

FISCAL AND ACCOUNTING OPTIONS AND POLICIES ON TAX RESULT

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ABSTRACT

According to international accounting standards (IAS 12 Income taxes), income tax includes all domestic and foreign taxes which are based on taxable profits. Meanwhile, income taxes include withholding taxes that are paid by a subsidiary, associate or joint venture on distributions to a reporting entity². The main problem that arises in accounting income taxes is the way current and future tax consequences of recovery, future liquidation, or book value of assets/liabilities are accounted for, that are recognized in the balance sheet of a company and the transactions and other events of the current period that are recognized in an entity's financial statements. When it is probable that recovery or settlement of an asset or liability will result in future tax payments smaller or larger than their value, then the recovery or settlement would have no tax consequences, so the company must recognize either a deferred tax liability or a deferred tax asset.

KEYWORDS: income tax, accounting options and policies, fiscal policies and options, deferred tax, fiscal consequences, assets, liabilities.

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1. INTRODUCTION

The issue of accounting for income tax is based on the **two international existing approaches**, an approach that should recognize only income taxes currently payable, deferred taxes are not recognized (method of payable tax) and an approach that in addition to current tax must recognize even deferred taxes.

Based on the second approach, IAS 12 *Income Taxes* states that when it is probable that recovery or settlement of an asset or liability, lead to future tax payments larger or smaller on taxes than their value, If the recovery or settlement would have no tax consequences, the company must recognize a deferred tax liability or a deferred tax asset..

IAS 12 – *Income tax*, addresses the financial results of the entity from two points of view, accounting and taxation. Differences arising between the accounting and tax result that don't have tax repercussions on future taxes exercises represent *permanent differences*. *Temporary differences* between the accounting and taxation arise from the time lag between when an item has appeared in accounting and its inclusion in the fiscal result. Temporary differences are described in the literature as differences in timing, *that are actually taxable temporary differences resulting in deferred tax liabilities*.

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² CECCAR, 2015, International Financial Reporting Standards 2015 Part A (conceptual framework and provisions), Publishing House CECCAR, pg. A844.

2. DISCREPANCIES ON CURRENT TAX - DEFERRED TAX

Conflicts between supporters of the two approaches appeared with the initiation of the IASB project to develop an accounting standard applicable to small and medium sized entities¹. Some of those who prepare financial statements of SMEs maintain that addressing temporary differences in the accounting for income taxes is difficult to implement: SMEs do not develop *tax balance sheets and generally don't track the tax bases of many assets*², so they consider that separating a tax into two parts, one for the current year and another for the next year is useful because on one hand it warns the entity of payments / debts or receipts / receivable tax, on the other hand it ensures the creation of a source of financing a future tax.

Other reviews mention that the introduction of fundamental deviations from the recognition principles in IAS 12 - *Income tax* is not justified from the point of view of cost - benefit. The final conclusion was that deferred taxes satisfy the provisions for recognition as assets and liabilities and therefore can be measured reliably.

Initially (IAS 12 - *Accounting for income tax*) there were two ways to account for deferred tax by an entity: deferral method and liability method based on the profit and loss approach. The revised version (IAS 12 *Income Taxes*) banned the use of deferral method and provided the use of other methods of debt based on a balance sheet approach. While the income approach dealt with time differences³, the balance sheet approach treats temporary differences⁴. Timing differences are differences arising between the accounting and taxation that find their origin in a financial year and are reabsorbed in one or more future exercises. Temporary differences are differences between the tax basis of an asset or liability and its carrying amount is recorded in the balance sheet. Tax balance sheet method seems most equitable in terms of the relationship between the state and entity because it takes into account all changes in deferred tax balance between opening and closing. Even if the temporary differences are seen as temporary differences, there are some situations of temporary differences that don't give rise to timing differences:

- subsidiaries, associates or joint-venture who have not distributed the whole benefits for their parent company or another investor;
- assets are revalued and an equivalent adjustment is not made in terms of tax;
- the identifiable assets acquired and liabilities assumed in a business combination are generally recognized at their fair values but no equivalent adjustment is performed from a fiscal point of view.

In addition, there are some temporary differences which are not timing differences, such as when the temporary differences:

¹ In June 2004, the Council published a discussion document: Preliminary Views on Accounting Standards for Small and Medium Enterprises.

² 2011, A. F. Popa, Company accounts and taxes result, Ed. CECCAR, Bucharest, pag. 288

³ The differences between taxable profit and accounting profit that originate in one period are grouped in one or more future periods.

⁴ Differences arising between the tax basis of an asset or liability and its carrying amount is stated in the statement of the financial position.

