there are some schedules);
- Because every sort of income is equal, the determination of total income has to follow the net income principle.

The net income principle states that taxable income is calculated as net income by offsetting all costs and losses against revenues. The net income principle also means that different groups of income from different sources have to be summed up to a total net income. By taxing the net income, the taxpayer is able to pay taxes from his income (ability-to-pay principle), with the outcome that adequate remaining income and private property is protected.

The taxpayer has to provide evidence that the costs have a link to his/her business activities.

The legislator is allowed to simplify the tax system or give special incentives with non-financial intentions. One often used method of simplification is typing (categorization). These rules are the legislator's legal assumptions of real-life circumstances. Categories can be set as either refutable or irrefutable assumptions. Such breaches of the general principle of net income taxation need to be



justified and must be necessary and reasonable to reach their aim. If typing is used to simplify taxation, it is supposed to cover a large number of real-life cases and should not make improbable or unrealistic conclusions.

The burden of proof is established as follows:

- Costs/Losses: evidence has to be given by the taxpayer;
- Revenues/Profits: evidence (for higher revenues/profits) has to be given by the tax authority;
- The taxpayer is obliged to file a tax return and to maintain accounting documents; and
- The taxpayer has to cooperate in the taxation process by handing over all relevant documents to the authority, otherwise the tax authority has the right to estimate the taxable basis and to set penalties.

The tax authority has to investigate and establish all tax-relevant circumstances to guarantee equal and fair taxation of all taxpayers (principle of judicial investigation). The taxpayer is nevertheless obliged to cooperate in this process. The obligation of the authority to investigate the facts can be dramatically reduced and/or the tax consequences can disadvantage the taxpayer if the taxpayer is unwilling to cooperate and to provide the relevant information.

With respect to production and natural losses, circumstances of undeclared sales must be proved by the authority. If a taxpayer's information and documentation of production/natural losses are properly recorded and there is no evidence of concealed (black) sales, the estimation of higher sales or income by the authority would be illegal.

According to the law of Germany, it would not be in line with legal principles to establish a system of general punishment like that in Georgia. The presumption of innocence, which is part of the rule of law, requires investigation of every single case and evidence of tax evasion to be provided by the authority.

2. EXCISABLE GOODS

The closed area where excisable goods can be handled tax free is determined by the main customs office (after a taxpayer's application) under an excise tax suspension arrangement. A tax warehouse or bonded warehouse is a place where excise goods are produced, processed, held, received or dispatched under the tax suspension arrangement. If excisable goods are brought into free circulation, excise tax is due.

In terms of excise taxes, it is in general irrelevant whether such goods have in fact been sold successfully or were unwillingly displaced from the bonded warehouse (if, for example, they were stolen). Excise taxes are nonrefundable.

These regulations are similar to the system of customs clearance, where bonded warehouses are also used as duty free areas.

A physical deficiency in an inventory is not considered a taxable event for VAT or income tax purposes. Such a deficiency can only lead to additional VAT or income tax if the tax authority has proof of generated revenues from the missing items.



2.1 SPECIAL DOCUMENTATION REQUIREMENTS AND OBLIGATORY STOCK TAKING

If products have been accidentally completely destroyed or have been irretrievably lost, the manufacturer or the warehouse owner has to notify the main customs office immediately and has to demonstrate the losses through operational documents. The tax authority may authorize simplifications and issue orders for proof.

The projected destruction of products has to be indicated, at least one week in advance, by the manufacturer or tax warehouse owner, and must be demonstrated through operational documents. The main customs office may authorize simplifications and issue orders for verification. The destruction has to be officially supervised, assuming the main customs office does not waive this rule regarding supervision.

Very large companies have obligatory tax officers who are permanently appointed by the authority but whose salaries must be paid by the company (for example, German breweries have so-called “beer tax officers”). In such very large companies, stock is physically counted in shorter intervals (e.g. quarterly or monthly).

2.2 ASSUMPTION OF TAXABLE EVENTS AND EXCULPATION

If deficiencies appear in the inventory of an excisable good, it is deemed that excise tax in the amount of the deficiency should be paid.

However, the taxpayer has the possibility to exculpate him/herself by furnishing prima facie evidence that the deficiency in the inventory relates to circumstances that do not lead to a taxable event. The physical removal of goods from a bonded warehouse may not have taken place because of the following circumstances:

- Production losses (for example, evaporation, technological or process-specific losses);
- Natural losses (for example, loss of weight because of drying);
- Errors of measurement;
- Input data error, mistakes of labeling of goods;
- Other events like accidents, destruction, leakage, and fire.

A deficiency for excise tax does not automatically lead to additional VAT or income tax.

It is also remarkable that the unrefuted assumption of a taxable event regarding excise tax does not automatically lead to prejudice in criminal law. Penalization is only applicable when evidence of guilt can be given by the authority (i.e. the benefit of doubt goes to the taxpayer / in dubio pro reo).

2.3 THRESHOLDS FOR PRODUCTION AND NATURAL LOSSES

For excisable goods/products, special regulations are generally set in special decrees. Today, excise taxes in Germany are set on alcoholic beverages, tobacco, coffee, energy (gas, petrol, diesel, coal, and oil), electrical power, and nuclear fuel.

In these special decrees, detailed regulations are set to identify tax-relevant issues, and in a few cases these include allowable thresholds for production or natural losses. The regulations on beer tax, tobacco tax and coffee tax do not contain such thresholds.

The following regulations are made on deficiencies in the inventory of alcoholic beverages:

- Deficiencies in the inventory that go back to losses caused by processing, filling and storing, are irretrievable losses that are not subject to excise tax;



- The generally accepted thresholds for losses in the amount of alcohol are;
- Losses in processing alcoholic beverages: cold processing up to 1.0%, warm processing up to 3.0%;
- Losses in the filling of alcoholic beverages: 0.3-0.5% (depending on the packaging used);
- Losses in the storage of alcoholic beverages: 1.0-4.0% per annum (depending on the method of storage and the packaging used).

The taxpayer is obliged to calculate and document its losses. The above mentioned thresholds are used to simplify the tax procedure in most practical cases, because if a taxpayer's production losses do not exceed these thresholds, he/she does not have to bear a higher burden of proof.

If the total losses exceed these thresholds, the refutable assumption by law (based on the decree) is made that the exceeding lost amount was brought into free circulation, which leads to excise tax. However, this is an automatic assumption that the taxpayer has the right to challenge and refute.

It is the duty of the tax authority to investigate all tax-relevant circumstances. In this situation, the taxpayer has to give evidence that the exceeding lost amount of alcohol was not brought into free circulation (burden of proof).

Such an obligation goes back to the excise tax suspension arrangement, where the taxpayer has to comply with special regulations if he/she wants to benefit from tax exemption.

Proven irretrievable losses are not taxed with alcohol tax.

The decision of the tax inspector to not accept accidental losses because of the late submission of information is a discretionary decision and can be re-examined in a formal appeal procedure.

3. ACCOUNTING REQUIREMENTS AND STOCK TAKING

In the case of a (smaller) company, that takes stock only once at the year's end, it is impossible to ascertain the reason for any differences as such companies are not obliged to document stock transactions over the year. As this method is also applicable for tax purposes, such differences are accepted by the tax authority as deductible costs/losses. No additional proof is requested.

4. DISHONEST TAXPAYERS AND SPECIAL TAX APPROACHES

4.1 INDIRECT METHODS/ESTIMATION OF TAXABLE BASIS

The tax authority is allowed and obliged to estimate the taxable base (sales, costs, profits), if one of the following preconditions is fulfilled:

- The tax authority is unable to calculate the taxable profit / taxable base in accordance with the facts in the relevant tax law (a failed "direct" method);
- The taxpayer's documents are unusable;
- The taxpayer cannot give information relevant to their tax circumstances;
- The taxpayer is unwilling to deliver information and documents.

In practice, methods of estimation are used by the authority as a first step to recalculate the profit (or revenues and costs) declared by the taxpayer. If such a plausibility check indicates that the information given by the taxpayer cannot be true, then further investigations will be undertaken.

If a taxpayer is unwilling to help clear up the facts, the tax authority's duty to investigate further is reduced to a minimum.



Only in the event of failed clarification, is the authority allowed and obliged (no discretionary power) to apply indirect methods of estimation to assess taxes.

It is also not allowed to penalize via the estimation of a higher taxable base. The aim of estimation is to determine the true taxable base as exactly as possible given the best information available. An uncertainty surcharge is not a penalty. It is an instrument used to reduce the risk of all facts not being cleared up, especially in cases with uncooperative taxpayers.

4.2 METHODS OF ESTIMATION

In general, we distinguish between recalculation, which is used to verify taxpayer's data, and the estimation of the taxable base.

For both instruments, the following methods are commonly used:

- Internal comparison: comparisons in time and recalculation on the basis of data from previous years;
- External comparison: comparisons with similar companies (such data is systematically collected by the tax authority and can easily be evaluated using database analysis);
- Re-calculation on the basis of cash circulation;
- Investigations in the event of an increase in assets: the assumption is that an increase of assets is caused by undeclared taxable income.

Estimations are usually undertaken as proportional considerations, e.g. cost-income-ratios. The ratios of the actual business year are compared with the ratios of previous years (internal comparison) or with those of similar companies.

Furthermore, estimations can be distinguished as follows:

- Single estimation: determination of a single issue/circumstance of the taxable basis;
- Partial estimation: determination of taxable basis in a delimited partition;
- Full estimation: determination of the taxable basis in total.

For example, if the accounting documents of a taxpayer are not in proper shape, the tax authority first has to apply the methods of single and partial estimation. In practical application, a full estimation is only undertaken if no accounting documents are available.

4.3 CASH DOMINATED BUSINESSES

In some lines of business, criminal activities that can lead to undeclared sales and income are more common. These companies are mainly dominated by a high amount of cash business (e.g. restaurants, hairdressers, bakeries, butchers, etc.). There are special regulations for such companies on how cash registers have to operate.

If there are some indications of implausible accounting, the fiscal authority looks through the books and verifies the declared sales and profits by using the following methods:

- Estimating sales based on the purchase of raw material;
- Estimating sales based on the purchase of consumed water, electrical power and gas;
- Estimating sales based on the number of employees.

4.4 SPECIAL TAXATION REGULATIONS

German law has some exceptions whereby taxes are calculated through unusual methods:



- Very small companies have the choice of calculating profits on cash basis accounting if they do not fall under the accounting regulations of commercial law. For simplification purposes profit is determined as result of cash inflows and outflows and, in general, inventories do not have to be counted or documented;
- In agricultural businesses the income of smaller companies is calculated (by a standard rate) on the basis of units (land, heads of animals, etc.) that are in use.

4.5 ELECTRONIC SYSTEMS

On 14 November 2014, the tax authority provided new guidelines and interpretations for electrical accounting procedures (GoBD). Based on GoBD, the right of the tax authority to review accounting electronically was extended to subsystems such as inventory accounting and distribution systems, and cash registers.

4.6 ALTERNATIVES TO THE NET PROFIT PRINCIPLE FOR GREATER EFFICIENCY

Simplifications are used where profits are determined on the basis of assets in use (as in agriculture, with land, animals, etc.), and in flat rate tax systems and withholding tax systems that ensure taxation in the cases of fleeting taxpayers. The reverse charge for VAT makes the receiver responsible too.

The tax authority must be able to work efficiently. It seems to be almost impossible to install an administrable application system for write-offs on inventories or for the determination of individual allowable thresholds regarding production losses for purpose of income tax and/or VAT.

If the tax authority in effect is unable to consistently administrate such application systems, general legal principles are seriously undermined. Such a procedure is not in line with the principle of equal and consistent taxation of all taxpayers.

AUSTRIA

1. GENERAL TAX TREATMENT

If there is no evidence of dishonest or criminal action, the tax authority will not estimate higher sales or income.

The ability-to-pay-principle does not have a constitutional status with respect to the Austrian High Court (VfGH). A breach of the net income principle and the ability-to-pay-principle must be justified by the legislator.

If the taxpayer does not cooperate sufficiently, the duty of the authority to investigate can be reduced.

2. EXCISABLE GOODS

These taxes are imposed on alcoholic beverages, tobacco and energy products (e.g. petrol, diesel and oil).

Until 31 December 2000, specific thresholds for losses regarding the processing, filling and storage of alcoholic beverages were set. These regulations were very similar to the German rules.

In Austrian law, these thresholds were used to simplify taxation procedures by defining generally accepted thresholds as refutable legal categorization. Under this approach, the taxpayer had the possibility to prove higher rates of losses in his/her company with adequate documentation.

Since 1 January 2001, these thresholds were removed without any replacement. The legislator explained this change with the following arguments:



- The thresholds did not reach their aim of non-taxation of the allowed shortfalls and could be misunderstood;
- The new regulation does not stop the possibility of using individual or general empirical values to determine allowable shortfalls.

It thus seems that the repeal of the thresholds was justified with the aim of simplification.

If goods or products are lost in the warehouse, the taxpayer has to inform the tax authority immediately.

In case of the planned destruction of excisable goods, the owner of the bonded warehouse has to inform the Customs Office in advance and give it the possibility to supervise the destruction.

Furthermore, the taxpayer has to comply with documentation requirements. Such records must be completed immediately, at the latest two days after a notifiable event (e.g. the purchase of raw materials, the consumption of raw materials or goods in the production process, or the sale of goods).

3. IMPAIRMENT TEST/WRITE-OFFS

Inventories can be written off by an impairment test.

Otherwise, this loss is deductible with the physical dispatch of the good (when the item is sold at a loss or is scrapped). Finally, write-offs or losses of inventory are fully recognized in the tax return.

4. DISHONEST TAXPAYERS AND SPECIAL TAX APPROACHES

INDIRECT METHODS/ESTIMATION OF TAXABLE BASIS

The function of Art. 184 BAO is only to give the tax authority the possibility to estimate the taxable base in single cases, where there is no further chance to investigate tax-relevant issues (no discretion) because of effective or legal reasons (ultima ratio).

If the accounting is formally correct in general, factual correctness can also be assumed.

The authority is allowed to estimate profits if, based on a control calculation, the profits of a company are significantly different from the peer group without any clear reason. Differences of up to 10% have to be accepted in general.

Estimation cannot be used by the administration to simplify the tax procedures, as was allowed previously.

Estimation of the taxable base is allowed by law, if:

- Accounting documents are not in the necessary format and/or have grave errors;
- The taxpayer does not cooperate with investigation circumstances;
- Peer group companies have significantly different data and there is no obvious reason for this discrepancy.

The authority has the burden of proof to show that accounting documents are seriously false. The authority is obliged to make any peer group data used fully transparent for the taxpayer.



POLAND

1. GENERAL TAX TREATMENT

In the absence of specific regulations (such as for excise) with respect to natural and production losses, the Polish tax authorities use general anti-tax evasion rules to combat malpractice from certain taxpayers which unjustly claim natural and production losses and (1) to challenge the deductibility of the losses claimed or (2) to estimate the costs and revenues of the taxpayer.

2. DEDUCTIBILITY OF PRODUCTION AND NATURAL LOSSES

The following conditions, implied by the general principles outlined above, should be satisfied cumulatively to recognize tax deductible costs (including losses) in the case of production and natural losses:

- i) The cost is incurred to earn or maintain or secure a source of revenue (purpose and causality);
- ii) The cost does not belong to any of the expenditures that are not allowed for deduction by the CIT Act;
- iii) The cost is properly documented;
- iv) The taxpayer exercised appropriate due diligence.

In terms of (iii), production and natural losses should not be established by the taxpayers as estimated values or as statistical data, but be calculated at its real value.

Production and natural losses should be documented in accordance with the following principles:

- The natural/production losses should be confirmed by the protocol prepared by the taxpayer;
- The protocol should include the type, amount, quantity, and cause of loss;
- The protocol should be signed by the authorized persons;
- The protocol should meet the requirements of the Accounting Act established for accounting records.

As for (iv), this relates to the non-deduction of avoidable costs, for example, because of inefficient production methods. For instance, in order to eliminate losses arising in the production process, a company might take measures aimed at effectively reducing losses (i.e. repair, modernization, modification, maintenance of production equipment and staff training).

If the tax authorities did not prove that in a particular case the natural/production losses could have been avoided, the taxpayer is entitled to treat them as a tax-deductible cost (provided the other mentioned conditions are fulfilled). This requires knowledge of the production process, which is why tax authorities usually compare data with other similar entities or solicit expert opinion.

3. EXCISABLE GOODS

Upon the application of individual entities, the competent head of a customs office shall determine, by decision, the limits on losses of excise goods. The Minister of Finance shall lay down: 1) the maximum limits on losses of particular excise goods as a result of certain activities; 2) the scope and manner of establishing limits on excise goods losses or consumption; 3) a manner of accounting for excise goods losses, until such a time when the competent head of a customs office determines the limits.

Losses of excise goods shall be exempt from excise duty up to the respective amounts determined for a given entity by the competent head of a customs office.



According to the provisions of the PIT/CIT Act, losses due to shortages in excise goods that are not subject to exemption from excise duty should be considered as tax non-deductible costs.

4. ACCOUNTING REQUIREMENTS

The taxpayer shall classify the purchase of assets at the cost actually incurred as tax costs, although in the accounting records these materials/goods will be recognized at a different price (fixed price).

