FISCAL AND ACCOUNTING IMPLICATIONS OF INCOME TAX IN ROMANIA

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ABSTRACT: *This paper presents some fiscal and accounting aspects of income tax like payers, applicability. It describe fiscal and accounting treatments of income tax and also IAS 12 treatment of tax income. Income taxes are an expense incurred in operating most businesses, and as such are to be reflected in the entity's operating results. However, accounting for income taxes is complicated by the fact that, in most jurisdictions, the amounts of revenues and expenses recognized in a given period for taxation purposes will not fully correspond to what is reported in the financial statements*

KEY WORDS: *income tax; tax base; amount; revenue; expense; benefits; tax lose.*

JEL CLASSIFICATION: *M41; M48; H2 ; K34.*

1. INTRODUCTION

The standards which prescribe accounting treatment for income tax are IAS 12.

The principal issue in accounting for income taxes is how to account for the current and future tax consequences of the future recovery of the carrying amount of assets that are recognised in an entity's balance sheet and transactions and other events of the current period that are recognised.

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount.

The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.

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Some items have a tax base but are not recognized as assets and liabilities in the balance sheet. For example, research costs are recognized as an expense in determining accounting profit in the period in which they are incurred but may not be permitted as a deduction in determining taxable profit (tax loss) until a later period. The difference between the tax base of the research costs, being the amount the taxation authorities will permit as a deduction in future periods, and the carrying amount of nil is a deductible temporary difference that results in a deferred tax asset.

Where the tax base of an asset or liability is not immediately apparent, it is helpful to consider the fundamental principle upon which this standard is based: that an entity shall, with certain limited exceptions, recognize a deferred tax liability (asset) whenever recovery or settlement of the carrying amount of an asset or liability would make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences.

In consolidated financial statements, temporary differences are determined by comparing the carrying amounts of assets and liabilities in the consolidated financial statements with the appropriate tax base. The tax base is determined by reference to a consolidated tax return in those jurisdictions in which such a return is filed. In other, jurisdictions, the tax base are determined by reference to the tax returns of each entity in the group.

2. SOME FISCAL IMPLICATION OF TAX INCOME

Income tax expense will be comprised of two components: current tax expense and deferred tax expense.

Either of these can be a benefit, rather than an expense, depending on whether there is taxable profit or loss for the period. For convenience, the term "tax expense" will be used to denote either an expense or a benefit. Current tax expense is easily understood as the tax effect of the entity's reported taxable income or loss for the period, as determined by relevant rules of the various taxing authorities to which it is subject.

Deferred tax expense, in general terms, arises as the tax effect of timing differences occurring during the reporting period.

Using the liability method, the reporting entity's current period total income tax expense cannot be computed directly (except when there are no temporary differences). Rather, it must be calculated as the sum of the two components: current tax expense and deferred tax expense. This total will not, in general, equal the amount that would be derived by applying the current tax rate to pretax accounting profit. The reason is that deferred tax expense is defined as the change in the deferred tax asset and liability accounts occurring in the current period, and this change may encompass more than the mere effect of the current tax rate times the net temporary differences arising or being reversed in the present reporting period.

Under provisions of IAS 12, current period deferred tax expense incorporates the effects of changing tax rates on the as-yet-unreversed temporary differences that originated in prior periods. In other words, current period tax expense may include not merely the tax effects of currently reported revenue and expense items, but also certain tax effects relating to items reported previously.

Although the primary objective of income tax accounting is no longer the proper matching of current period revenue and expenses, the once-critical matching principle retains some importance in financial reporting theory. Therefore, the tax effects of items excluded from the statement of income are also excluded from the statement of income.

The statement of financial position oriented measurement approach of IAS 12 necessitates the reevaluation of the deferred tax asset and liability balances at each year-end. Although IAS 12 does not directly address the question of changes to tax rates or other provisions of the tax law which may be enacted that will affect the realization of future deferred tax assets or liabilities, the effect of these changes should be reflected in the year-end deferred tax accounts in the period the changes are enacted. The offsetting adjustments should be made through the current period tax provision. When revised tax rates are enacted, they may affect not only the unreversed effects of items which were originally reported in the continuing operations section of the statement of income, but also the unreversed effects of items first presented as other comprehensive income. Although it might be conceptually superior to report the effects of tax law changes on such unreversed temporary differences in these same statement of comprehensive income captions, as a practical matter the complexities of identifying the diverse treatments of these originating transactions or events would make such an approach unworkable. Accordingly, remeasurements of the effects of tax law changes should generally be reported in the tax provision associated with continuing operations.