- Non-monetary assets and liabilities of an activity (branches) are valued in their working currency , but their tax base is determined in a foreign currency;
- Non-monetary assets and liabilities are treated as provisions according to IAS 29 - *Financial reporting in hyperinflationary economies*;
- the initial carrying amount of an asset or liability is different in time from its initial tax base.

The main differences between the two versions of IAS 12 relate to the following:

- the *original version allowed*, but did not require, an entity to defer recognition of the benefit of tax losses until the period of execution;
- The *revised version* requires the recognition of deferred tax assets when it is probable that taxable profits to which a deferred tax asset can be utilized will be available. The revised IAS 12 prohibits the recognition of liabilities and receivables relating to deferred tax arising from certain assets or liabilities for which carrying amount is different at initial recognition from their initial fiscal basis. Revised IAS 12 *Income Taxes* ¹ requires an entity to account future consequences of transactions and other events in the same way that it accounts for the transactions and other events, namely:
 - for transactions recognized in the profit or loss statement, any related tax effects are also recognized in profit and loss;
 - for transactions recognized outside profit and loss (either in the global result or straight into equity), any related tax effects are also recognized outside profit and loss (either in the global result or straight into equity).

3. LIMITS ON THE ACCOUNTING RESULT, THE FISCAL RESULT, PERMANENT AND TEMPORARY DIFFERENCES

International Accounting Standards (IAS 12 - *Income Taxes*) address the financial results of the entity in terms of accounting and taxation. *Accounting result* is profit or loss for a period before deducting tax expense. *Tax result (taxable)* is profit or loss from a given period, determined in accordance with rules established by the tax authority, on which tax is payable or recoverable. L. Cernușcă (2007) *mentions that international accounting doctrine takes into account two types of distortions between the accounting and tax result, which manifest as permanent differences and temporary differences*. M. Ristea defines as permanent differences reincorporated elements or deducted from the final tax outcome (M.Ristea, 1995). They include the following types of income and expenses (A.Stoian, 2001)):

⇒ *non- deductible expenses for tax purposes for which the non- deduction is final;*

¹ CECCAR, 2015, International Financial Reporting Standards 2015 Part A (conceptual framework and provisions), Publishing House CECCAR

- ⇒ *income for which tax authority renounces permanently to tax, because they come from already taxed results (dividends received from a subsidiary);*
- ⇒ *granted tax relief to encourage certain economic activities promoted by the state.*

Permanent differences don't give rise to deferred taxes because they appear within the year as generating only extra restatement. Temporary differences are the differences which arise when the carrying amount of an asset or liability recorded in the statement of financial position differs from their tax base. It follows that they appear due to the fact that fiscal frequency of tax transactions or events takes place at a different time from the moment of recognition in accounting. Temporary differences may include:

- ⇒ *differences between the accounting and taxable income, such as:*
 - *revenues recognized* for accounting purposes in years prior to tax recognition, for example, the result for which contracts for building is recognized in the accounts as they advance work, and as tax when work is completed;
 - *income recognized* for tax purposes in exercises prior to accounting recognition, such as fees received in advance, which are taxed in the year of receipt, but are recognized in the profit or loss statement in the year it is due;
 - *expenses recognized* for tax purposes in exercises prior to accounting recognition, such as prepaid rents are recognized in tax payment in the year that they are paid, and in accounting in the exercise that is due the rent;
 - *expenses recognized* for accounting purposes in years prior to tax recognition, such as: adjustments for impairment of receivables recognized in the accounting year in which recovery is uncertain, but tax deductible in the year in which the court ruled that customer is bankrupt.
- ⇒ *differences arising from the adjustment of balance sheet items* - this can include for example revaluation of property if there are no similar adjustment for tax purposes;

In accordance with the international accounting rule IAS 12 - Income tax, temporary differences may arise from:

- **① taxable temporary differences** - are taxable amounts in determining taxable profit or tax loss to future periods in which the carrying amount of the asset or liability is recovered or settled. A taxable temporary difference arises in two situations:
 - ⇒ for balance sheet assets (figure no.1a) when the carrying amount of an asset > its tax base;
 - ⇒ for liabilities balance sheet (figure no.1b) when the carrying amount of a debt < tax base.