In matters not governed by the provisions of the Accounting Act, reporting entities may apply the national accounting standards issued by the Polish Accounting Standards Committee. Where no applicable national standards exist, reporting entities may apply International Accounting Standards.

5. SAF-T REQUIREMENTS

The act of 10 September 2015 on Amending the Tax Regulations Act, alongside some other acts, implemented the concept of SAF-T. This idea was developed by the OECD and requires taxpayers using computer software to submit accounting books and evidence in the form of structured (XML) format files. With the use of appropriate algorithms, this format will automatically allow tax authorities to extract the required substantive data and verify them.

The warehouse part in SAF-T provides data concerning:

- Materials, products and packages (each single item);
- Internal release, movements between warehouses, receipt from outside, and external release.

This amendment became effective from 1 July 2016. Under the transitional provisions, in the period between 1 July 2016 and 30 June 2018, small and medium entrepreneurs will have no obligation to provide data in accordance with the standard; however, they will be able to do it optionally. Thus, this category of taxpayers will only be required to submit data to tax authorities in the SAF-T format as of 1 July 2018. However, for SAT-T based reporting of VAT data, large entities are obliged to submit monthly reports from June 2016, and small and medium enterprises (SMEs) from January 2017.

Categories of entrepreneurs are defined based on (1) number of employees, (2) annual turnover and (3) value of total assets.

This kind of standardization will significantly automate tax audits, increase efficiency and save taxpayers' time costs.

6. STOCK TAKING

Physical stock taking is also performed for assets owned by third parties; such third parties will be informed of the results of such stock taking. This obligation does not apply to any entities providing postal, transport, forwarding, and storage services.

6.1 TAX CONSEQUENCES OF INVENTORY DIFFERENCES

In some cases, the conduct of stock taking may result in the recognition of inventory differences (surplus or shortage). If a taxpayer holds more assets than indicated in their accounting records, the taxpayer is obliged to record the surplus amount as revenue. Specifically, any surplus in inventory shall be considered as a free of charge benefit received by the taxpayer. In other words, it is a gain that should be added to the company's revenue as a gratuitous receipt subject to CIT/PIT.

If the stock taking discovers that the taxpayer holds fewer assets than indicated in their accounting records, then the taxpayer shall not be allowed to deduct the cost of missing assets. At the same time, the taxpayer shall not be deemed to have sold the missing inventory. Polish tax regulations do not instruct what the tax treatment of the situation should be when the missing inventory is explained by



the taxpayer as production and/or natural losses. These are not automatically treated as non-deductible costs (except for excise goods) or as taxable revenues.

6.2 SPECIAL DOCUMENTATION REQUIREMENTS FOR PRODUCTION AND NATURAL LOSSES

Analysis of binding tax rulings and the jurisprudence of courts led to the conclusion that proper documentation should:

- Indicate the amount of the losses;
- Present the causes and circumstances concerning the losses;
- Present evidence that the losses were not caused by the taxpayer's fault or negligence.

Documents include a list of inventory prepared by the stock taking committee (internal documentation); official confirmation of the liquidation of goods (internal documentation); the report of damage (in case of the beneficiary of insurance); and expert opinion.

Simultaneously, natural/production losses should be properly reflected in the accounting records (entered into the accounts).

7. IMPAIRMENT TEST/WRITE-OFFS

Write-offs based on the impairment may be established when there is a high probability that an asset controlled by the entity will not generate the expected economic benefits (in a part or as a whole) in the future. The value of an asset from the accounting books will be adjusted to the net sales price or other fair value. However, it should be noted that the impairment write-down is an interim solution and it must be analyzed by the entity until the cause of the revaluation write-off has ceased. A reversal of the impairment write-off should then be made.

Revaluation write-offs of inventories, made in accordance with the provisions of the Accounting Act and recognized as the operating cost for accounting purposes, are tax non-deductible costs under the CIT/PIT Act. It is the lasting difference between the tax and accounting treatment of cost, because the write-off will never be recognized as a tax deductible cost.

The method of setting the limit on natural losses and determining the volume of permitted natural loss, is established by the entity and should be stated in the instructions on stock taking or in the accounting policy. Shortages established during the inventory within fixed norms or limits of natural losses are recognized as the cost of sold goods. The above mentioned limits are set by the taxpayers at their sole discretion, considering objective conditions for accounting purposes.

8. DISHONEST TAXPAYERS AND SPECIAL TAX APPROACHES:

8.1 INDIRECT METHODS/ESTIMATION OF TAXABLE BASIS

A tax authority calculates the estimated tax base, only if:

- 1) Tax books or other data necessary to determine the tax base are unavailable; or
- 2) The data provided in tax books does not enable determination of the tax base; or
- 3) The taxpayer infringed the conditions entitling him/her to apply a flat-rate tax.

A tax authority should not calculate the estimated tax base if the data provided in the tax books, supplemented by evidence obtained in the course of proceedings, make it possible to determine the tax base.

The estimated tax base is calculated using the following methods:



- 1) Internal comparison method - comparing the amount of turnover to previous periods for which the amount of turnover is known for the same enterprise;
- 2) External comparison method - comparing the amount of turnover to other enterprises that conduct similar business in similar conditions;
- 3) Inventory method - comparing the value of the assets of an enterprise at the beginning and the end of a period, taking into account the turnover ratio;
- 4) Production method - determining the production capacity of an enterprise;
- 5) Cost method - determining the amount of turnover on the basis of the amount of costs incurred by an enterprise, taking into account the cost to turnover ratio;
- 6) Income to turnover ratio method - determining the amount of income from the sale of certain goods and the provision of certain services, taking into account the ratio of those sales (services) in overall turnover.

In special circumstances, where it is impossible to apply the methods listed above, a tax authority may estimate the tax base in another manner. A tax authority has to justify its selection of a particular estimation method.

The tax ordinance further specifies the following:

- Tax books maintained in a reliable and correct manner serve as evidence for what is recorded therein;
- Tax books are considered to be reliable if what is recorded therein reflects the actual state of affairs;
- Tax books are considered to be correct if they are maintained in accordance with the relevant principles determined in separate provisions;
- A tax authority does not consider tax books maintained in an unreliable or incorrect manner to be evidence within the meaning mentioned above;
- However, a tax authority shall consider tax books maintained in an incorrect manner as evidence, if the errors are not relevant to the case concerned;
- If a tax authority decides that tax books are maintained in an unreliable or incorrect manner, the tax authority specifies, in a report following the review of the books, the periods and parts of the books that do not serve as evidence for what is recorded therein;
- A tax authority delivers a copy of the minutes as referred above;
- Within 14 days from the delivery of the minutes, a party may object to the conclusions reported therein, presenting relevant evidence to enable the tax authority to calculate the correct tax base.

Example of tax treatment:

A company was engaged in commercial activity involving the buying-in, storage and sale of mushrooms. Natural losses were recorded in the company's accounting books in accordance with the accounting policies specified in the Polish Accounting Act. The company recognized as a tax deductible cost a loss calculated as the fixed amount expressed in percentage (10% of the quantity sold) of every sale and confirmed this with one general internal monthly document, which was incompatible with the entire process of transactions.



The tax authority challenged the deductibility of those expenses, because the quantity of natural losses recognized by the company did not reflect the commercial reality, as natural losses were settled on the grounds of a fixed ratio (10%).

The evidence must reflect the legal requirements for accounting documents, as established in the Polish Accounting Act. These kinds of losses are often confirmed in an internal protocol issued by the commission appointed to assess such losses.

The tax authorities estimated the value of the natural losses. For this purpose, the tax authority collected data from three companies engaged in buying-in, storing and selling mushrooms (the selected companies were from the same geographical area and conducted business activity under similar rules).

The average ratio of natural losses in the case of storing mushrooms was (data for comparison):

- 1.50% within two days of storage – data from the first company;
- 2.29% within three days of storage – data from the second company;
- 5.54% within seven days of storage – data from the third company.

The tax authority took into account the duration of mushroom's storage and estimated the loss as being 5.29%.

8.2 AGRICULTURAL BUSINESS

The problem of production and natural losses is not relevant for some simplified tax regimes, such as the regime applicable to agricultural businesses.

Agricultural activities generate (natural) plant or animal products, without further processing, from a business's own farming or animal breeding. Generally, the provisions of the PIT/CIT Act do not apply to revenue from agricultural activities, except for revenue from special branches of agricultural production (greenhouses and heated plastic tunnels, growing of mushrooms and their mycelia, farm breeding and raising for slaughter, and laying poultry). These special sectors are dealt with only when production exceeds certain amounts.

In general, there are two possible ways of calculating the tax base for income tax purposes:

- 1) On the grounds of accounting books or the tax revenue and expenses ledger;
- 2) On the basis of estimated norms of annual income established by law (fixed income, for example, per 1m² of a mushroom farm) – only for personal income tax.

The taxpayer shall choose a way of setting the tax base. If revenues exceed a specific amount, the taxpayer is obliged to keep accounting books. Natural/production losses are relevant for taxpayers performing special forms of agricultural production, who are obliged to maintain accounting books.

Tax losses in the context of special sectors of agricultural production are settled on the basis of a general rule that losses may be offset in the following five consecutive fiscal years, where in any year the amount of reduction may not exceed 50% of the carried forward loss. The said entitlement does not relate to taxpayers who choose the estimated method.

Farmers are also subject to agricultural tax (applied to land classified in the land and buildings register). The tax rate is based on the price of rye (the average buying-in price for the eleven quarters preceding the quarter preceding the tax year). The conversion unit is 1 hectare.



In conclusion, if the agricultural activity is subject to income tax, the same general principles as in the case of other businesses apply to the treatment of natural/production losses.

KEY FINDINGS (CONCERNS AND SUGGESTIONS) FROM MEETINGS WITH STAKEHOLDERS IN GEORGIA

The grantee coordinated the process of planning meetings with interested parties. The International Relations Department of the RS was involved in the process of planning and organizing several meetings.

All interested parties were supplied with the full version of the report detailing tax treatment of production and natural losses in the selected EU member states, an executive summary of the document and a preliminary version of the reform roadmap on losses elaborated by Georgian experts.

Governmental bodies expressed their willingness to reform the existing system and apply the fundamental principles of a fair society (these principles were widely discussed in the part of the attached report covering Germany). Active interest was generated towards the OECD's SAF-T standard, which became known as a result of the Polish experience study.

KEY CONCERNS AND SUGGESTIONS OF RS

The existing practice of setting of norms on losses by the RS is not appropriate for two reasons:

- The fact that the interested institution establishes norms of losses and then relies on its own research generates conflicts of interest and damages the sense of justice;
- There are many specific sectors where it is impossible for the RS to establish fixed norms. For several sectors (nuts, for example), the state relied, to a certain extent, on private sector data. In the case of oil, various literature and documents were studied. These measures do not imply a detailed study (of factors like temperature changes, geographical location, etc.). Notwithstanding these particular cases, this may be not a viable solution for all cases as there might be a mismatch with reality.

There are industries with a small number of enterprises – some have only one or a few active businesses (sugar production, for example). In such cases, the RS does not have the ability to conduct comparative analysis and weighting.

The large gap between applied technologies adds to the difficulties in comparison. However, it is relatively easy to trust enterprises equipped with modern technologies because it is possible to control losses in such enterprises (for example, by equipment documentation that describes productivity, amortization, etc.).

The tax culture in Georgia creates problems. Tax and entrepreneurial culture is more developed in developed markets where trust towards the entrepreneur is strengthened by the tendency that losses are treated as an efficiency problem of the enterprise and entrepreneurs will avoid demonstrating themselves as ineffective (only for tax reasons), to maintain their reputation. There is an understanding that trust towards the internal documentation of a business should exist, but this is hindered by the existing attitude in Georgia towards tax obligations.

The RS supports the introduction of solutions adopted in leading EU member states, but acknowledges that the different starting positions should be taken into account. In the case of Georgia, in order to show reasonable trust towards the taxpayer, relevant experience and resources



are necessary. The report on the practice of selected EU states indicates that trust towards the taxpayer is supported by the accumulated experience in investigative activities – something that is missing in the Georgian RS.

KEY CONCERNS AND SUGGESTIONS OF MOESD

Business associations and their experts, using their knowledge of industry particularities, may support their members in various ways: finding appropriate information and evidence with regard to losses, descriptions of procedures, elaboration of methodology, confirmation of information obtained from independent experts, and other means that will substantially facilitate the process of fixing losses by sector. The associations may discuss and work on the list of documentation that should be considered as confirmation/evidence for particular sectors.

MoESD platforms could be used to discuss these issues (as officials of the MoESD highlighted, a platform for communication with businesses exists where around 20 associations are united. Periodical meetings with associations are held for the identification of problematic areas and the exchange of ideas and thoughts).

KEY CONCERNS AND SUGGESTIONS OF THE BUSINESS OMBUDSMAN

The Office of the Business Ombudsman welcomes the idea of the electronic filing of internal documentation and the creation of a respective database at the RS Level. However, the frequency of declarations will have to be defined and the list of recommended documentation elaborated.

The usage of such a module should be voluntary but sufficiently incentivized.

It is possible that business representatives themselves may suggest realistic and workable incentives in order for them to volunteer.

Examples of incentives include:

- The burden of proof is minimal for the entrepreneur when he/she has submitted full and reliable documentation to the RS for previous periods;
- The RS shall consider the norms of losses and actual loss by internal documentation as being reliable and, in turn, will not perform an audit if one of the following conditions are met; (1) The preconditions for the application of indirect methods do not exist; and/or (2) the norm and specific data substantially differs from industry standards (the term “substantial difference” shall be interpreted depending on the particularities of a specific industry);
- If the audit of substantially different data reveals that the difference of declared data with reality does not exceed a certain percentage, no loss is considered to have occurred. The allowable difference in the case of voluntary electronic declarations shall exceed the standard allowable rate;
- In the case of substantial differences, the burden of proof (including financial and administrative resources) shall be on the RS.

KEY CONCERNS AND SUGGESTIONS OF BUSINESS ASSOCIATIONS

Discussions with business associations highlighted the following issues:

- An improved definition of losses should be introduced in the tax code (it should be clarified what are considered as natural and production losses, as far as different processes exist in



production: losses at the conversion stage, losses during the transformation and technological process, etc.);

- Improved prevention of tax avoidance by dishonest taxpayers (for example, through better control of sales) is needed;
- Presumption of innocence of entrepreneurs should be an established principle, as is highlighted in the report on the practice in EU member states. When internal documentation is complete and reliable, the burden of proof should be on the State;
- The setting of fixed allowable thresholds by the State for specific industries would also be a possible solution;
- The restricted use of indirect methods in EU states is a good example of fair tax treatment.



5. RECOMMENDATIONS

As previously stated, the objective of this project was to design a reform roadmap based on:

- Evaluation of Georgia's legislation and procedures on natural and production losses for taxation purposes;
- The results of discussions on the current Georgian Production Loss Deduction System with various business associations, the RS and other stakeholders;
- Analysis of the Production Loss Deduction Systems of selected EU member states (Germany, Austria and Poland), which may be adapted to the needs of Georgia.

As a result, the following roadmap for the reform of the Georgian system of deduction of natural and production losses for tax purposes was elaborated.

ROADMAP FOR THE REFORM

INTRODUCTORY REMARKS

The primary goal of this project was the elaboration of a roadmap for the reforms (the "**Roadmap**"). This document sets out

- (1) Recommendations with respect to the improvement of Georgian tax regulations regarding the tax treatment of production and natural losses; and
- (2) Methodology for the implementation of these recommendations.

The objectives of the roadmap are twofold: (i) improvement of current tax regulations; and (ii) prevention of abuse of production and natural losses by dishonest taxpayers. The importance of the second objective should be stressed. Any change in regulations, if not carefully weighted, may have a negative impact on honest taxpayers by leading to undue penalization or by opening a gap for dishonest taxpayers who may abuse loopholes in the regulations and thereby gain a competitive advantage over honest taxpayers. In both scenarios, the incentives for tax compliance may be undermined, which would eventually damage public and private interest.

RECOMMENDATIONS

After the detailed study of the status quo with respect to production and natural losses in Georgia, as well as the approaches EU member countries adopt to the same subject, the following recommendations for the change of tax treatment for production and natural losses in Georgia were elaborated.

While drawing up the recommendations, the following factors were taken into consideration:

- (1) **Strong historical factors relevant for Georgia.** Not long ago, black market and tax evasion practices were widespread in Georgia. Even though Georgia has largely overcome these problems, the risk of their reoccurrence may still exist.
- (2) **Need for improvement of the business environment.** For the business community, production and natural losses remain some of the key tax risks that may sometimes result in the undue penalization of honest taxpayers. Mitigation of this risk would greatly improve the business environment in Georgia.



Thus, based on the factors and studies referred to above, the recommendation to Georgian tax policy makers is to amend the tax regulations of Georgia so that both tax regulations and tax enforcement practices follow the following principles:

- (1) In the transition period to a more sophisticated system, the Government of Georgia by its resolution or the MoESD (the “Authorized Person”) may:
 - I. Establish the allowable amount only for natural losses; or
 - II. Identify and authorize the entity for this purpose; and/or
 - III. Recognize the amount of natural losses established by third parties.

However, the taxpayer shall have the right to declare more than this amount of losses; provided it proves that its natural losses exceeded the established thresholds (i.e. the burden of proof in this scenario shall be on the taxpayer).