Changes in the tax status of the reporting entity should be reported in a manner that is entirely analogous to the reporting of enacted tax law changes. When the tax status change becomes effective, the consequent adjustments to deferred tax assets and liabilities are reported in current tax expense as part of the tax provision relating to continuing operations.

The most commonly encountered changes in status are those attendant to an election, where permitted, to be taxed as a partnership or other flow-through enterprise.

3. RECOGNITION OF CURRENT TAX LIABILITIES, CURRENT TAX ASSETS, DEFERRED TAX LIABILITIES AND DEFERRED TAX ASSETS TAXABLE TEMPORARY DIFFERENCES

Current tax for current and prior periods shall, to the extent unpaid, be recognized as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognized as an asset.

The benefit relating to a tax loss that can be carried back to recover current tax of a previous period shall be recognized as an asset.

When a tax loss is used to recover current tax of a previous period, an entity recognizes the benefit as an asset in the period in which the tax loss occurs because it is probable that the benefit will flow to the entity and the benefit can be reliably measured.

A deferred tax liability shall be recognized for all taxable temporary differences, except to the extent that the deferred tax liability arises from the initial recognition of goodwill or the initial recognition of an asset or liability in a transaction which is not a business combination and at the time of the transaction, affects neither accounting profit nor taxable profit.

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax liability shall be recognized.

It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. When the carrying amount of the asset exceeds its tax base, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes.

This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability. As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. This makes it probable that economic benefits will flow from the entity in the form of tax payments. Therefore, this standard requires the recognition of all deferred tax liabilities except in certain circumstances described in paragraphs 15 and 39 from IAS 12.

Some temporary differences arise when income or expense is included in accounting profit in one period but is included in taxable profit in a different period. Such temporary differences are often described as timing differences.

The following are examples of temporary differences of this kind which are taxable temporary differences and which therefore result in deferred tax liabilities:

- interest revenue is included in accounting profit on a time proportion basis but may, in some jurisdictions, be included in taxable profit when cash is collected. The tax base of any receivable recognized in the balance sheet with respect to such revenues is nil because the revenues do not affect taxable profit until cash is collected;
- depreciation used in determining taxable profit (tax loss) may differ from that used in determining accounting profit;
- development costs may be capitalized and amortized over future periods in determining accounting profit but deducted in determining taxable profit in the period in which they are incurred. Such development costs have a tax base of nil as they have already been deducted from taxable profit.

Temporary differences also arise when:

- the cost of a business combination is allocated by recognizing the identifiable assets acquired and liabilities assumed at their fair values, but no equivalent adjustment is made for tax purposes;
- assets are revalued and no equivalent adjustment is made for tax purposes;
- goodwill arises in a business combination;
- the tax base of an asset or liability on initial recognition differs from its initial carrying amount, for example when an entity benefits from non-taxable government grants related to assets;

- the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures becomes different from the tax base of the investment or interest.

4. DEDUCTIBLE TEMPORARY DIFFERENCES

A deferred tax asset shall be recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized, unless the deferred tax asset arises from the initial recognition of an asset or liability in a transaction that is not a business combination and at the time of the transaction, affects neither accounting profit nor taxable profit.

However, for deductible temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, a deferred tax asset shall be recognized in accordance with paragraph 44 from IAS 12.

It is inherent in the recognition of a liability that the carrying amount will be settled in future periods through an outflow from the entity of resources embodying economic benefits. When resources flow from the entity, part or all of their amounts may be deductible in determining taxable profit of a period later than the period in which the liability is recognized. In such cases, a temporary difference exists between the carrying amount of the liability and its tax base. Accordingly, a deferred tax asset arises in respect of the income taxes that will be recoverable in the future periods when that part of the liability is allowed as a deduction in determining taxable profit.

5. UNUSED TAX LOSSES AND UNUSED TAX CREDITS

A deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.

The criteria for recognising deferred tax assets arising from the carryforward of unused tax losses and tax credits are the same as the criteria for recognising deferred tax assets arising from deductible temporary differences. However, the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing otherevidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity. In such circumstances, paragraph 82 requires disclosure of the amount of the deferred tax asset and the nature of the evidence supporting its recognition.