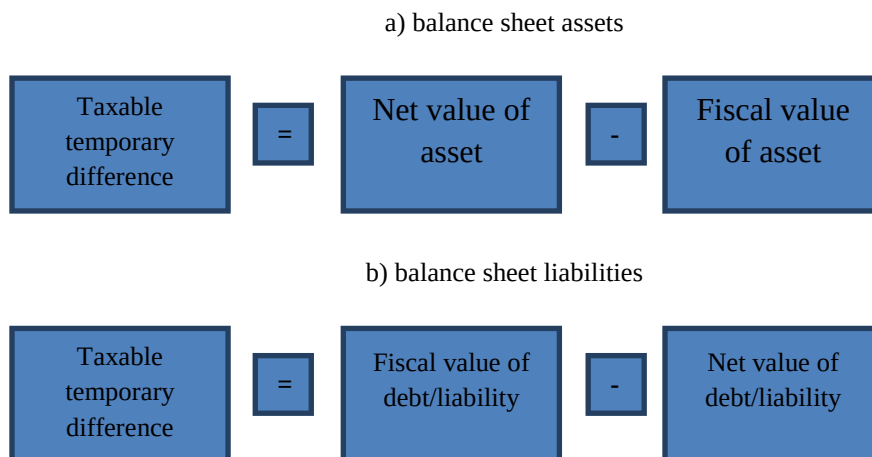


Figure 1. Defining taxable temporary differences

Source: own projection

In case of taxable temporary differences, the value of economic benefits exceeds the amount allowed by the tax authorities for deduction for tax purposes. The temporary difference is reversed as the recovery of the carrying amount of the asset or settlement of the carrying amount of the liability takes place. In this case the entity will achieve taxable profit and will have to pay income tax.

An example can be presented if an entity brought into use a machine worth 4,000 m.u. on Jan. 1 year N. For accounting purposes the equipment is amortized on a straight-four year's system. Tax depreciation for the machine amounts to 1,300 m.u. On 31.12.N. the situation is:

The carrying amount of the machine: $4.000 \text{ m.u.} - 1.000 \text{ u. m} = 3.000 \text{ m.u.}$

The tax base of the machine: $4.000 \text{ m.u.} - 1.300 \text{ m.u.} = 2.700 \text{ m.u.}$

Since the carrying amount of the machine is higher than its tax base it results a taxable temporary difference of 300 m.u.

Transactions and events that give rise to taxable temporary differences may affect both the profit and loss account (depreciation of an asset is different from tax depreciation, etc.) and the entity's balance sheet (costs of a loan are deductible at the time of initial recognition of a loan, etc.). Taxable temporary difference leads to an increase in tax payable in future periods resulting in a deferred tax liability.

The following are accounting records:

- establishing deferred tax liability:

Debit					Credit		Amount
6912	Expenses with deferred	=	4412	Deferred income tax		X	
	current income tax						

- deferred tax debt assumption:

4412	Deferred income tax	=	7912	Income from deferred income tax	X
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➤ **deductible temporary differences** - are those differences that will result in amounts that are deductible in determining taxable profit or tax loss of future periods when the carrying amount of the asset / liability is recovered / settled.

Deductible temporary differences will result in lower future tax payments on income tax. A deductible temporary difference leads to a decrease in tax payable in future periods, giving rise to a deferred (receivable) tax asset. Deductible temporary differences arise in the following situations:

⇒ for balance sheet assets (figure No. 2), when the value of an asset < tax base (tax) of that asset

⇒ for liabilities balance sheet (figure no.2b), when the carrying amount of debt > tax base of that liability

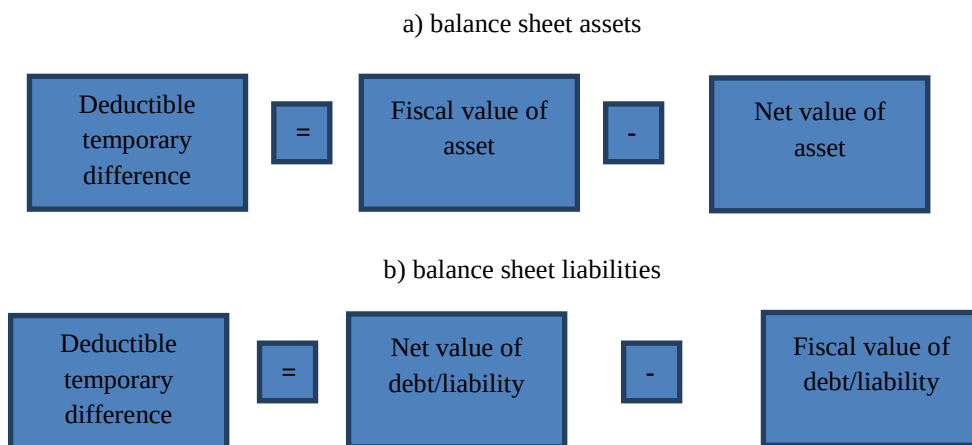


Figure 2. Defining deductible temporary differences
Source: own projection

Deferred tax assets must be recognized for all deductible temporary differences to the extent that it is probable that a taxable income will be available against which the deductible temporary difference can be utilized.