- (2) The RS and the MoF shall introduce software to make it possible for taxpayers to submit information on production losses to the RS or make the relevant documents accessible. This software shall contain prompts and directions to help the taxpayer select the relevant information/documentation and to submit/make it accessible in a format with the necessary content for the RS to analyze general trends in the industry with respect to losses.
- (3) The RS shall allocate its staff to continuously analyze the information received from taxpayers with the goal of determining general trends with respect to production and natural losses among taxpayers.
- (4) The taxpayers will always be better positioned, if they properly document their transactions, but for those areas for which no allowable amount of natural losses has been established, the taxpayer should remain **obligated** to document and show the amount of natural losses sustained in its accounting records. The RS shall have an obligation to rely on this documentation, unless:
 - I. The RS demonstrates that the taxpayer’s documentation is wrong (i.e. the burden of proof shall be on the RS); or
 - II. Preconditions for the use of indirect methods are present.
- (5) With respect to production losses, the taxpayer shall remain obligated to document and show the amount of production losses sustained in its accounting records. In addition to this, the taxpayer has a continued obligation to submit updated documents with respect to production and natural losses to the RS on an annual basis. If the level of production and natural losses fluctuate considerably within a year, then upon the occurrence of such fluctuations, the taxpayers shall submit updated documents to the RS within one month. The RS has an obligation to rely on such documentation, unless:
 - I. The RS demonstrates (i.e. the burden of proof shall be on the RS) that the amount of production and natural losses claimed by the taxpayer is grossly in excess of the industry practice in the same area and that this cannot be justified by special circumstances (for example, the spread of disease in a specific area leading to an abnormal loss of livestock); or
 - II. Preconditions for the use of indirect methods are present.



- (6) The level of production and natural losses to be deemed grossly excessive shall be published by the RS in regard to specific industries and shall be consistently used in the same industry.
- (7) The indirect method should, however, be used with respect to production losses and natural losses, only if the relevant preconditions for their use is warranted. Furthermore, in determining the taxpayer’s estimated tax base, the RS should take into account the production and natural losses the taxpayer would have incurred during the ordinary course of business.

With respect to production and natural losses, the indirect method should only be used if
 (1) the taxpayer does not have accounting books or its books are materially deficient; or
 (2) the tax authorities discover illegal/shadow sales of inventory by the taxpayer. In the latter case, the tax should be assessed on the proven amount of illegal/shadow sales.

- (8) During the inventory count, the RS should take into account that the inventory amount at the time of the count was affected by (among other things) production and natural losses arising at relevant times.
- (9) The RS should elaborate particular control mechanisms with respect to production and natural losses. These should include, but should not be limited to, the following:
 - I. Introduction of special software for the online submission of documents relating to production and natural losses by taxpayers;
 - II. Creation of a statistical database of production and natural losses, for at least the key industries;
 - III. Elaboration of a risk system for the detection of possible abusive practice in the area of production and natural losses;
 - IV. Carrying out targeted audit and other control procedures of taxpayers who declare significantly higher levels of production and natural losses.

IMPLEMENTATION OF THE RECOMMENDATIONS

Given the magnitude of the subject matter of the recommended reforms, the methodology for the implementation of the recommendations should be carefully selected. In light of a number of factors, including those noted above, the implementation of the recommendations set out above is proposed in the following stages:

Stages	MEASURES TO BE TAKEN
Stage 1	MoF and the RS: <ul style="list-style-type: none"> (a) Identifying and analyzing specific risks associated with the implementation of the recommendations and quantifying such risks; (b) Identifying specific administrative measures that could assist in the management of the referred risks (the creation of databases for different industries, risk based monitoring/audit of taxpayers, collaboration with law



	enforcement bodies, etc.); (c) Introduction of special software for online submission of documents relating to production and natural losses by taxpayers.
Stage 2	Drafting amendments to the tax code and relevant sub-legislative acts for the implementation of recommendations.
Stage 3	Public discussions of the draft amendments.
Stage 4	Amendment of the tax code and relevant legislative acts for the implementation of recommendations.
Stage 5	Creation of guidelines for taxpayers;
Stage 6	(a) Creation of a statistical database of production and natural losses, for at least key industries; (b) Elaboration of a risk system for the detection of possible abusive practice in the area of production and natural losses; (c) Drafting guidelines and audit manuals for RS auditors for the implementation of new regulations and the detection of risks associated with production and natural losses during the audit.
Stage 7	Training of auditors on the new regulations, guidelines and audit manuals.
Stage 8	Monitoring and detection of tax evasion practices, (e.g. the introduction of various control mechanisms at the RS to combat possible tax evasion practice – including desk risk analysis and collaboration with other law enforcement bodies for the detection of possible fraud).



APPENDIX A:

PRODUCTION AND NATURAL LOSSES IN THE TAXATION OF SELECTED EU-MEMBER-STATES

(Written by Lutz Reichelt)

Description of Research

In Georgia, the tax treatments on so called production or manufacturing losses and natural losses are one of the biggest tax risks for business activities.

Production losses or manufacturing losses are typically caused by technical parameters of production process, equipment and used (raw) materials. Between production input and output a physical loss of (raw) material is recognizable. The amount of lost material lead to the so called “production losses”. The same term is used to describe the incident that with more or less input of materials the taxpayer’s outputs vary (Output Variations). Such variation in the level of output may be caused by (i) the use of more efficient technology or if the used technology remains the same, by the use of more efficient raw materials or (ii) by the dishonest practices of the taxpayer.

Natural losses are typically caused by the inherent characteristics of goods, for example agricultural products. These goods are often characterized by a physical loss of substance by time.

Many business activities are confronted with the tax treatments of production or natural losses. Georgian fiscal authority treats such loss of products or raw materials as sales, subject to taxation. By the approach of the authority, production and natural losses are recognized as deductible costs but taxpayer’s income and VAT is estimated on higher sales.

The purpose of this report is to:

- 1) Identify whether there is any specific regulation concerning the tax treatment of the production and natural losses in Germany, Austria, and Poland and to provide a description of such regulations (if they exist);
- 2) In the absence of such regulations in the referred countries, to set out how the production and natural losses are treated for tax purposes under general tax regulations; and
- 3) Give advice how Georgia can improve its tax regulations with respect to the production and natural losses to improve protection of the honest taxpayers without creating loopholes for the dishonest taxpayers through which they may evade due taxes.

1. Selected EU-Member-States

1.1 Germany

a) Structure of German tax system

Tax law is part of public law, which is used to regulate the relationship between the state and private individuals or legal entities.

Therefore the main purpose of tax law is to generate revenues for the state (fiscal purpose).

The (corporate) income tax as well as the accounting law are to be examined as a part of the relevant provisions of the research topic.

Accounting law in general is part of commercial law (HGB). Income taxes have to be paid on the base of the profit that is calculated under the rules set by the HGB. But in many cases, profits calculated according to the HGB are modified by tax law, to receive the taxable income.

Value added tax and the most of special excise taxes are under common legislative procedure of the European Union. Directives and regulations from the European Community are transformed in the national law of EU-Member-States. That is why all three of the selected EU-member-states have very similar regulations within this field of taxation. Thus, the German part wants to give a general overview to VAT regulations and to the special rules in the field of excise taxes (selection). The Austrian and the Polish part have a limited scope on VAT and excise taxes as the law in these countries is similar to the German law.

Such EU-wide harmonization has not happened in the field of income tax and accounting law until now. Harmonization in the accounting law is made with the IFRS that are applicable for listed companies. But IFRS are not allowed to use for income taxation in Germany. Listed companies have to reconcile their IFRS financial statements according to HGB, on which income taxes are calculated.

b) Sources of tax law and tax regulations

In the German tax system there are three sources of law.

The first of the three kinds of regulations are set as an Act by the legislator (Bundestag, Bundesrat and Bundespräsident). E.g. the Income Tax Act (EStG), the Corporate Income Tax Act (KStG) and the Value Added Tax Act (UStG). In the Federal Republic of Germany the standard legislative procedure is the following:

- Act is prepared and discussed in committees;
- Act has to pass the lower house of parliament (BT);
- Act has to pass the upper house of parliament (BR);
- Act has to be signed by the president (BP).

According to Art. 80, GG additional tax decrees can be set on the basis of an enabling act by the executive bodies (government, ministries or ministers) in a simplified procedure without involving the legislative bodies again. This procedure of enacting such decrees is justified by reference to the enabling act which passed the full legislative procedure. In legal practice such decrees (e.g. BrStV, TabStV) also have the character of a legislative “Act.”

The second source of law is judgments by the courts.

Acts and judgements are binding for both taxpayers and tax authority.

The third source of law is set by the fiscal authority as administrative instructions and interpretations. This kind of regulation is binding only for the authority.

c) General principles and higher law

Within the German tax law, by the time general principles of taxation have developed by judgments of the high court with regards to constitutional requirements. If a tax regulation is legally challenged, the taxpayer is allowed to call the courts, up to high court (BVerfG).

The European Court can be called for disputes with contact to European law. Overall, the principle of law is applicable also in taxation. For more details see C.1.1.

1.2 Austria

a) Set-up of Austrian tax system

Tax law is part of public law, which is used to regulate the relationship between the state and private individuals or legal persons.

Main purpose of tax law therefore is to generate revenues for the state (fiscal purpose).

Regarding the topic of research (production/natural losses), relevant tax regulations are part of (corporate) income tax and accounting law.

Accounting law in general is part of commercial law (UGB). Income taxes have to be paid on base of the profit that is calculated under UGB. But in many cases, UGB profits are modified by tax law, to calculate the taxable income.

b) Sources of tax law and tax regulations

In the Austrian tax system, there are three sources of law.

First group are rules that are set as act by the legislator (Nationalrat, Bundesrat, Bundespräsident). E.g. the Income Tax Act (EStG), the Corporate Income Tax Act (KStG) and the Value Added Tax Act (UStG). In Austria, the standard legislative procedure is the following:

- Act is prepared and discussed in committees and in the plenum;
- Act has to pass the lower house of parliament (Nationalrat);
- Act has to pass the upper house of parliament (Bundesrat); or
- Act needs the approval of all federal states; or (generally not used to set tax law);
- Act needs to pass a plebiscite (generally not used to set tax law);

- Act has to be signed by the president (Bundespräsident).

According to Art. 18, par. 2 B-VG, additional tax decrees can be set on the basis of an enabling act by the executive bodies (government, ministries or ministers) in a simplified procedure, without involving the legislative bodies again. The settlement of such decrees is based on the enabling act, which passed the full legislative procedure. In legal practice, such decrees also have the character of a legislative “Act.”

Second group are judgements of the courts.

Acts and judgements are binding for both, taxpayers and fiscal authority.

Third group of regulations are set by the fiscal authority as administrative instructions and interpretations. This source of law is binding only for the authority.

1.3 Poland

a) Remarks concerning the scope of the report

i) The tax provisions

This information concerns exclusively the natural and production losses resulting from business activity (excluding such losses regarding fixed assets) under the provisions of the Polish CIT Act, the Polish PIT Act and the Polish Tax Ordinance.

ii) The accounting provisions

The tax law and the accounting law are different branches of law (the premises and purposes of their provisions differ). The accounting law does not regulate tax issues. However, according to Article 9 of the CIT Act taxpayers shall maintain accounting records in accordance with separate provisions in such a way as to enable calculation of income (loss), taxable amount and the tax due in a given tax year, and shall include the information required to calculate write-offs for tax purposes in their fixed and intangible asset records. In practice, in order to calculate income tax, taxpayers use data presented in accounting books. However, because of the differences between the tax and the accounting law (see: point c) herein Differences between tax and accounting principles), the taxpayers prepare separate calculation for tax purposes in order to eliminate the above mentioned differences. The form of separate calculation is not regulated in any tax act and it is used in order to facilitate the settlement of income tax. The Polish legislation provides different accounting rules to certain groups of companies.

Such differences may concern:

- Tax deductible cost under the Polish CIT/PIT Act and cost recognised under the Polish Accounting Act; and
- Taxable revenues under the Polish CIT/PIT Act and the revenues recognised under the Polish Accounting Act.

As a result, revenues, costs and gross financial result calculated on the grounds of accounting regulations usually differ from the tax base calculated on the basis of tax regulations.

Example: In case of natural and production losses this may mean that natural/production losses recognized as the operating cost for the accounting purposes, are tax non-deductible cost under the CIT/PIT Act if the losses are the result of failure to maintain due diligence by the taxpayer e.g. higher losses created in the production process which would not have been created if the taxpayer acted reasonably and took measures to prevent them.

There is no specific regulation considering the permissible standards/limits of natural/production loss. Therefore, each case must be examined on its own merits. An effective evaluation must be based on indicators allowing adequate data comparison, e.g. data from other companies conducting similar business, expert’s opinion etc.

b) Tax environment and sources of tax law

Poland is a member of the European Union, the European Economic Area, the World Trade Organization and the Organization for Economic Co-operation and Development (OECD). As an EU member state, Poland is required to comply with all EU directives and regulations. EU directives

should be implemented into the Polish tax system. Notably, there are no special EU tax regulations specifically on Production and Natural Losses.

The Constitution provides for a tripartition of power in Poland into: the executive, judiciary and legislative branch. The sources of the Polish law are divided into two categories: universally binding law and internal law. The universally binding law includes, in particular: the Constitution, ratified international agreements and the Acts – a fundamental source of Polish law passed by the Sejm (the Parliament is composed of the Sejm and the Senate). Article 217 of the Constitution highlights the particular importance of tax Acts: the imposition of taxes, as well as other public imposts, the specification of those subject to tax and the rates of taxation, as well as principles for granting tax reliefs and remissions, along with categories of taxpayers exempt from taxation, shall be means of the Act. It means that the key components of tax system shall not be regulated in lower-rank legal acts.

The Polish tax legislation consists in particular of:

- The Constitution of the Republic of Poland (the “Constitution”);
- Acts governing Personal Income Tax (PIT), Corporate Income Tax (CIT), Goods and Services Tax (VAT) and other taxes with executive acts;
- The Polish Tax Ordinance Act.

The Polish Tax Ordinance is the most general tax act which regulates, in particular:

- General taxation rules – common standards for other tax acts (e.g. occurrence of tax liability, expiry of tax liabilities, tax overpayment);
- Tax liabilities of third parties;
- Binding tax rulings;
- Tax proceedings;
- Structure of the tax administration;
- Fiscal confidentiality;
- Exchange of Tax Information with other States etc.

Taxpayers are entitled to request a ruling from the tax authorities on the correct tax treatment of their particular transactions. There are two kinds of binding tax rulings:

- General interpretation of tax provisions;
- Individual interpretation of tax provisions.

General tax rulings are issued by the Minister of Finance (at the request or on his own initiative) in order to ensure uniform application of tax law by the tax authorities. Individual tax rulings of tax provisions in Poland are issued on behalf of the Minister of Finance by four directors of tax chambers in order to explain application of tax regulations in a particular case. Every taxpayer, tax remitter, collector of payment, nonresident natural person or legal person having no seat or board of management on the territory of the Republic of Poland may request for an individual binding tax ruling. The request may also be filled by two or more undertakings taking part in the same actual or future event. The request for the said tax ruling may relate to actual or future events. Any entity making the request should express in detail the actual or future situation and its legal opinion concerning the event. Basically, application of the individual interpretation protects the requesting party. If the issued tax ruling is not in line with the opinion of the requesting party/taxpayer, the entity may challenge the decision of the tax authority at the administrative court.

c) Overview of the Major Rules relevant for Production and Natural Losses

PIT/CIT:

Generally, there are no special rules concerning natural and production losses under the CIT/PIT Act. There is no definition of natural and production losses in the CIT/PIT Act or in any act governing excise tax. Jurisprudence and representatives of the legal doctrine have challenged the problem of

Production and Natural Losses basing on general rules. Therefore, at first, it is important to set out basic PIT/CIT rules.

The taxable base:

The taxable base is the difference between the revenue and the costs incurred by earning it and if the difference is negative, the taxpayer declares a tax loss. In certain cases, revenue without deduction of related expenses may be the taxable base. Tax loss may be deducted from income during five subsequent tax years. The deduction of a tax loss carried forward in a single year cannot exceed 50 percent of the value of such loss.

Revenues:

The Polish PIT Act (in Article 11) provides the definition of revenues. According to this definition, in general revenues shall be money and money equivalents received by or rendered available to the taxable person, and the value of in-kind benefits and other gratuitous benefits received by them. The PIT Act sets out different taxation rules depending on source of income. According to Article 10 of the PIT Act sources of revenue shall include, inter alia: employment relationship, activity performed in person, non-agricultural economic activity, special branches of agricultural production, money capital and property rights.

The Polish CIT Act does not provide the definition of revenue. However, it contains an open list of situations when the revenue arises. The CIT Act provides two general methods of CIT calculation: cash method and accrual method.

With respect to business activity the revenue is calculated based on an “accrual” method. In general, the income shall be recognized, with certain exceptions, upon release of the tangible property, disposal of the property right, or supply of the service, but in each case no later than an invoice is issued, or the amount due is paid.

Tax-deductible costs:

Tax-deductible costs are documented costs incurred to earn, maintain or secure a source of revenue that are not excluded by the CIT/PIT Act from the tax-deductible cost category (specific cases indicated in the CIT or PIT Act). The CIT/PIT Act contains a list of more than 60 items that are not regarded as costs for tax purposes which includes loss due to shortages in excise goods that are not subject to exemption from the excise duty or excise duty on those shortages.