An entity considers the following criteria in assessing the probability that taxable profit will be available against which the unused tax losses or unused tax credits can be utilised:

a) whether the entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses or unused tax credits can be utilised before they expire;
b) whether it is probable that the entity will have taxable profits before the unused tax losses or unused tax credits expire;
c) whether the unused tax losses result from identifiable causes which are unlikely to recur;
d) whether tax planning opportunities are available to the entity that will create taxable profit in the period in which the unused tax losses or unused tax credits can be utilised.

At each balance sheet date, an entity reassesses unrecognised deferred tax assets. The entity recognises a previously unrecognised deferred tax asset to the extent that it has become probable that future taxable profit will allow the deferred tax asset to be recovered. For example, an improvement in trading conditions may make it more probable that the entity will be able to generate sufficient taxable profit in the future for the deferred tax asset.

6. INVESTMENTS IN SUBSIDIARIES, BRANCHES AND ASSOCIATES AND INTERESTS IN JOINT VENTURES

Temporary differences arise when the carrying amount of investments in subsidiaries, branches and associates or interests in joint ventures (namely the parent or investor's share of the net assets of the subsidiary, branch, associate or investee, including the carrying amount of goodwill) becomes different from the tax base (which is often cost) of the investment or interest. Such differences may arise in a number of different circumstances, for example:
a) the existence of undistributed profits of subsidiaries, branches, associates and joint ventures;
b) changes in foreign exchange rates when a parent and its subsidiary are based in different countries;
c) a reduction in the carrying amount of an investment in an associate to its recoverable amount.

In consolidated financial statements, the temporary difference may be different from the temporary difference associated with that investment in the parent's separate financial statements if the parent carries the investment in its separate financial statements at cost or revalued amount.

An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint ventures, except to the extent that both of the following conditions are satisfied the parent, investor or venturer is able to control the timing of the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future.

As a parent controls the dividend policy of its subsidiary, it is able to control the timing of the reversal of temporary differences associated with that investment. Furthermore, it would often be impracticable to determine the amount of income taxes that would be payable when the temporary difference reverses. Therefore, when the parent has determined that those profits will not be distributed in the foreseeable future the parent does not recognise a deferred tax liability. The same considerations apply to investments in branches.

The non-monetary assets and liabilities of an entity are measured in its functional currency. If the entity's taxable profit or tax loss (and, hence, the tax base of its non-monetary assets and liabilities) is determined in a different currency, changes in the exchange rate give rise to temporary differences that result in a recognised deferred tax liability or asset. The resulting deferred tax is charged or credited to profit or loss.

An investor in an associate does not control that entity and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits of the associate will not be distributed in the foreseeable future, an investor recognises a deferred tax liability arising from taxable temporary differences associated with its investment in the associate. In some cases, an investor may not be able to determine the amount of tax that would be payable if it recovers the cost of its investment in an associate, but can determine that it will equal or exceed a minimum amount. In such cases, the deferred tax liability is measured at this amount.

An entity shall recognise a deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, to the extent that, and only to the extent that, it is probable that the temporary difference will reverse in the foreseeable future and taxable profit will be available against which the temporary difference can be utilised.

7. CONCLUSIONS

Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date.

Deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates and tax laws that have been enacted or substantively enacted by the balance sheet date.

Current and deferred tax assets and liabilities are usually measured using the tax rates and tax laws that have been enacted. However, in some jurisdictions, announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, tax assets and liabilities are measured using the announced tax rate (and tax laws).

When different tax rates apply to different levels of taxable income, deferred tax assets and liabilities are measured using the average rates that are expected to apply to the taxable profit (tax loss) of the periods in which the temporary differences are expected to reverse.

The measurement of deferred tax liabilities and deferred tax assets shall reflect the tax consequences that would follow from the manner in which the entity expects, at the balance sheet date, to recover or settle the carrying amount of its assets and liabilities.

In some jurisdictions, the manner in which an entity recovers (settles) the carrying amount of an asset (liability) may affect either or both of:
a) the tax rate applicable when the entity recovers (settles) the carrying amount of the asset (liability);
b) the tax base of the asset (liability).
In such cases, an entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement.

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