According to international accounting standard IAS 12 - *Income taxes* (Ceccar, 2015, p. A837):

⇒ *deferred tax liabilities* are the amounts of income taxes payable in future periods in respect to taxable temporary differences (figure no.3).

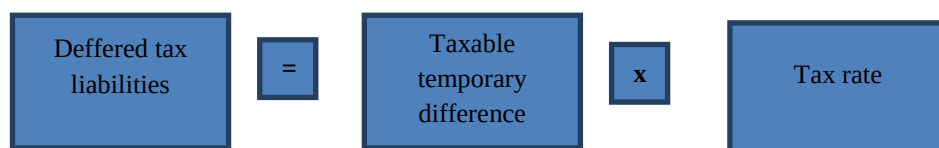


Figure 3. Defining deferred tax liabilities

Source: own projection

⇒ *deferred tax assets* are the amounts of income taxes recoverable in accounting periods relating either to deductible temporary differences, or to fiscal losses/fiscal credit unused (figure no.4).

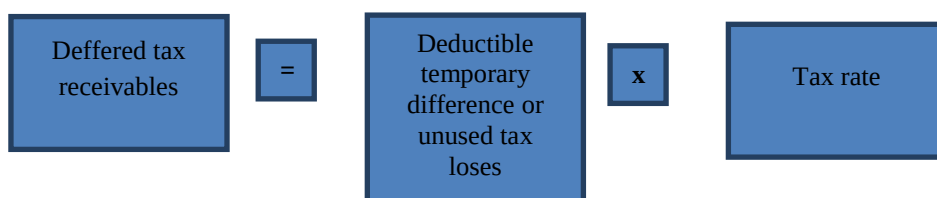


Figure 4. Defining deferred tax receivables

Source: own projection

4. THE ACCOUNTING BASIS AND THE TAX BASIS OF ASSETS AND LIABILITIES. VALUATION OF RECEIVABLES AND DEFERRED TAX LIABILITIES

4.1. The tax base of an asset

The taxable amount of an asset is the amount that can be deducted from taxable economic benefits when it recovers the carrying amount of an asset, given that the economic benefits will not be taxable, the tax base of an asset will be equal to the net book value and no temporary differences will result as a consequence¹.

The taxable amount is the amount that may be deducted from taxable economic benefits, when the carrying amount of an asset is recovered.

To determine the taxable value of interest receivables there are two way of thinking:

¹ Morariu A, Radu G., Păunescu M., 2005, Accounting and taxation in business development, Publishing house Expronto, Constanța pg 208.

First: IAS 12¹ specifies whether the economic benefits when the company recovers the carrying amount of an asset are not taxable, then the tax base of the asset is equal to its carrying amount, so income from dividends is not taxable in determining the outcome of tax base therefore claims relating to the taxation of income of a dividend is equal to the carrying amount of claims relating to income from dividends.

Second: Income dividend is taxable, the taxable income related to these receivables is 0 lei. There is a taxable temporary difference between the carrying amount and tax base. Income dividend is income that will not be taxable either at registration or thereafter, upon receipt. It follows that the tax rate applied to the taxable temporary difference is 0%, and therefore does not create any deferred tax liability.

In conclusion, we can say that the income that will never be taxable will never generate temporary differences; however, income that is not taxed in a particular year but is taxed in a subsequent year generates taxable temporary differences.

4.2. The tax base of a liability

The tax base of a liability is its carrying amount, less any amount that will be deducted for tax purposes in future periods in respect of that liability. Current liabilities include accrued expenses at a book value. The related expense will be deducted for tax purposes after cash accounting; expenses have already been deducted for tax purposes.

Case 1: The carrying amount of debt on interest (the value stated in the balance sheet) is 100 m.u. Base tax liability is zero interest (interest expense is not deductible in year N but the following year the pay will be made). Next year, the debt interest will have taxable base of 100 m.u. In year N, the taxable amount of debt interest is null and its carrying amount is 100 m.u. less 100 m.u. that is deducted for tax purposes in future periods in respect of that liability. The carrying amount of interest debt is higher than the taxable amount of debt on interest, which leads to a deductible temporary difference of 100 m.u. which gives rise to a deferred tax asset of 16 m.u. (16% x 100).