The moment of tax-deductible cost recognition is influenced by cost categories indicated in the CIT/PIT Act. The CIT/PIT Act establishes two categories of costs: direct costs (related to specific income) and indirect costs (i.e. costs which cannot be directly assigned to a defined product, e.g. administrative, sales and other operating costs).

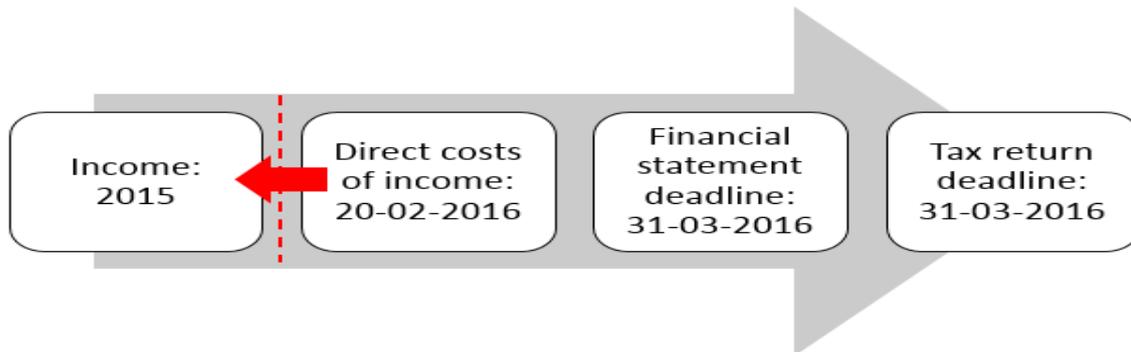
Expenditures for purchase of commercial goods and materials for production are recognized as direct costs.

According to the CIT Act, subject to other conditions, tax deductible expenses directly associated with revenue, incurred in the years preceding the tax year and in the tax year itself are deductible in that tax year in which the corresponding revenue is earned.

The CIT Act provides more specific rules relating to the cost of revenue directly connected with the revenue in a given year but actually borne in the next tax year. According to CIT Act, such expenses should be deducted in a tax year in which the relevant revenue has been generated, until:

- The day of drawing up a financial statement but no later than the deadline for submitting a tax return – if a taxpayer is obliged to prepare financial statements; or
- Until the day of submission of a tax return but no later than until the deadline for filling a tax return – if a taxpayer is not obliged to draw up financial statements.

Example: The taxpayer concluded sales transaction and generated income in 2015. Some direct cost of this income was borne in 2016 (20-02-2016). The deadline for drawing up financial statements is 31-03-2016 and the deadline for submitting a tax return is 31-03-2016. According to this provision of the Polish CIT Act, a taxpayer should allocate this cost to the income generated in 2015 until 31-03-2016.



If, however, tax deductible expenses directly associated with revenue, corresponding to revenue earned in a given tax year but incurred after the one of the days referred above, are deductible in the tax year following that in which financial statements are prepared or a tax return is submitted.

In conclusion, at the moment of acquisition of raw materials and materials for production by the taxpayers, they are not included in tax deductible cost (because they are treated as direct cost related to specific income). They are deductible in that tax year in which the corresponding revenue is earned (“cost of sales method”).

Approach to the Production and Natural Losses

As noted above, the Polish tax regulations do not provide specific treatment for Production and Natural Losses. Therefore, for CIT and PIT purposes, such losses are generally deductible if they satisfy the general requirements which are set for other types of deductible costs (e.g. the taxpayer has relevant documents). Besides, there are no rules under which the natural/production losses should be automatically recognized as tax revenues.

At the same time, the Polish tax authorities are equipped with certain tools to detect and combat against tax evasion practices under the disguise of Production and Natural Losses. Specifically, under certain circumstances, the tax authorities may:

- Challenge the amount of tax deductible costs;
- If the tax authorities are not able to determine the tax base on the basis of taxpayer’s documentation/accounting books, the authorities are obliged to apply the provisions of the Polish Tax Ordinance concerning the estimation of the tax base, which includes estimation of both, the costs and revenues.

The above approach to the Production and Natural Losses is described in more detail below.

A. GERMANY

1. Tax treatments with respect to production and natural losses

1.1. General tax treatments

With the exception of specific rules for excisable goods/products (see C.1.2.) there are no comparable tax treatments with respect to production and natural losses in Germany. Especially, no thresholds for allowable production and natural losses are set.

The tax authority accepts such kind of losses in general. The full costs are deductible from the taxable basis if they are caused by business activities. If there is no evidence of dishonest or criminal action, the tax authority will not estimate higher sales or income. For more details on the preconditions of estimation see C.1.4.1.

According to Art. 2, par. 1 GG, Art. 3 par. 1 GG and Art. 14 GG in connection with Art. 2 EStG and the jurisdiction of the high court, in the German tax system the principles of net income and protection of private property are applicable.

The general principle of equality is protected by Art. 3, par. 1 GG in the rank of the constitution. This principle is in terms of tax law interpreted as follows:

- Comparable tax issues have to be taxed equally and consistently;
- Every sort of income is equal (very general, in effect there are some schedules);
- Because every sort of income is equal the determination of total income has to follow the net income principle.

The net income principle says that taxable income is calculated as a net income by setting off all costs and losses from the revenues. Net income principle also means that different groups of income from different sources have to be summed up to a total net income. By taxing the net income the taxpayer is able to pay taxes from his income (ability-to-pay principle), with the outcome that an adequate remaining income and private property is protected.

Of course only costs with a link to the business activity can be recognized (Art. 4 par. 4 EStG). The costs must be caused by a business activity to obtain revenues. The taxpayer has to provide evidence that costs have a link to his business activities.

Legislator is allowed to simplify the tax system or to give special incentives with a non-financial intention or background as well. One often used method of simplification is **typing (categorization)**. Typing rules are legal assumption of the real-life circumstances made by the legislator. Types can be set as refutable or irrefutable assumptions. These breaches of the general principle of net income taxation need to be justified. Such exceptions must be necessary and reasonable to reach their aim. If typing is used to simplify taxation it is supposed to cover a big number of real-life cases and should not make improbable or unrealistic conclusions.

The burden of proof is placed as follows:

- Costs/Losses: evidence has to be given by taxpayer;
- Revenues/Profits: evidence (for higher revenues/profits) has to be given by tax authority; but
- Taxpayer is obliged to file in a tax return and to maintain (accounting) documents; and
- Taxpayer has to cooperate in taxing process by handing out all relevant documents to the authority otherwise tax authority has the right to estimate taxable basis and to set penalties.

According to Art. 88 AO, the tax authority has to light up all tax-relevant circumstances, to guarantee an equal and fair taxation of all taxpayers (**principle of judicial investigation**). The taxpayer is nevertheless obliged to cooperate in this process (Art. 90, 93 AO). The duty of the authority to investigate the facts can be dramatically reduced or tax consequences can be made to the disadvantage of taxpayer, if the taxpayer is unwilling to cooperate and to give relevant information.

With respect to production/natural losses, the circumstances of undeclared sales must be proved by authority. If tax payer's information and documentation of production/natural losses are properly and there is no evidence for concealed sales (black sales), an estimation of higher sales or income by authority would be illegal.

According to the law of Germany, it wouldn't be in line with legal principles, to establish a system of general punishment like in Georgia. The presumption of innocence, which is part of the rule of law, requires to investigate every single case and to give evidences for tax evasion by the authority.

1.2. Special regulations on excisable goods

1.2.1. Tax liability

The tax on excise goods arises, in principle, when such goods are released for consumption in Germany. Once the excise tax has been paid, the goods are available for free circulation within the German tax territory. It is possible, to release such goods from excise taxes under a special excise tax suspension arrangement. An excise tax suspension arrangement is a tax arrangement which is applied during the production, processing, holding or movement of excise goods, under which no tax liability arises where conditions specified in the relevant provisions are met. Such institutions like authorized warehouse keeper, registered consignees and tax warehouses are strictly connected with that arrangement.



c) A registered consignee is a person or entity, who is authorized to acquire excise goods (once or in a permanent manner) from another Member State under a tax suspension arrangement in the course of his business. A tax warehouse or bonded warehouse is a place where excise goods are produced, processed, held, received or dispatched under tax suspension arrangement.

d) If excisable goods are brought in free circulation, excise tax is due.

Especially, excise taxes fall due in the moment when excisable goods are physically leaving the bonded warehouse (taxable event). With view on excise taxes, it's in general irrelevant, if such goods in fact have been sold successfully or were displaced from the bonded warehouse unwillingly (for example if they were stolen). Excise taxes are nonrefundable. Especially in the case, that a client does not pay the invoice on delivered excisable goods, there is no possibility to refund the excise tax, already paid by the producer or supplier of the goods.

This strict approach is set because companies which are authorized to produce and store excisable goods are responsible to secure their inventory against unwarranted access. As long as such goods are in the process of production or in the bonded warehouse, they are in a tax free area. Excise tax is coming up in the moment when goods are physically leaving this closed area (bonded warehouse). These regulations are similar to the system of customs clearance where bonded warehouses are used as duty free areas too. This approach cannot be transferred to VAT or income tax.

Regarding this matter, the system of excise tax is very different to the system of VAT and income taxation.

For VAT purpose (Art. 1 par. 1 No. 1 UStG) a taxable event is caused if a good/product is:

- Delivered domestically (delivery to another company in the EU or abroad is free of VAT);
- By a company/an entrepreneur;
- In the course of its business;
- Against payment (cash or equivalent).

In terms of income taxation, it is only possible to tax income which is defined as balance of revenues and costs. Revenues must be realized in cash (or equivalent).

Both VAT and income tax do not determine a taxable event in the case of a physical deficiency in inventory. Such a deficiency can only lead to additional VAT or income tax, if the tax authority has a proof of generated revenues from the missed items (for more details see 1.4.1. and 1.4.2.).

1.2.2. Special documentation requirements and obligatory stock taking

If a taxpayer is operating in the business of producing or storing excisable goods, he can apply to be authorized by the HZA to handle such goods free of excise tax, while the goods are under his physical control. He has to ensure, that the excise tax is paid in the moment, when such goods are brought in free circulation.

The closed area, where excisable goods can be handled tax free, is determined by the HZA under an excise tax suspension arrangement.

Based on special regulations for excisable goods, which are mostly set in decrees (e.g. BrStV, TabStV), tax payer is obliged to declare the amount of stocks at least once a year on the basis of a physical stock counting. Three weeks before the stock counting takes place, taxpayer has to inform tax authority about date and time, so that authority has the possibility to participate with a tax officer. It is also possible, that tax authority direct an additional stock taking under the control of a tax inspector at any time in the year.

As a tax warehouse keeper, taxpayer has to keep a document folder. HZA may take arrangements on this. Tax warehouse owner has to keep records for all receipts and dispatches of goods in a stock book according to official form. On the request of warehouse owner, HZA allows to use other company's records instead of the stock book in official form, if tax considerations are not affected. The tax warehouse keeper has to record entries and exits immediately.

If products have been accidentally destroyed completely or have been lost irretrievable, the manufacturer or the warehouse owner has to notify HZA immediately and has to demonstrate the losses through operational documents. The tax authority may authorize simplifications and issue orders for proof.

The projected destruction of products has to be indicated, at least one week in advance, by the manufacturer or tax warehouse owner, and must be demonstrated through operational documents. HZA may authorize simplifications and issue orders for verification. The destruction has to be supervised officially, as far as the HZA does not waive on supervising.

In very big companies, a permanent tax inspector is supervising the goods movements and the declarations of excise tax. For example, very big German breweries have a so call “beer tax officer,” who is obligatorily sent over permanently by the authority, but whose salary must be paid by the company. In such big companies, stocks are physically counted in shorter and frequent intervals (e.g. quarterly or monthly).

For example, in the financial statements for the year 2014 of Bitburger Holding GmbH, one of the largest German brewery groups, beer tax paid in the amount of 56.3 million € on a turnover of 1203.8 million € is shown. The Bitburger Group comprises of 5 breweries and each brewery has its own beer tax officer with an annual salary of approximately 50-70 k€.

1.2.3. Assumption of taxable event and exculpation

The results of such a physical stock taking are compared with the amounts of goods in the books of the company.

If deficiencies appear in the inventory of an excisable good, it is deemed according to Art. 161 AO, that in the amount of the deficiency an excise tax arose. Such a deficiency must be uncovered by an obligatory stock taking (see 1.2.2.).

But the taxpayer has the possibility, to exculpate himself by furnishing prima facie evidence on that the deficiency in inventory goes back to circumstances, which don't lead to a taxable event.

Therefore, the taxpayer has to substantiate, that the deemed physical removal of goods from the bonded warehouse in effect didn't take place, e.g. because of the following circumstances:

- Production losses appear (for example evaporation, technological or process-specific losses);
- Natural losses appear (for example loss of weight because of trying);
- Errors of measurement;
- Input data error, mistakes of invert of similar goods;
- Others, like accidental events, destruction, leakage, fire.

Remark, that the assumption of a taxable event in case of inventory-deficiency is only relevant for the imposition of excise taxes. Such a deficiency doesn't lead automatically to additional VAT or income tax. At best, it can be an indicator of implausibility of income statement or VAT declaration.

It is also remarkable, that the unrefuted assumption of a taxable event regarding the excise tax, doesn't lead automatically to a prejudice in penal law. Penalization is only applicable, when evidence of guilt can be given by authority (i.e. benefit of doubt goes to the taxpayer / in dubio pro reo).

1.2.4. Thresholds for production and natural losses

For excisable goods/products, special regulations are mostly set in special decrees. Today, excise taxes in Germany are set on:

- Alcoholic beverages;
- Tobacco;
- Coffee;
- Energy (gas, petrol, diesel, coal, oil);



- Electrical power;
- Nuclear fuel.

For these goods, Art. 161 AO (see 1.2.3.) is applicable. In the special decrees mentioned above, detailed regulations are set, to identify several tax-relevant issues, including also allowable thresholds for production or natural losses in some few cases (thresholds for production losses could be found only in Art. 15 par. 2 BrStV/Spirits Tax Decree). The regulations on beer tax, tobacco tax and coffee tax don't contain such thresholds. No research was done in the field of special excise taxes on energy, electrical power and nuclear fuel, because such research would blow up this report without giving much useful information for producers of physical goods.

In Art., 15 BrStV, the following regulations are made on deficiencies in the inventory of alcoholic beverages:

- Par. 1: Deficiencies in the inventory, which are going back to losses caused by processing, filling and storing, are irretrievable losses.

Such irretrievable losses are not subject to excise tax.

- Par 2 defines the following general accepted thresholds for losses in the amount of alcohol;
- Losses in processing of alcoholic beverages: Cold processing up to 1.0 percent, warm processing up to 3.0 percent;
- Losses in filling of alcoholic beverages: 0.3-0.5 percent (depends on the used packaging);
- Losses in storing of alcoholic beverages: 1.0-4.0 percent per annum (depends on the used method of storing and packaging).

The tax payer is obliged to calculate and document its losses. The above mentioned thresholds are used to simplify the tax procedure in the most practical cases, because if the taxpayer's production losses do not exceed these thresholds, he doesn't have to bear a higher burden of proof.

If the losses exceed in total these thresholds, a refutable assumption by law is made (based on the decree), that the exceeding lost amount was brought into free circulation (has left the bonded warehouse), which leads to an excise tax. However, this is only an assumption and the taxpayer has a right to challenge and refute such assumption.

Art. 15, par. 3 BrStV is overriding the general approach of Art. 88 AO, under which it is the duty of tax authority to investigate all tax relevant circumstances. Under this exception, the taxpayer has to give evidence, that the (exceeding) lost amount of alcohol wasn't brought in free circulation (burden of proof).

This breach of the general legal approach in Art. 88 AO is justified by the taxpayer's responsibility for securing its bonded warehouse from unwarranted access. Such obligation goes back to the excise tax suspension arrangement, where taxpayer has to comply with special regulations, if he wants to benefit from tax exemption.

In difference to the rules in Georgia, the assumption of a taxable event in case of lost in inventory or in case of exceeding the above mentioned thresholds can be refuted by taxpayer by giving evidence.

Example:

Taxpayer is a distillery. An obligatory stock taking under the control of a tax inspector takes place on 5th of January, with the following results:

In the books:

- 700 x 0,7-liter-bottlesspirits (sort A);
- 605 x 0,5-liter-bottles spirits (sort A);
- 700 x 0,7-liter-bottles spirits (sort B);
- Input of alcohol in the production process 150000 liter (total period);
- Output of alcohol in finished goods 143000 liter (total period).

Physical counting and measurement:

- 800 x 0,7-liter-bottles spirits (sort A, 42,5 % alc.) → difference: +100 bottles;
- 550 x 0,5-liter-bottles spirits (sort A, 42,5 % alc.) → difference: -55 bottles;
- 650 x 0,7-liter-bottles spirit (sort B, 40,0 % alc.) → difference: -50 bottles.

The inspector assumes, that 55 x 0,5-liter-bottles (sort A) and 50 x 0,7-liter-bottles (sort B) left the warehouse and were brought in free circulation.

Furthermore, he has calculated the loss of alcohol in the last period (difference between input and output) in the amount of 7000 liters. According to Art. 15 par. 2 BrStV he is recalculating the allowable losses as following:

- Allowable loss in the section of processing: 3.0 % x 150000 liters = 4500 liters (remaining 145500 liters before filling);
- Allowable loss in the section of filling: 0.3 % x 145500 liters = 436.5 liters;
- Allowable loss in the section of storage: 0.0 %, because the fill directly in the glass bottle (no more loss appear after filling);
- Total allowable loss 4946.5 liters;
- Exceeding total loss: 2053.5 liters (7000.0 – 4946.5).

In the amount of 2053.5 liters of alcohol, he assumes a taxable dispatch from the warehouse.

According to Art. 15 par. 1 BrStV, the taxpayer could prove by his documents, that 5 bottles (0.5 liter sort A) were broken accidental on 1st of September (=irretrievable loss).

According to Art. 15 par. 3 BrStV, the taxpayer could prove by his documents, that:

- Because of a leak in a container, 1800 liters get lost in September (= irretrievable loss);
- Because of a failure in the heating, temperature was much too high from 15th of June to 18th of June, which lead to additional losses in the production process in the amount of 450 liters.

Tax inspector accepts the taxpayer's documents and the additional production losses because of the defect on the heating. The documents for the broken 5 bottles and the leaked 1800 liters were also proper, but according to Art. 13 par. 1 BrStV taxpayer was obliged to inform the HZA immediately. Because taxpayer neglects to inform immediately after the accidents, these losses can't be accepted subsequently.

The differences in pieces, counted by the tax inspector, could be cleared up by a mistake of confusion:

- The difference of +100 bottles is the result of a confusion between items of sort A and B and between different types of bottles of sort A, taxation must be rectified only in the amount of the different alcohol volume in these bottles.

The proved irretrievable losses are not taxed with alcohol tax, according to Art. 143 par. 3 BrantwMonG:

“The tax does not arise if the products are gone, due to their nature or of unforeseeable circumstances or force majeure, completely destroyed or irretrievably lost. Products shall be deemed to have gone completely destroyed or irretrievably lost when they can no longer be used as such. The total destruction and irretrievable loss of the products have to be demonstrated sufficiently.”

The decision of the tax inspector, not to accept the accidental losses because of late information, is a discretionary decision and can be re-examined in a formal appeal procedure.

1.3. Accounting requirements and stock taking

1.3.1. Stock taking

In general, the methods of stock counting and valuation are set in the commercial code (HGB).

According to Art. 240 par. 1 and 2 HGB enterprises are obliged to count stocks physically at the beginning of business (date of establishment) and at the end of every business year.

Art. 240, par. 3 HGB allows also the assessment of a fixed-value of stocks in total, if the amount of stocks is steady and unimportant (e.g. dishes in a hotel, tools in garage). This “block” has to be revised by a stock taking every 3 years.

Art. 240 par. 4 HGB allows, to add groups of similar goods/items (similar in specification and value), e.g. screws, tools.

The general rule is, to take the stocks at the end of every business year.

Art. 241, par. 3 HGB allows, to take the stocks 3 months before or 2 months after the end of business year, if the enterprise is able to record all transactions between the date of stock counting and the date of business year ends.

If the enterprise is able, to record all transaction of stocks in the year and every item can be localized and identified in the IT-system, it is also allowed to use the method of continuous inventory (Art. 241 par. 2 HGB). This method usually is used in very big warehouses and means that every single item has to be counted physically at least once in a business year at any time.

All the methods described above, can be used also for tax purpose. German tax law doesn't have own rules for stock taking.

With respect to the general rule in Art. 240 par. 1 and 2 HGB, that is applicable also for tax purpose, it is not necessary to record any transactions in the stock accounting in the year. Only the stock taking at the end of the business year has to be done.

Production and natural losses appear latest in the moment of physically stock counting at the end of business year and will be recognized as differences in the amount of stocks. This difference is calculated as subtraction of the amount of stocks at the end of the business year (proved by the stock taking) and the amount of stocks at the beginning of the year (proved by the previous stock taking). The change in inventory value is recognized in the accounting as profit (positive change) or loss (negative change). In the general case of a (smaller) company, that takes the stocks only once at the year's end (Art. 240 par. 1 and 2 HGB), it is impossible to find out the reason of such differences, because such companies are not obliged to document stock transactions in the year. As this method is also applicable for tax purpose, such differences are accepted by tax authority as deductible costs/losses. No additional proofs are requested.

If a company is using the method of continuous inventory with a complete documentation of all physical transaction, production and natural losses will be recognized as physical dispatch of items in these documents. Such kind of documentation will be accepted by tax authority, too.

1.3.2. Additional documentation requirements

Based on Art. 144 AO enterprises, who are selling goods to retailers also have to record all such sales of goods in their stock accounting. This documentation has to include the following information:

- Date of delivery or date of invoice;
- Name, firm and address of client;
- Description of goods delivered;
- Price of goods sold;
- Note on the accounting records.

The tax authority can easily use these records of the seller, to control the completeness and correctness of the accounting on the side of the receiving company, because:

According to Art. 143 AO, every enterprise is obliged, to record its purchase of raw materials and goods in its stock accounting, too. This documentation has to include the following information:

- Date of delivery or date of invoice;



- Name, firm and address of deliverer;
- Description of goods purchased;
- Price of purchased goods;
- Note on the accounting records.

Nowadays, both documentations are usually integral part of the stock accounting system, for which special software is used.

If a taxpayer is using software systems for accounting, tax authority has the right to review recorded information in taxpayer's IT-systems. Almost all software applications, which are developed and sold by private parties, have an export function, where data can be exported in a standard format to be electronically reviewed by tax inspectors. This makes it much easier, to analyze records systematically and completely.

Tax inspectors use the instrument of control notices, to compare the accounting documents of both companies (seller and purchaser).

By this, undeclared revenues on the side of the seller can be discovered easily by the information, given from the books of the purchaser.

Especially in the case, where a tax inspection comes to the result, that deficiencies in the inventory of the selling company seem implausible high, further investigations will be done by using the above-mentioned records and sending over control notices to the tax office of the clients company.

1.3.3. Special documentation requirements for production and natural losses

In Germany, there are no specific requirements set by tax authority, how production and natural losses have to be documented in the books. General rules are applicable. It would be helpful, if the taxpayer can show e.g. that some items were given to recycling (waybills, etc.) or that technical processes have caused the loss of an amount. These explanations must be reliable.

If the tax authority has serious doubts about the explanations and documentation of the taxpayer, they will test the consistence of the data by using indirect methods or data base analysis.

More details are given under point 1.3.1.

1.3.4. Primary valuation/historical costs

Raw materials or purchased goods are valued at purchase price. If the purchase price of a separate item is available, than taxpayer can take this price as valuation basis. Mostly, individual purchase prices for several items in a stock house cannot be identified/are not available. Then, taxpayers are using the average price for a group of articles/items. According to Art. 240 par. 4 HGB also similar items can be combined to bigger groups.

In accordance with HGB, all consuming follow procedures are available.

For tax purpose, LIFO only can be used, if this method reflects the typical processes in the company (Art. 6 par. 1 No. 2a EStG).

For tax purpose, FIFO and weighted average method are also usable.

Work in process and finished goods are valued at costs of production, including direct costs and indirect costs.

Example:

A company is manufacturer of furniture. The company purchases 100 units of wood to produce a chair. 40 percent of the input material is lost in the production process. This amount of lost material can be proved e.g. by the design drawings of the chair, where unavoidable waste of input material can be seen. Maybe, it's also possible, to give evidence by recording the amount of sawdust (e.g. waybill of recycled material). At the end of business year, the chair is still in the warehouse of the company. The production costs of this chair include the price for 100 units of wood (also the 40 units lost in process) and other direct costs (e.g. cost of employees) and indirect costs (e.g. overhead, depreciation).

When the chair is sold, the costs for 100 units of wood will be tax deductible.

Beside of the special field of excise taxes, taxpayers are in general not obliged to document production/natural losses in the accounting. In comparison to the treatments in Georgia, in German tax law (except excise taxes) profit/natural losses are not really of big interest. As it is well known, that such losses appear every day in every business, they are generally accepted for tax purpose. Only in extreme cases of very high losses, further investigations will be done by tax authority. If production/natural losses arise in an extraordinary amount, e.g. in case of accidental events in the production, taxpayer should document preventative the circumstances, to be able to demonstrate in case of a later inquiry of tax authority.

Following the presumption of innocence and the principle of judicial investigation (Art. 88 AO), with respect to production/natural losses, the circumstances of deemed undeclared sales must be proved by authority.

1.3.5. Impairment test/write-offs

For inventory, historical costs are the basis for valuation at the end of the business year as well as in following periods. Inventories can be written-off by an impairment only test.

The impairment test has two perspectives. The perspective of purchase or reproduction of goods (lower current purchase price or production costs) and the perspective of sale (sales price less costs to sell is lower than historical costs). According to Art. 253 par. 4 HGB, inventories have to be written-off strictly to their fair value.

For tax purpose, according to Art. 6 par. 1 No. 2 EStG write-offs are accepted only, if the loss in value is enduring (more than 3 months from date of balance). Otherwise, this loss is deductible in the moment of physical dispatch of the good (item is sold with a lost or is scrapped). Finally, write-offs or losses of inventory are fully recognized in the tax return. There is no assumption of additional sales.

Example:

Taxpayer is a big food retailer. At the end of business year 2015, all stocks are physically counted. In the books for every item is noted its amount, its purchase price and also its characteristics (e.g. age, date of expire). There are the following critical items:

- 5000 kilogram meat products have a date of expire on 20th of January 2016;
- The purchase price for duck meat has decreased from 5.50 € per kilogram to 3.80 € per kilogram.

At the beginning of January, taxpayer tries to sell the 5000 kilogram meat products. Because of the date of expire he can sell only 1500 kilogram with a price discount of 50 percent. The sales price therefore is only 2.25 € per kilogram instead of 4.50 € per kilogram and is lower than the purchase price for these products that is 3.75 € per kilogram. The result is a loss in the amount of 2.250 €. The other 3500 kilogram must be depolluted. The result is an additional loss of 13125 €.

When finishing the balance sheet for the business year 2015 in March 2016, taxpayer is making the following write-off on the inventory:

- 15375 € on 5000 kilogram of meat product with a date of expire on 20th of January;
- 3400 € on 2000 kilogram of duck meat.

With respect to the expired meat products, which must be thrown away, the write-off goes back to the inherent characteristics of the meat. This natural loss is recognized as loss in value already on the date of balance sheet (write-off on date 31st of December 2015) and becomes an irretrievable physical loss in the moment of depollution of the meat. The losses in value because of the lower actual purchase price for duck meat and because of the discount on the sold 1500 kilogram meat products must be recognized also already on the balance sheet date 31st of December 2015.

All the above mentioned write-offs and losses are also recognized for purpose of income tax.

1.4. Dishonest taxpayers and special tax approaches

1.4.1. Indirect methods/estimation of taxable basis



Tax authority is allowed and obliged to estimate the taxable basis (sales, costs, profits) according to Art. 162 AO, if one of the following preconditions is fulfilled:

- Tax authority is unable to calculate taxable profit / taxable basis in accordance with the matter of facts in the relevant tax law (failed “direct” method);
- Tax payer’s documents are unusable;
- Tax payer cannot give information to tax relevant circumstances;
- Tax payer is unwilling to deliver information and documents.

In practice, the methods of estimation are used by the authority in a first step to recalculate the profit (or revenues and costs) declared by taxpayer. If such a plausibility check is coming to the result that the information given by the taxpayer cannot be true further investigations will be done.

According to Art. 85 and 88 AO the tax authority has to strain all possibilities to investigate the true facts and circumstances. In this procedure of investigation the taxpayer must cooperate to clear up the facts (Art. 90-100 AO). Art. 96 AO allows authority to call an independent expert.

If it is finally impossible to clear up the facts, tax authority can ask taxpayer for an affirmation in lieu of an oath (Art. 95 AO).

The authority’s duty of investigation and taxpayer’s duty of cooperation are in interdependence. If taxpayer is unwilling to help clearing up the facts the tax authority’s duty to further investigate is reduced to a minimum.

Only in case of failed clarification, authority is allowed and obliged to apply the indirect methods of estimation to assess taxes. This obligation is part of the general principle of consistent and equal taxation of all taxpayers. Under this general principle the decision of using the method of estimation is not subject to any discretionary power. Administrative discretion is exercisable only in the procedure of calculation the taxable basis. But it is also not allowed to penalize with estimation of a higher taxable basis. The aim of estimation is to determine the true taxable basis at the best knowledge as exactly as possible. If an estimation is necessary because taxpayer did not comply with documentation requirements and is unwilling to cooperate an uncertainty surcharge can be calculated. Such a surcharge is not seen as a penalty. By using an uncertainty surcharge tax authority ensures to estimate a more exact result (assumption, that there are some unidentified taxable items). Therefore, the uncertainty surcharge is an instrument, which is used to reduce the risk that not all facts could be cleared up, especially in cases of uncooperative taxpayers.

The assessment of additional penalties is part of other procedures and must have a legal basis in the act.

It is also remarkable that the law regarding fiscal offenses is disconnected from tax law itself.

Methods of estimation

In general we have to distinguish between a re-calculation which is used to verify taxpayer’s data and an estimation of taxable basis.

For both instruments the following methods are usually used:

- Internal comparison: comparing in time and recalculation on the basis of the data from previous years;
- External comparison: comparing with similar companies (such data is collected systematically by the tax authority and can be evaluated easily by using data base analysis);
- Re-calculation on basis of cash circulations;
- Investigations in the case of an increase in assets: assumption that an increase of assets is caused by undeclared taxable income.

In Germany the isolated problem of deficiencies in inventory and possible artificial production/natural losses are not addressed by special methods of estimation.

Estimations are usually done as proportional considerations, e.g. cost-income-ratios. The ratios of the actual business year is compared with the ratios of previous years (internal comparison) or with the ratios of similar companies.

Furthermore estimations can be distinguished as following:

- Single estimation: determination of a single issue/circumstance of taxable basis;
- Partial estimation: determination of taxable basis in a delimited partition;
- Full estimation: determination of the taxable basis in total.

For example if the accounting documents of a taxpayer are not in a proper shape at first the tax authority has to apply the method of single and partial estimation. In practical application a full estimation is done only if no accounting documents are available.

Lines of business with a lot of cash business:

In some lines of business criminal activities are more often recognized which could lead to undeclared sales and income. These companies are mainly dominated by a high amount of cash business (e.g. restaurant, hairdresser, bakery, butchery). There are special regulations for such companies on how the cash register has to be done.

If there are some indications on implausible accounting documents the fiscal authority looks through the books and verifies the declared sales and profits for example by using the following methods:

- Estimating sales based on purchase of raw material;
- Estimating sales based on purchase of consumed water, electrical power, gas;
- Estimating sales based on a number of employees.

But estimations of sales are possible only under the preconditions of Art. 162 AO (see above 1.4.1.).

By using indirect methods in single cases of dishonest taxpayers the German tax authority is able to address the problem of black sales (false production/natural losses).

1.4.2. Self-consumption and private costs

Only costs with a link to the business activity can be recognized in the tax return. Other expenditures, especially private costs of the owner of the business cannot be set-off from business income.

Therefore Art. 4 par. 5 EStG and Art. 12 EStG enumerate several items of costs that cannot be recognized as tax deductible costs or that are deductible only with limitations.

Based on Art. 2 EStG, Art. 4 par. 4 EStG and Art. 12 EStG the general linking principle or the principle of reason is applicable, to separate private costs from business costs.

Example:

The taxpayer is in the business of textile industry as a retailer. He goes on a business trip to New York for 2 days to meet some important clients. Costs for dining with the clients in the amount of 500 US\$ are borne by the taxpayer. On this trip he takes two expensive suits from his warehouse to dress himself. After the meetings he goes for 5 days to Florida for vacation.

According to Art. 4 par. 5 No. 2 EStG only 70 percent of the dining costs (350 US\$) can be set off from taxable profit. The 30 percent are nondeductible because the taxpayer also consumes as private individual. The suits taken for private use can be treated as non-deductible costs. The travel costs for the first 2 days are fully tax deductible because they have a relevant link to business activity. The travel costs for the additional vacation days in Florida are private costs that cannot be recognized for tax purpose.

If the owner of a business does self-consumption of his company's assets or goods the market value of such consumption is recognized as additional revenue.

Example:

The taxpayer runs a restaurant business. His wife and two sons are working with him in the restaurant. Some of the food which cannot be sold is consumed by themselves. Also some drinks are

on private consume of the owner and his family. For tax purpose the costs of these goods are fully tax deductible but the market value of the goods is recognized in the tax return as additional revenue. If taxpayer has no documentation about the amount of private consumption the value of consumption can be estimated by the tax authority. The same principles are applicable if fixed assets are used for private object. E.g. if the owner of the restaurant would use the company's car for private trips.

The examples want to show that deficiencies in inventory can be caused also by (hidden) private costs and/or self-consumption. To avoid tax evasion, in the first step it is important, to eliminate all private costs from the taxable basis. Alternatively a monetary benefit from self-consumption is recognized as virtual business revenue.