In year N, the interest expense was not deductible, it was gathered in accounting profit to determine taxable income and the entity paid more with 16 m.u in taxes. Next year, interest expense will be deductible in determining taxable income and the entity will pay less tax by 16 m.u. than would be normal for accounting purposes, if such a transaction would not have tax consequences, which is why there is a deferred tax asset of 16 m.u.

Interest expense in year is deductible when calculating taxable income.

Current liabilities include fines and penalties with a carrying amount .Fines and penalties are not deductible for tax purposes. The carrying amount of fines and penalties debt is equal to the taxable amount of debt on fines and penalties, as a result there are temporary differences.

¹ CECCAR, 2015, International Financial Reporting Standards 2015 Part A (conceptual framework and provisions), Publishing House CECCAR

4.3. Recognizing assets and liabilities from payable tax

Recognizing tax payable for assets and liabilities of the current year and the previous ones must be recorded as a liability. If the amount already paid, on behalf of the current year and previous years exceeds the amount due for these exercises, the excess must be counted as an asset. As a tax loss can be carried back to recover payable tax of a previous financial year, this advantage should be counted as an asset.

IASB states that the benefit obtained from the use of tax loss must be accounted for as an asset during the year in which the tax loss occurs because it is probable advantage for the enterprise and can be measured reliably fulfilling the conditions of an asset.

4.4. Recognizing deferred tax assets and liabilities

In all the cases when taxable temporary differences arise, a deferred tax liability must be recorded, except in the following cases:

- goodwill for which the amortization is non-deductible;
- the initial accounting of an asset or liability resulting from a transaction that is not a business combination and affects neither accounting result, nor taxable at the transaction date.

In all the cases when there are deductible temporary differences a deferred tax asset must be accounted, to the extent that it is probable that taxable profit will be available, on which these differences will be charged, except when:

- badwill is treated with a deferred income in accordance with IAS 22 enterprise clusters;
- the initial recognition of an asset or liability resulting from a transaction that is not a business combination affects neither the accounting result nor the taxable one at the transaction date.

Accounting for all deferred tax assets is explained by the fact that the carrying amount of the liability will be settled in future periods to come, by an outflow of resources, which attracts accounting for liabilities. If this resource exiting the entity is deductible in a subsequent year in which the accounting was done, then a deferred tax asset is generated on behalf of tax on earnings.

Regarding badwill, this rule does not authorize accounting for a deferred tax asset arising from temporary differences associated with it, which is treated as deferred income in accordance with standard IAS 22, as badwill is a residue, and accounting for a deferred tax asset would increase the carrying amount of it. The initial recognition of an asset or liability is the case of a non-taxable public subsidies related to an asset that is not allowed to be deducted from the tax base of the asset. The carrying amount of the asset is less than its tax base, resulting in a deductible temporary difference that is not permissible in accounting for deferred tax assets.

In conclusion, we can say that those expenses that will never be deductible don't generate temporary differences; however, expenses that are not deductible in a given year, but become deductible in a subsequent year generate deductible temporary differences.

There are countries where the tax authorities charge different tax depending on how an asset or liability will be recovered or liquidated. Liabilities or deferred tax assets are determined using on the one hand, the tax rates in effect at the time the value of an asset or liability will be recovered or disposed of, and on the other hand, tax rates specific to how it is expected to recover or liquidate an asset or a liability.

5. CONCLUSIONS

IAS 12 – Income Taxes addressing the financial results of the entity from two points of view, accounting and taxation. Differences arising between the accounting and tax result that don't have tax repercussions on taxes of future exercises are permanent differences. Temporary differences between the accounting and taxation result arise from the time lag in accounting between when an item is accounted and when it is included in the fiscal result. Some differences that are temporary come when income and expense is included in accounting profit in one period, but they appear in the taxable income of another period. Such *temporary differences are described in the literature as differences in timing*, that are *actually taxable temporary differences resulting in deferred tax liabilities*. Examples include:

- interest income –The tax base on such revenues is null because the revenues do not affect taxable profit until cash is collected;
- depreciation used in determining taxable profit – may be different from that used in determining accounting profit. In this regard, a taxable temporary difference arises, and results in a deferred tax liability, when tax depreciation is accelerated, being more rapid than accounting depreciation;
- development costs – They can be capitalized and amortized over future periods to determine accounting profit but deducted when determining taxable profit in the period they are incurred.

The importance given to deferred taxes lies in the numerous debates on financial reporting. Deferred tax should be recognized only for temporary differences. An entity should account for tax consequences of transactions when these are recognized in the financial statements. As a result of the complexity of issues relating to deferred taxes, the experts consider the application of *IAS 12 Income Taxes* as a process difficult to implement.

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