In the first example the private use of the suits is treated as non-deductible cost. This assessment is correct if the good/product was purchased already with the intention of private use. If it is seen as a good which was primarily intended to be used by the company the second approach is applicable and the private consumption has to be recognized as revenue at its market value.

Input VAT deduction is canceled in case of non-deductible private costs. In case of monetary benefits additional VAT falls due.

When real natural and production losses are fully recognized for tax purpose like in Germany, private cost and self-consumption as other possible reasons for deficiencies in inventory must be treated by the law. The private sphere of taxpayer has to be strictly delimited from his business activities.

1.4.3. Simplified determination of profits for small companies

It is worth to mention that in Germany very small companies (sole proprietorship and private partnerships with a turnover < 600 k€ or profit < 60 k€) have the choice to calculate profits on a cash basis accounting instead of balancing if they do not fall under the accounting regulations of commercial law.

If the method of cash accounting is used profit is determined as result of cash inflows and cash outflows and, in general, inventories do not have to be counted or documented.

This method was established by legislator to simplify accounting and documentation requirements for small companies.

The regulations for these small companies do not meet the focus of this research (deficiencies in inventory, write-offs of inventory). But it is important to know the existence of such facilitations.

1.4.4. Agricultural business

For the purpose of profit determination in the agriculture industry, German tax law has a different income approach (Art. 13a EStG). In this industrial sector, income of smaller companies is calculated on the basis of units (land, pieces of animals, etc.) that are in use. For example, every piece of animal is taxed with a normalized amount of income.

This method of taxation is comparable with a flat rate tax by using an indirect method of profit determination. Profits are calculated with a standard rate on the assets in use.

If this simplified method of profit calculation is applicable the taxpayer is not concerned with the problem of deficiencies in inventory and production/natural losses.

This approach is used only for income taxation.

As far as the taxpayer is also liable to VAT he has to pay VAT on effective revenues.

1.4.5. Flat rate tax, withholding tax and reverse-charge method

With the projection on the improvements to the Georgian law, that are given at the end of this report, the following paragraph wants to show three possible methods that can be used to reduce tax evasion.

Flat rate tax

In some few cases income taxation is done by applying a flat rate tax. One example is the business of a prostitute. Since prostitution became a legal business in Germany, legislator had introduced a flat rate tax for prostitutes on a daily rate. Before introducing this flat rate tax prostitutes did not pay any

taxes on income. Main problem is that prostitutes do not write bills and do not keep accounting books. It turns out to be an improvement for the German fiscal authority to collect at least a (small) flat rate tax rather than no tax. Therefore flat rate taxation is a good instrument to tax on basis of normalized revenues or income.

Withholding tax

Another possible method to secure tax yield is the withholding method. One example of a withholding tax in case of business income is the German tax regulation for artists. Artists are qualified as self-employed or sole-proprietorship. Normally such business is taxed on the basis of calculated profits. But especially artists from abroad do not file in tax returns in Germany. That is why artists are taxed with a withholding tax similar to payroll tax. This withholding tax has to be held in by the payer of remuneration.

Both systems should not be transferred to business income from bigger companies.

Flat rate tax and withholding tax systems are a possible instrument to reduce tax evasion.

Until now, these systems are not used in the field of income tax to counteract dishonest practice of taxpayers who are selling goods/products.

Reverse charge method

Only for VAT purpose in some situations the reverse-charge-method (similar to withholding tax system) is used, e.g. for delivery of some electrical equipment (mobile phones, computers, electric circuits), metal waste, gold and silver.

A withholding tax or a reverse-charge-tax has the advantage that the receiver of service or delivery is (also) liable for tax. That makes tax evasion more difficult because the receiver normally has no interest in criminal actions. The documents of the receiving company also can be used to control the deliverer.

2. Historical review

Except of the specific rules for excisable products (see 1.2.), in the last 20 years, no special tax treatments with respect to production and natural losses can be found in German tax law.

Simultaneously with the development of information technology and software applications, tax authority is coming up to use these new possibilities. One recognizable fact is, that (electronic) documentation requirements for taxpayers become tightened and tax authority is evaluating much more systematically such electronic information. Since few years ago, companies have to file in the financial statements electronically in a standardized official form. Based on such collected information tax office is building up data bases which can be used to compare different companies operating in the same sector. Today, e.g. journal entry tests of accounting systems and data base researches are a consistently part of tax reviews.

According to Art. 146 par. 5 AO, the taxpayer is allowed to record books in electronic form. On 14th November 2014, tax authority has given (new) guidelines and interpretations for electronic accounting procedures (GoBD). Based on GoBD, the right of tax authority to review the accounting electronically was extended also on subsystems, such as inventory accounting and distribution systems or cash registers.

3. Conclusion

In Germany, production and natural losses are not addressed by special tax treatments, except of the specific regulations in the field of excise taxes.

Nevertheless, these issues can be solved by general principles (net income principle, linking principle/principle of reason, non-deduction of private cost) and in case of abuse by sanction mechanism (estimation of profits by using the indirect methods).

The rule of law constrains estimation of profits to single cases of failed documentation and cooperation of taxpayers. Indirect methods and control mechanisms (e.g. control notices) are additional instruments to verify the data of taxpayer's accounting. The general principles of net income taxation and the right to give evidence can be overridden by the principle of simplification, if such override is necessary and reasonable to reach the aim. Simplifications are used for example in

the agriculture industry where profits are determined on basis of assets in use (land, animals), or by flat rate tax systems and withholding tax systems which ensure taxation in cases of fleeing tax payers.

Otherwise, tax authority must be able to work efficiently and in adequate time. It seems to be almost impossible to install an administrable application system for write-offs on inventories or for determination of individual allowable thresholds regarding production losses for purpose of income tax and/or VAT, like it is done in Georgia.

If tax authority in effect is unable, to administrate consistently such application systems, general legal principles are seriously concerned. According to German law, it would be illegal, to install an application system, which is not administrable. Such a procedure is not in line with the principle of equal and consistent taxation of all taxpayers.

B. Austria

1. Tax treatments with respect to production and natural losses

1.1. General tax treatments

In Austria, there are no comparable tax treatments with respect to production and natural losses for the purpose of income tax and VAT. Especially, no thresholds for allowable production and natural losses are set for income tax or VAT purposes.

In general, tax authority accepts such kind of losses. The full costs are deductible from taxable basis, if they are caused by business activities. If there is no evidence of dishonest or criminal action, tax authority will not estimate higher sales or income.

In Austria, the ability-to-pay-principle doesn't have a constitutional status of law. But for income taxation, the net income is seen as a useful indicator for financial capability.

With respect to the judges of Austrian high court (VfGH), a breach of the net income principle and the ability-to-pay-principle must be justified by the legislator.

Taxation on net income means, that taxable income is calculated by setting off all costs and losses from the revenues. Net income principle also means that different groups of income from different sources have to be summed up to a total net income. By taxing the net income, taxpayer is able to pay taxes from his income (**ability-to-pay principle**), so that an adequate remaining income and private property is protected.

Of course, only costs with a link to the business activity can be recognized (Art. 4 par. 4 EStG). The costs must be caused by a business activity to obtain revenues. Tax payer has to give evidence, that costs have a link to his business activities.

In general, it is irrelevant, if costs are economically necessary. According to Art. 20 par. 1 No. 2 b EStG, inappropriate high business costs are non-deductible only, if they have also a tangency to private consume. E.g. manager uses a luxury and very expensive business car (Ferrari, Bentley, etc.) also for private purpose. The circumstances under which such costs are seen as inappropriate high depend on the single case (e.g. it makes a difference, if the company is unprofitable or if it has high revenues and profits).

Fairness in taxation is not only a question of correct application of law. It is also the duty of tax authority, to clarify all the tax relevant circumstances.

According to Art. 115, 161 BAO, tax authority is obliged to investigate the tax relevant circumstances in every single case. To investigate and to clarify tax relevant circumstances, tax authority has the right and the duty to ask for information. General means to demonstrate and to give evidence are laid down in Art. 166-183 BAO. E.g. based on Art. 177 BAO, experts can be consulted by the tax authority.

Tax payer is obliged to cooperate in the taxing procedure. If he doesn't cooperate sufficiently, the duty to investigation by the authority can be reduced.

1.2. Excise taxes



Only in the field of special excise taxes, rules regarding deficiencies in inventory can be found. It is also remarkable, that there are additional obligations on documentation.

Special excise taxes are imposed on:

- Alcoholic beverages;
- Tobacco;
- Energy products (e.g. petrol, diesel, oil).

Actually, no thresholds for production or natural losses are set in the excise tax acts.

Until 31st of December 2000, specific thresholds for losses regarding the processing, filling and storing of alcoholic beverages were set in Art. 81 par. 3 AlkStG. These former regulations were very similar like the above mentioned actual German rules in Art. 15 par. 3 BrStV (see C.1.2.4.).

Also in Austrian law, these thresholds were used to simplify the taxation procedures by defining general accepted thresholds as refutable legal typing. Under this approach, taxpayer had the possibility, to proof higher rates of losses in his company with adequate documentation.

Since 1st of January 2001 these thresholds were deleted without any replacement.

Today, Art. 81 AlkStG has the following context:

- Shortfalls in the bonded warehouse, which goes back to cleaning, handling, processing, filling and storage losses, are not taxed with alcohol tax;
- If shortfalls appear in the procedure of stock taking and cannot be cleared up by the owner of the bonded warehouse, alcohol tax on the deficiency amount falls due;
- Tax authority can order the owner of the bonded warehouse, to determine the shortfalls;
- Tax authority can determine the shortfalls by itself and at the expense of the owner of the bonded warehouse.

This change was explained by the legislator with the following arguments:

- The thresholds did not reach their aim of non-taxation of the allowed shortfalls and could be misunderstood;
- The new regulation does not suspend the possibility to use individual or general empirical values, to determine allowable shortfalls.

Regarding the explanatory statement of the legislator, it seems, that the repeal was justified by the aim of simplification of law.

According to Art. 80 AlkStG the owner of a bonded warehouse has to execute once a year an official stock taking. He has to inform tax authority, at the latest 3 weeks in advance, about time of beginning and proposed end of the stock counting. Tax authority is allowed to participate at the stock taking. The owner of the bonded warehouse has to report about the results of the stock taking to the ZA within one month after its ending.

ZA can allow to apply the method of permanent stock counting according to commercial law (see D.1.3.1.), instead of annual inventory count.

If taxpayer does comply with the regulations on stock taking, ZA has the right, to execute a stock counting by itself and at the expense of the warehouse keeper.

The owner of the bonded warehouse has to report on differences in inventory.

If goods or products are lost in the warehouse, taxpayer has to inform tax authority immediately.

In case of a projected destruction of excisable goods, the owner of the bonded warehouse has to inform ZA in advance, to give ZA the possibility to supervise the destruction. Taxpayer has to document the destructed amount in his stock books.



Furthermore, taxpayer has to comply with the documentation requirements in Art. 71, 72 AlkStG. Such records must be done immediately, at the latest 2 day after the notifiable event (e.g. purchase of raw material, consumption of raw materials or goods in the production process, selling of goods).

1.3. Accounting requirements and stock taking

1.3.1. Stock taking

In general, the methods of stock counting and valuation are set in the commercial code (UBG).

According to Art. 190 par. 3 UBG and Art. 192 par. 1 UBG enterprises are obliged to count stocks at the end of every business year.

The tax authority also allows the assessment of a fixed-value of raw materials, if the amount of these stocks in total is steady and unimportant.

Art. 209 par. 2 HGB allows, to add groups of similar goods/items (similar in specification and value).

The general rule is, to take the stocks at the end of every business year.

Art. 192 par. 3 UBG allows, to take the stocks 3 months before or 2 months after the end of business year, if the enterprise is able to record all transactions between the date of stock counting and the date of business year ends.

If the enterprise is able, to record all transaction of stocks in the year and every item can be localized and identified in the IT-system, it's also allowed to use the method of permanent stock counting (Art. 192 par. 2 UBG). This method usually is used in very big warehouses and means that every single item has to be counted physically at least once in a business year at any time.

All the methods described above, can be used also for tax purpose. Austrian tax law doesn't have own rules for stock taking.

With respect to the general rule in Art. 192 par. 1 UBG, that is applicable also for tax purpose, it isn't necessary to record any transactions in the stock accounting in the year. Only the stock taking at the end of the business year has to be done.

1.3.2. Additional documentation requirements

Based on Art. 127 and 128 BAO, every enterprise is obliged, to record its purchase of raw materials and goods in its stock accounting.

1.3.3. Special documentation requirements for production and natural losses

In Austria, there are no specific requirements set by tax authority, how production and natural losses have to be documented in the books. General rules are applicable. It would be helpful, if the taxpayer can show e.g. that some items were given to recycling (waybills, etc.) or that technical processes have causes the loss of amount. These explanations must be reliable.

If the tax authority has serious doubts about the explanations and documentation of a taxpayer, they will test the consistence of the data by using indirect methods or data base analysis.

1.3.4. Primary valuation/historical costs

Raw materials or purchased goods are valued at purchase price. If the purchase price of a separate item is available, than taxpayer can take this price as valuation basis. Mostly, individual purchase prices for several items in a stock house cannot be identified/are not available. Then, taxpayers are using the average price for a group of articles/items. According to Art. 209 par. 2UBG also similar items can be combined to bigger groups.

In accordance with UBG, all consuming follow procedures are available.

For tax purpose, FIFO and LIFO only can be used, if these methods reflect the typical processes in the company.

The weighted average method is also usable for tax purpose.

Work in process and finished goods are valued at costs of production, including direct costs and indirect costs.

1.3.5. Impairment test/write-offs

For inventory, historical costs are the basis for valuation at the end of the business year as well as in following periods. Inventories can be written-off by an impairment only test.

The impairment test has two perspectives. The perspective of purchase or reproduction of goods (the lower of current purchase price or production costs) and the perspective of sale (sales price less costs to sell is lower than historical costs).

For tax purpose, write-offs are accepted, if the impairment test has been passed. Otherwise, this loss is deductible in the moment of physical dispatch of the good (item is sold with a loss or is scrapped). Finally, write-offs or losses of inventory are fully recognized in the tax return.

1.4. Dishonest taxpayers and special tax approaches

1.4.1. Indirect methods/estimation of taxable basis

The function of Art. 184 BAO is only, to give tax authority the possibility to estimate taxable basis in single cases, where there is finally no more chance to investigate tax relevant issues, because of effective or legal reasons. The right and the duty to estimate taxable basis (revenues, profits, costs, etc.) presume, that investigations by the authority have failed in a single case. It is not the aim of Art. 184 BAO, to relieve the authority from their duty of full investigation or to relieve the taxpayer from its duty of cooperation in the taxing process.

If the accounting is formally correct in general, also factual correctness can be assumed (Art. 163 BAO).

The authority is allowed to estimate profits, if based on a control calculation, the profits of a company are significantly different from the peer group, without any reason. Differences up to 10 percent have to be accepted in general.

According to law, an estimation of a taxable basis is only allowed as ultima ratio, to ensure a consistent and fair taxation of all taxpayers.

It is not part of administrative or jurisdictional discretion, to estimate tax relevant issues instead of undertaking investigating activities. Estimation is only legal, in case of failed investigation of the true circumstances.

According to legal principles, estimation can't be used by administration to simplify the tax procedures. A different approach was used in the very past in Art. 217 par. 3 RAO, where such simplification was allowed.

Estimation of taxable basis is allowed by law, if:

- Accounting documents are not in due form and have grave errors;
- Taxpayer doesn't cooperate, to investigate circumstances;
- Peer group companies have significantly different data and there is no reason for this discrepancy.

The authority has the burden of proof, that accounting documents are seriously false. Authority is obliged, to make the used peer group data fully transparent for the taxpayer.

1.4.2. Agricultural business

Small agricultural entities can apply a simplified method of profit calculation. According to Art. 17 par. 5a EStG profits are determined on the basis of standard value. The standard value is assessed on the fundament of units in use (land, pieces of animals, etc.).

If this simplified method of profit calculation is applicable, taxpayer isn't concerned with the problem of deficiencies in inventory and production/natural losses.

This approach is used only for income taxation.

As far as taxpayer is also liable to VAT, he has to pay VAT on effective revenues.

2. Historical review



With respect to production and natural losses, in the last 20 years, no special tax treatments can be found in Austrian tax law.

The historical review on alcohol tax, especially the former Art. 81 AlkStG, is already described in chapter D.1.2.

3. Conclusion

In Austria, production and natural losses are not addressed by special tax treatments, except of the specific regulations in the field of excise taxes, that cannot be transferred to income tax and VAT.

In several cases, tax authority has the right and the duty to estimate the taxable basis according to Art. 184 BAO.

Indirect methods are also used to verify the taxpayer's information.

C. POLAND

1. Tax treatments with respect to production and natural losses

1.1. General tax treatments

1.1.1. Tax deductible cost under the Polish PIT/CIT Act

Polish legislation does not provide specific regulations with respect to the Production and Natural Losses. Respectively, the Polish tax regulations do not set any allowable amount of Production and Natural Losses, with a single exception which is set out in Regulation of the Minister of Finance on Maximum Permissible Standards for Excise Goods. Under this regulation, losses due to shortages in excise goods that are not subject to exemption from the excise duty or excise duty on those shortages are considered tax non-deductible cost.

As noted above, in the absence of specific regulations with respect to the Natural and Production Losses, the tax authorities use general anti-tax evasion rules to combat with malpractices of certain taxpayers which unjustly claim Natural and Production Losses. Under such anti avoidance rules, the tax authorities may challenge: (1) deductibility of the losses claimed; or (2) may estimate the costs and revenues of the taxpayer.

1.1.2. Deductibility of the production and natural losses

The following conditions, implied by general principles outlined above, should be satisfied cumulatively to recognise tax deductible cost in case of Production and Natural Losses:

- Cost is incurred to earn or maintain or secure a source of revenue (purpose and causality);
- Cost does not belong to any of the expenditures which are not allowed for deduction by CIT Act;
- The cost is properly documented;
- Taxpayer exercised appropriate due diligence.

Thus, if Production Natural Losses do not satisfy any of the above requirements, then Production and Natural Losses shall not be allowed for deduction. Therefore, this report sets out in more detail the essence of each of these requirements.

Re: item i)

Under Polish tax regulations, the cost are deemed incurred to earn or maintain or secure a source of revenue, if both of the following conditions are satisfied:

- The expenditures must be connected with the taxpayer's business activity (causality); and
- The taxpayer should bear the cost for a specific purpose: to earn or maintain or secure a source of revenue.

Particular expenditure may be considered tax deductible cost in case when it results in/gives rise to taxable income or when the taxpayer failed to achieve the desired impact (revenue), but the expense was incurred for the purpose of generating revenues (irrespective of whether the taxpayer succeeded in selling produced goods or whether those sales were profitable or not).

Example: The Company involved in the production of furniture purchased 100 units of wood for production of the furniture with the goal of selling this furniture with profit. The company indeed produced an item of furniture which was made up of 60 units of wood; the company recognized remaining 40 units of wood as production waste which was not reusable for the production purposes.

In this case, cost of all woods purchased satisfies the first condition of deductibility of the expenses described in item a) above because the Company purchased the wood in order to earn the revenue. It means that the whole amount of expenditures incurred for the purchase of wood (100 units) may be considered tax deductible cost, provided that other conditions of deductibility are fulfilled.

Re: item ii)

In the next step, it is required to check if the natural/production losses are indicated in closed list of expenses that may not be claimed as tax deductible costs under CIT/PIT Act. From this perspective, the following expense considered as tax non-deductible cost should receive particular attention: loss due to shortages in excise goods that are not exempt from the excise duty or excise duty on those shortages.

Thus, the CIT/PIT Act does not allow deduction of excise goods, regardless whether other conditions for deductibility are satisfied. Besides of this exception relating to excise goods, generally Production and Natural Losses shall be deductible, provided other deductibility requirements set out above are satisfied.

Re: item iii)

The taxpayer is obliged to prove that the cost was actually incurred and present sufficient documentation to the tax authorities upon request. To this respect, it should be noted that the Production and Natural Losses should not be established by the taxpayers as estimated values or as statistical data. The Production and Natural Loss should be calculated at its real value.

There are no provisions in the PIT/CIT Act which expressly indicate what the documentation concerning natural/production losses should include.

The Production and Natural Losses should be documented in accordance with the following principles:

- the natural/production losses should be confirmed by the protocol prepared by the taxpayer;
- the protocol should include in particular: type of loss, amount, quantity, and cause of loss;
- the protocol should be signed by the authorised persons;
- the protocol should meet the requirements of the Accounting Act established for accounting records.

Re: item iv)

The natural/production loss may be considered tax deductible cost, provided that the loss cannot be totally eliminated despite all reasonable efforts made by the taxpayer.

The taxpayer is allowed to recognise natural and production losses as tax deductible cost if the losses are incurred irrespective of the taxpayer's will (involuntary losses). If the taxpayer fails to exercise due diligence, he is not allowed to recognise tax deductible cost.

Example: The Company, in order to eliminate losses arising in the production process, has taken measures aimed at effectively reducing the losses i.e. repair, modernisation, modification, maintenance of production equipment, staff trainings. Despite the measures taken, the production losses still arises. In this case, the taxpayer is entitled to recognise the losses as tax deductible cost (provided that other conditions are fulfilled)

If the natural/production losses are unjustified with e.g. economic/production needs, they can not be treated as tax-deductible. So if the tax authorities didn't prove that in particular case the natural/production losses could have been avoided, the taxpayer is entitled to treat them as tax-deductible cost (provided other mentioned conditions are fulfilled). This is strongly related to technical issues and requires knowledge of the production process. That is why tax authorities usually compares data with other similar entities or take advantage of expertise of the experts.

Thus, to conclude, one of the possible treatments of Production and Natural Losses by tax authorities is that such losses are not allowed for deduction. In order to claim the deduction, the losses should satisfy all of the above described conditions. Another possible treatment of the Production or Natural Losses is estimation of revenues. This approach, however, may be used under limited circumstances only. This other possibility is described in more detail below.

1.1.3. Tax revenues under the Polish PIT/CIT Act

There are no rules under which the natural/production losses should be automatically recognised as tax revenues. The institution of estimation concerning tax base is applied exclusively in cases indicated in an exhaustive way in the Polish Tax Ordinance subject to specified tax proceedings.

1.1.4. Losses concerning excise goods

According to Article 85(1) of the Polish Law on Excise Duty, the competent head of a customs office shall determine, by a decision, for individual entities, upon their application limits on losses of excise goods. According to Article 85(5) of this Act, by regulation (Regulation of the Minister of Finance on maximum permissible standards for excise goods) the minister competent for public finance shall lay down:

- 1) Maximum limits on losses of certain excise goods formed while certain activities are performed during which excise goods losses may occur;
- 2) The detailed scope and manner of establishing the limits on excise goods losses or limits on excise goods consumption;
- 3) A manner of accounting for excise goods losses, in particular, where technical or technological conditions are commenced while performing said activities till a time when the competent head of a customs office determines the limits on excise goods losses.

According to Article 30(4) of the same act: losses of excise goods shall be exempt from excise duty up to their following respective amounts determined for a given entity by the competent head of a customs office.

According to the provisions of PIT/CIT Act, loss due to shortages in excise goods that are not subject to exemption from the excise duty or excise duty on those shortages should be considered as tax non-deductible cost.

1.2. Accounting requirements and stock taking

In practice, the Deficiency in Inventory often may be triggered by Production and Natural Losses. To this respect, it is important to know what are the accounting rules with respect to the stocktaking, how the taxpayers and tax authorities shall establish what is the amount of inventory the taxpayer should have at any given moment in time. For this reason, this chapter of the report provides high level description of the relevant accounting rules.

1.2.1. Accounting Framework

This section provides high-level description of the general legal framework relating to the accounting requirements set for the Polish enterprises.

According to the CIT Act: taxpayers shall maintain accounting records in accordance with separate provisions in such a way as to enable calculation of income (loss), taxable amount and the tax due in a given tax year. The PIT Act contains very similar provision. Therefore, accounting rules with respect to inventory accounting are relevant for CIT/PIT purposes too and the taxpayers who keep accounting books do not maintain separate records of purchased goods and materials for tax purposes.

Materials as well as goods can enter storage at various prices (e.g., fixed prices), depending on the valuation method applied by an undertaking. Under income tax acts, tax deductible costs can include costs in the amount actually incurred. The taxpayer shall, therefore, classify the purchase of the abovementioned assets at the cost actually incurred as tax costs, although in the accounting records these materials/goods will be recognised at a different price (fixed price).

In matters not governed by the provisions of the Accounting Act, reporting entities, when accepting accounting principles (policy), may apply the national accounting standards issued by the Polish



Accounting Standards Committee. Where no applicable national standard exists, reporting entities, other than those entities which are obliged to apply IAS, may apply IAS.

According to the Accounting Act, the taxpayer should keep Sub-ledger accounts specifically for:

- 1) Property, plant and equipment, including construction in progress, intangible assets, as well as any depreciation (amortisation) charges in respect of those assets;
- 2) Settlements with counterparties in business transactions;
- 3) Settlements with employees, especially in the form of payroll of individual employees that gives access to payroll-related information for the entire period of employment;
- 4) Sales transactions (consecutively numbered invoices issued by the reporting entity and other accounting documents, at the level of detail required for tax purposes);
- 5) Purchase transactions (third-party invoices and other accounting documents, at the level of detail required for the measurement of assets and for tax purposes);
- 6) Expenses and assets of material value for the reporting entity;
- 7) Cash transactions, where a cash register is used by the reporting entity.

1.2.2. SAF-T requirements

The Act of 10 September 2015 on Amending the Tax Regulations Act and some other acts implement the concept of the so-called Standard Audit File for Tax (hereinafter referred to as "SAF-T") - an idea developed by the OECD, which requires taxpayers using computer software to submit accounting books and evidence in the form of structured format files. With the use of appropriate algorithms, the format will automatically allow tax authorities to extract the required substantive data and to verify them. The concept of SAF-T requires taxpayers to present tax authorities with accounting books and evidence in the form of structured XML format files. The obligation to submit data in a specific, structured format has been introduced with Article 193a added to the Polish Tax Ordinance.

The SAF-T should apply to:

- Tax proceedings;
- Tax audits;
- Verification activities, including verification activities of a taxpayer's contractor - provided that the taxpayer's contractor keeps accounting books with the use of computer programmes.

The SAF-T concerns, in particular:

- Account books;
- Bank statements;
- Warehouse;
- VAT sales and purchase records;
- VAT invoices.

Warehouse structure in SAF-T, basically provides the data concerning:

- Materials, products, packages (each single item);
- Internal release, movements between warehouses, receipt from outside, external release.

This amendment is effective from 1 July 2016, and it shall apply to large enterprises within the meaning of the Act on Freedom of Economic Activity. Under the transitional provisions, in the period from 1 July 2016 to 30 June 2018, small and medium entrepreneurs will have no obligation to provide data in accordance with the standard; However, they will be able to do it optionally. Thus, this category of taxpayers will be required to submit data to tax authorities in the form of SAF-T only as of 1 July 2018. However in respect of SAT-T based reporting of VAT data, large entities are obliged to submit monthly reports from June 2016, and SMEs from January 2017.

Categories of entrepreneurs are defined in the Polish Act on Business Freedom Activity. According to the provisions of the act there are the following categories:

- Micro entrepreneur – an entrepreneur who at least in one of the two last financial year:
 - Employed on average less than 10 employees; and
 - Generated an annual turnover from the sale of goods, products and financial operations not exceeding PLN equivalent of EUR 2 000 000 or total assets in its balance sheet at the end of one of these years did not exceed PLN equivalent of EUR 2 000 000;
- Small entrepreneur - an entrepreneur who at least in one of the two last financial year:
 - Employed on average less than 50 employees; and
 - Generated an annual turnover from the sale of goods, products and financial operations not exceeding PLN equivalent of EUR 10 000 000 or total assets in its balance sheet at the end of one of these years did not exceed PLN equivalent of EUR 10 000 000;
- Medium entrepreneur - an entrepreneur who at least in one of the two last financial year:
 - Employed on average less than 250 employees; and
 - Generated an annual turnover from the sale of goods, products and financial operations not exceeding PLN equivalent of EUR 50 000 000 or total assets in its balance sheet at the end of one of these years did not exceed PLN equivalent of EUR 43 000 000;
- Big entrepreneur has not been regulated in the said act. However, in order to define this category of entrepreneur an analysis of criteria concerning medium entrepreneur is required. Big entrepreneur – an entrepreneur who at least in one of the two last financial year:
 - Employed on average at least or more than 250 employees; or
 - Generated an annual turnover from the sale of goods, products and financial operations exceeding PLN equivalent of EUR 50 000 000 or total assets in its balance sheet at the end of one of these years exceeding PLN equivalent of EUR 43 000 000;

The introduction of this kind of standardization of data reporting to tax authorities will significantly automate tax audits, which should shorten the duration of tax inspections and increase their efficiency. Submitting data in electronic form should also save taxpayers' time and reduce their administrative costs associated with delivering documents to tax offices. On the other hand, it should be noted that taxpayers will need to have software allowing them to submit data in the requested format - which may lead to additional costs related to the acquisition or extension of the one used previously. With this in mind, a specific audit of the financial and accounting system in use, as well as the IT system in general, should be carried out without delay in order to adapt them to the new regulations, taking into account additional risks involved with transferring data in the electronic form. In the event of failure to implement the changes on time, one must bear in mind possible criminal and fiscal liability for obstructing tax audit procedures.

1.2.3. Stock taking

Detailed rules on stock taking are set out in the Polish Accounting Act. There are no specific and separate stock-taking rules for tax purposes. However, the tax impact assessment of the stock-taking results should be carried out according to the PIT/CIT Act provisions (e.g. tax effect of surplus). Stock taking rules are important for Production and Natural Losses for the following reason: if the tax authorities and the taxpayers arrive at a different number as to what should be taxpayers level of inventories at any given time, then the question shall arise how this difference should be treated for tax purposes.

According to this Act, the reporting entities perform inventory counts of the following assets as at each financial year-end:

- 1) Monetary assets (with the exception of cash at bank);
- 2) Paper-form securities;
- 3) Tangible current assets;



- 4) Property, plant and equipment;
- 5) Immovable investment property;
- 6) Plant and machinery classified as construction in progress;
- 7) Other.

The stock-taking is conducted by way of physical inventory of their quantities, valuation of those quantities, comparison of the resulting value with entries in books of account, and explanation and settlement of differences, if any;

Physical stock-taking is also performed for assets owned by third parties and handed over to the reporting entity for sale, storage, processing, or use; such third parties will be informed of the results of that physical stock-taking. This above obligation does not apply to any entities providing postal, transport, forwarding, and storage services.

According to the Accounting Act, the dates and frequency of inventory counts, specified above are considered respected if the inventory count:

- 1) Of assets - with the exception of monetary assets, securities, work in progress, raw materials, goods for resale and finished products, is started not earlier than 3 months before the financial year-end and completed by the 15th day of the following year, and the actual balance of assets is determined by adding or deducting the receipts and issues (increases and decreases) occurring between the date of physical inventory or balance confirmation and the date of determination of the balance derived from books of account, to/from their balance determined as a result of that physical inventory or balance confirmation, subject to the provision the balance derived from books of account cannot be determined after the reporting date;
- 2) Of the stock of raw materials, goods for resale, finished and semi-finished products stored in secure storage locations and recorded by quantity and by value - is performed once every 2 years;
- 3) Of immovable property recognised under property, plant and equipment, and investment property, as well as other property, plant and equipment or plant and machinery classified as construction in progress - is performed once every 4 years;
- 4) Of the stock of goods for resale and (packaging) materials recorded by value in the reporting entity's retail outlets - is performed once a year;
- 5) Of the stock of wood in the entities involved in forestry and forest farming - is performed once a year.

According to the Accounting Act, the inventory count referred to in above is performed at an earlier date, in case of discontinuation of operations by a reporting entity, and at the date preceding the date when a reporting entity goes into liquidation or is declared bankrupt.

According to the Accounting Act, the process and results of inventory counts should be duly documented and cross-referenced to the corresponding entries in the books of account. Any differences between the actual balance and the balances recorded in books of account, identified during an inventory count, must be explained and reconciled in the books of account of the financial year during which that inventory count was performed.

Tax consequences of inventory differences

In some cases conduction of stock-taking may result in recognition of inventory differences (surplus or shortage). If a taxpayer holds more assets than indicated in accounting records kept by him, the taxpayer is obliged to record the surplus amount as a Revenue. Specifically, any surplus in inventory, shall be considered as a free of charge benefits received by the taxpayer. In other words it is a gain which should be added to the company's revenue as gratuitous receipts subject to CIT/PIT.

If the stock-taking discovers that the taxpayer holds less assets than indicated in the accounting records kept by him, then taxpayer shall not be allowed to deduct the cost of missing assets. At the same time, the taxpayer shall not be deemed to have sold the missing inventory. As noted above,

Polish tax regulations do not instruct what should be a tax treatment of the situation in which the missing inventory is explained by the tax payer in reference to Production and/or Natural Losses.

To this respect, it should be noted that Polish legislator did not treat natural/production losses automatically as non-deductible costs (there is only one exception concerning excise goods) or as taxable revenues. It means that the taxpayer has a possibility to treat that kind of losses as tax deductible cost, provided that the specific losses meet the deductibility conditions set out above. If these conditions are not met, then the taxpayer shall not have the right to deduct subject matter losses; however, the loss of goods shall not be deemed to be sold at market price.

1.2.4. Special documentation requirements for production and natural losses

Provisions of the Polish CIT/PIT act do not indicate the manner of documentation of natural/production losses, even though the appropriate manner of documentation affects the right of the taxpayer to recognize tax deductible cost. Analysis of the binding tax rulings and the jurisprudence of the Polish Administrative Courts leads to the conclusion that proper documentation in particular should:

- Indicate the amount of the losses;
- Present the causes and circumstances concerning the losses;
- Present evidence that the losses are not caused by taxpayer's fault or negligence.

The following documents, among others, may be considered proper documentation for tax purposes: protocol of inventory prepared by the stock-taking committee (internal documentation); protocol confirming the liquidation of goods (internal documentation); the report of damage (in case of the beneficiary of insurance); an expert opinion.

Simultaneously, the natural/production losses should be properly reflected in accounting records (entered in the accounts).

1.2.5. Primary valuation/historical costs

The following rules relate to accounting provisions applicable to goods and materials which have been entered into storage. Goods and materials which have been entered into storage shall be recognized in accounting books at the date on which they are acquired:

- At actual prices e.g. purchase prices; or
- At fixed prices adopted in books.

Materials as well as goods can enter storage at various prices (e.g., fixed prices), depending on the valuation method applied by an undertaking. Under income tax acts, tax deductible costs can include costs in the amount actually incurred. The taxpayer shall, therefore, classify the purchase of the abovementioned assets at the cost actually incurred as tax costs, although in the accounting records these materials/goods will be recognised at a different price (fixed price).

1.2.6. Impairment test/write-offs

Impairment write-offs may be established in case of impairment losses of an asset e.g. impairment loss on inventories. That would be the position in the case when there is a high probability that an asset controlled by the entity will not generate the expected economic benefits (in a part or as a whole) in the future. The said write-off shall cause that the value of an asset resulting from accounting books will be adjusted to the net sales price or other fair value. However, it should be noted the impairment write-down is an interim solution and it must be analysed by the entity until such time as the cause of the revaluation write-offs has ceased. Then a reversal of the impairment write-off should be made.

Revaluation write-offs of inventories made in accordance with the provisions of the Accounting Act, recognised as the operating cost for the accounting purposes, are tax non-deductible cost under the CIT/PIT Act. It is the lasting difference between tax and accounting treatment of cost, because the write-off will never be recognised as tax deductible cost.

The method of setting the limit on natural losses, determining the volume of permitted natural loss is established by the entity and should be stated in the instruction on stock-taking or in the accounting

policy. Shortages established during the inventory within fixed norms or limits of natural losses are recognised as a cost of sold goods. The above mentioned limits are set by the taxpayers at their sole discretion considering objective conditions for accounting purposes.

1.3. Dishonest taxpayers and special tax approaches

1.3.1. Indirect methods/estimation of taxable basis

In some cases a tax authority will have to undertake actions aiming at determination of the tax base of its own. It will occur, in particular, in the situation when tax authority negates the establishment concerning the tax base made by a taxpayer. A tax authority is obliged in this case to undertake appropriate measures to assess the tax base in a way that is possibly reflecting the actual state and conditions. It is not possible, inter alia, when the taxpayers do not keep required documents for tax purposes. In such cases it is permitted to assess the tax base by estimation. A tax authority determines the tax base by estimation exclusively in cases indicated in an exhaustive way in the Polish Tax Ordinance. The institution of estimation should be applied within the frames of specified tax proceedings. A tax authority is obliged to justify the choice of method of estimation.

Experience shows that the method of estimation is applied by a tax authority when tax records are unreliable or maintained in an incorrect manner by a taxpayer.

A tax authority calculates the estimated tax base, only if:

- 1) Tax books or other data necessary to determine the tax base are unavailable or
- 2) The data provided in tax books does not enable determination of the tax base, or
- 3) The taxpayer infringed the conditions entitling him to apply flat-rate tax.

A tax authority should not calculate the estimated tax base, if the data provided in tax books, supplemented by evidence obtained in the course of proceedings, make it possible to determine the tax base.

Estimate tax base is calculated using the following methods:

- 1) Internal comparison method - comparing the amount of turnover in previous periods for which the amount of turnover is known in the same enterprise;
- 2) External comparison method - comparing the amount of turnover in other enterprises that conduct similar business in similar conditions;
- 3) Inventory method - comparing the value of the assets of an enterprise at the beginning and at the end of a period, taking into account the turnover ratio;
- 4) Production method - determining the production capacity of an enterprise;
- 5) Cost method - determining the amount of turnover on the basis of the amount of costs incurred by an enterprise, taking into account the cost to turnover ratio;
- 6) Income to turnover ratio method - determining the amount of income from the sale of certain goods and provision of certain services, taking into account the ratio of those sales (services) in overall turnover.

In special circumstances, where it is impossible to apply the methods listed above, a tax authority may estimate the tax base in another manner.

Estimated tax base should be approximate to the actual tax base. When making estimations on the tax base, a tax authority should justify the selection of the particular estimation method.

The tax ordinance further specifies the following:

- Tax books maintained in a reliable and correct manner serve as evidence for what is recorded therein.
- Tax books are considered to be reliable if what is recorded therein reflects the actual state of affairs.
- Tax books are considered to be correct if they are maintained in accordance with relevant principles determined in separate provisions.

- A tax authority does not consider tax books maintained in an unreliable or incorrect manner to be evidence within the meaning mentioned above.
- However, a tax authority shall consider tax books maintained in an incorrect manner to be evidence, if the errors are not relevant to the case concerned.
- If a tax authority decides that tax books are maintained in an unreliable or incorrect manner, the tax authority specifies, in a report of the review of the books, the period and part of the books that do not serve as evidence for what is recorded therein.
- A tax authority delivers a copy of the minutes as referred above.
- Within 14 days from the delivery of minutes, a party may object to the conclusions reported therein, presenting relevant evidence to enable a tax authority to calculate the correct tax base.

The following real-life case will give some example of what kind of actions tax authorities undertake in practice to estimate the tax base for income tax purposes.

Case 1:

The company was engaged in a commercial activity involving the buying-in, storage and sale of mushrooms. The natural losses were recorded in company's accounting books in accordance with the accounting policies specified in the Polish Accounting Act. The natural losses identified by the company were considered by the company as tax deductible cost. The company deducted these costs at the time of the sale. The tax office challenged the right of the company to deduct these costs. In the company's opinion the said losses resulted from, among others, drying, ventilation, steaming and other circumstances affecting the mushrooms. The tax authorities had doubts concerning the amount of losses and the manner of documenting it.

The company recognized as a tax deductible cost the fixed amount expressed in percentage (10% of the quantity sold) with every sale and confirmed it by internal evidence (in most cases one general internal document concerning one month), what was incompatible with the entire process of transactions. For example: when the company sold 161.826,80 kg of mushrooms, the quantity of 16.182,68 kg was booked as natural losses.

The tax authority challenged the deductibility of those expenses, because the quantity of natural losses recognized by the company did not reflect the commercial reality, as the natural losses were settled on the grounds of a fixed ratio (10%).

The tax authorities underlined that the Polish tax provisions do not include specific provisions regarding an evidence of losses in current assets, including natural losses. However, for the purposes of evidence, it is necessary to keep credible documents which confirm the amount and circumstances of creation of natural losses. These kinds of losses are often confirmed in an internal protocol issued by a commission appointed to assess such losses. The evidence must reflect the legal requirements for an accounting document settled in the Polish Accounting Act.

The documents prepared by the company were considered unreliable, as the documentation did not reflect the reality. The tax authorities estimated the value of the natural losses. For this purpose the tax authority collected the data from three companies engaged in buying-in, storing and selling the groundcover (selected companies from the same geographical area and conducting the business activity under similar rules). The audit confirmed that the natural losses settled by the company (10%) were overstated.

The average ratio of natural losses in case of storing the mushrooms was (data for comparison):

- 1,50% within two days of storage – data from the first company;
- 2,29% within three days of storage– data from the second company;
- 5,54% within seven days of storage– data from the third company.

The tax authority estimated the reliable amount of natural losses by comparing the amounts determined by the company with the data presented by other companies (method of comparison). In

particular, the tax authority takes into account the duration of mushroom's storage. According to the tax authorities the real value should be 5, 29%.

1.3.2. Self-consumption and private costs

Only costs with a link to the business activity may be recognised in the tax deductible cost. Other expenditures, especially private costs of the owner of the business, could not be treated as tax deductible cost. Therefore, if the shortage in inventories is explained by the fact that the owner withdrew some inventory from business, then the taxpayer shall face certain negative consequences similar to what is described below.

Example: The taxpayer (natural person), conducting business activity, took some inventory (e.g. raw materials) for personal use. In order to hide the fact, the taxpayer deliberately treated this as natural/production losses. A tax inspection revealed that the natural/production losses were artificially excessive as shown by the amount of natural/production losses generated by other entities engaged in similar commercial activities (i.e. similar conditions of competition, offering similar business terms). This results, in particular, in the following negative tax consequences:

- Tax authority will challenge the right to recognise the above mentioned cost of acquisition of materials intended for personal use as tax deductible cost; the business from which the inventory was withdrawn shall not recognize revenues.
- Taxable revenue for the individual which took inventory from the business would arise under the Polish PIT Act (revenue arises on the user's part from the gratuitous benefit which shall be taxed with an income tax).

1.3.3. Agricultural business

The problem of Production and Natural Losses is not relevant for certain types of business because they are subject to simplified tax regime, e.g. tax regime applicable to Agricultural business.

Agricultural activities are activities consisting in generating (natural) plant products or animal products, without further processing, from own farming or animal breeding. Such activities are not subject to taxation with regard to income tax in the special sectors of agricultural production which are subject to income tax. In other words, generally, the provisions of the PIT/CIT Act shall not apply to revenue from agricultural activities, except for revenue from special branches of agricultural production. Under the PIT/CIT Act, such special branches of agricultural business include: plant growing in greenhouses and heated plastic tunnels, growing of mushrooms and their mycelia, farm breeding and raising slaughter and laying poultry. It is important to stress a general principle according to which the special sectors of agricultural production are dealt with only when the production exceeds amounts established by the Polish legislator. Moreover it should be noted that farmers have to pay an agricultural tax (in this case the taxable amount is not the income, but the amount of agricultural land).

In general there are two possible ways of calculating tax base for income tax purposes generated from the special sectors of agricultural production:

1. On the grounds of accounting books or tax revenue and expense ledger;
2. On the basis of estimated norm of annual income set by the law (fixed income per e.g. 1m² of mushroom farm) – only for personal income tax.

The taxpayer shall opt a way of setting tax base. However, the possibility is limited by the volume of income from the said source. If revenues do not exceed the Polish zloty equivalent of € 1 200 000 in a tax year preceding the current tax year, the taxpayer may keep the tax revenue and expense ledger or select the estimation method (the unit of area of plants or types of production determine the amount of money). If revenues do exceed the abovementioned amount, the taxpayer is obliged to keep accounting books. Furthermore accounting books are kept by taxpayers obliged to do this by other specific provisions of the Polish Accounting Act. The considerations and findings on natural/production losses made in this report are highly relevant in this case i.e. concerning taxpayers performing activities concerning special section of agricultural production, who are obliged to maintain accounting books.

The tax may be paid by natural persons on general rules, i.e. in compliance with progressive tax scale or may be taxed at 19% flat rate. Companies calculate tax at standard 19% tax rate.



As a rule, tax losses in the context of special sectors of agricultural production are settled on the basis of a general rule – in the five consecutive fiscal year, but the amount of the reduction in any of five years may not exceed 50% of the loss. The said entitlement does not relate to taxpayers who choose the estimated method.

Farmers are also subject to the agricultural tax. The agricultural tax is applied to land classified in the land and buildings register as agricultural area except lands used in commercial activities other than the agricultural activities. The tax rate is based on a price of rye (the average buying-in price for the eleven quarters preceding the quarter preceding the tax year). The conversion unit is 1 hectare.

In conclusion, if the agricultural activity is subject to income tax, the same general principles as in the case of other kinds of businesses apply to the treatment of natural/production losses.

2. Historical review

With respect to production and natural losses, in the last 20 years, no special tax treatments can be found in Polish tax law.

3. Conclusion

Generally, there are no special rules concerning natural and production losses under the CIT/PIT Act. There is no definition of natural and production losses in the CIT/PIT Act. Jurisprudence and representatives of the legal doctrine have challenged this problem basing on general rules. There are no rules under which the natural/production losses should be automatically recognised as tax revenues. The method of estimation of a tax base is applied exclusively in cases indicated in an exhaustive way in the Polish Tax Ordinance within the frames of specified tax proceedings (see point 1.3.). Currently, in the Polish legislation there is a lack of regulations defining standards of acceptable quantity of natural/production loss. There is one exception: Regulation from the Minister of Finance on maximum permissible standards for excise goods. Loss due to shortages in excise goods that are not subject to exemption from the excise duty or excise duty on those shortages are considered tax non-deductible cost. Polish legislator did not treat natural/production losses automatically as non-deductible costs (there is only one exception concerning excise goods). It means that the taxpayer has possibility to treat that kind of losses as tax deductible cost, provided that the conditions laid down in the provision are met.

4. Final conclusion

In the three selected EU-Member-States, production and natural losses are not addressed by special tax treatments, except of the specific regulations in the field of excise taxes, on which deficiencies in the inventory will be deemed automatically as additional revenues or profits.

Where such treatments could be found in the field of excise taxes, our research has shown, that the legal typing (categorization) of a taxable event in case of such shortfalls, was always made as a refutable assumption. The taxpayer now has the burden of proof, to clear up the reasons of the deficiencies and to demonstrate proper documentation.

Only in Poland, a shortfall in the inventory of excisable goods, is additionally threatened as non-deductible loss for the purpose of income tax. Another specific approach, which can be found only in the Polish income tax law, is the non-deduction of avoidable costs (e.g. in cases of waste of material because of inefficient production methods).

Nevertheless, the issue of (artificial) production and natural losses can be solved by general principles (net income principle, linking principle/principle of reason, non-deduction of private costs) and in case of abuse by sanction mechanism (estimation of profits or revenues by using the indirect methods).

But the rule of law constrains estimation of profits or revenues to single cases of failed documentation and cooperation of taxpayer. Indirect methods and control mechanisms (e.g. control notices) are additional instruments, to verify the data of taxpayer's accounting. The general principles of net income taxation and the right to give evidence can be overridden by the principle of simplification, if such override is necessary and reasonable to reach the aim. Simplifications are used for example in the agriculture industry, where profits are determined on basis of assets in use (land, animals), or by flat rate tax systems and withholding tax systems, which ensure taxation in cases of fleeting tax payers.

5. Suggestions for improvements to Georgia

We have got the impression that the treatments made in Georgian tax law on deficiencies in inventory and on production and natural losses, are very similar to the specific regulations which can be found in the field of excise taxes in the selected EU-Member-States.

The big difference between Georgia and the selected EU-Member-States is that such specific rules for excise taxes are not extended broadly to the area of income taxation and VAT.

Excise taxes have a very different systematic and methodology. Mainly because of the given authorization to keep a bonded warehouse as tax free zone, it is the duty of the privileged taxpayer, to secure the excisable goods from unwarranted access. In the moment of physical removal of such goods from the bonded warehouse, excise tax falls due and the owner of the bonded warehouse is liable to pay the tax.

In the case of a deficiency in inventory, the specific tax acts in the selected EU-Member-States assume refutable, that the missed excisable goods were brought in free circulation (taxable event). But tax payer shall always have the right of exculpation, especially because in practice many other circumstances (including production and natural losses) can cause a physical loss of goods inside of the production process or the bonded warehouse.

The legal assumption of additional revenues and profits in case of deficiencies in the inventory seems absolutely unsuitable for the purpose of income tax and VAT. Although, with respect to the principle of simplification, typing is one legal method to handle tax issues in a rational way, the assumption of additional revenues and profits in the case of a deficiency in inventory come to a false conclusion in many cases.

In the general case of production and natural losses it isn't obvious, that the most reasons justify the typing or the assumption of additional goods sold.

Otherwise, tax authority must be able to work efficient and in adequate time. It seems to be almost impossible to install an administrable application system for write-offs on inventories or for determination of individual allowable thresholds regarding production losses for purpose of income tax and/or VAT, like it is done in Georgia.

If tax authority in effect is unable, to administrate consistently such application systems, general legal principles are seriously concerned. Such administrative leak conflicts with the principle of equal and consistent taxation of all taxpayers.

We have the impression, that the Georgian tax treatments on deficiencies in inventory have the single aim, to counteract tax evasion in the field of income tax and VAT.

Although in practice, it can be a big challenge, to check the correctness of declared production and natural losses, such losses are typically in daily business. The general assumption of a dishonest behavior of all tax payers, by typing an artificially rising of production and natural losses, doesn't reflect the true circumstances in the most practical cases.

Such typing leads to an unfair taxation of honest taxpayers, which are under permanent punishment.

In the field of income tax and VAT, the liability-to-pay-principle demands for the existence of effective incoming payments. Tax authority has to exhaust all possibilities to investigate the true circumstances of the single case. Only if these investigations were unsuccessful, simplified estimations can be used to assess the taxable basis.

To make improvements to the Georgian income tax law and VAT law, we want to point out the following theses:

- Minimum improvement would be, to give taxpayer the possibility to refute the legal assumption of additional revenues in case of deficiencies, by giving evidence of the true circumstances;
- Setting refutable thresholds instead of non-refutable thresholds (Use refutable thresholds to simplify taxation procedure by waiving high by burden of proof.);



- According to general legal principles in the EU, it shouldn't be part of a legal assumption, to impose additional penalties. Penalization is only applicable, when evidence of guilt can be given by authority (in dubio pro reo);
- Allow simplifications for smaller companies, regarding the relevant rules for inventory accounting methods, write-offs and treatments of deficiencies (production/natural losses);
- Check, if the use of a reverse-charge-method (VAT) or a withholding system (income tax) can be used in critical sectors of business, to reduce possible tax evasion;
- Use information technology and data base analysis to verify correctness of accounting;
- Use the instrument of control notices, to check completeness of accounting. Sending control notices to the tax office of the company of seller or buyer;
- Cancel the regulations on deficiencies in inventory and use general instruments of control, re-calculation and estimation.



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