

Tax Implications of Significant PFRS Standards

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PFRS and Tax Laws

- Philippine Financial Reporting Standards (PFRS) – set of rules to govern the recognition, measurement and reporting of financial transactions of an entity
- Philippine National Internal Revenue Code (Tax Code) – set of laws governing the taxes imposed in the Philippines

PFRS and Tax Laws

- For tax purposes, revenue and expenses are generally determined based on the accounting method followed by the taxpayer (Sec. 43)

Exception –

- If accounting method is not reflective of true income, a different method may be used.
- If the NIRC provides for specific treatment of income or expenses, this should be followed.

What BIR says about the new accounting standards.....

- Generally accepted accounting principles (GAAP) and Generally accepted accounting standards (GAAS) approved by the Accounting Standards Council (ASC) may, from time to time, differ from the provisions of the Tax Code of 1997 and its implementing regulations.
- In such cases, the provisions of the Tax Code and its implementing rules and regulations shall prevail.

- *Rev. Memorandum Circular 22-2004*

What BIR says about the new accounting standards.....

- Taxpayers **must** maintain books and records that would **show clearly the reconciling items** or differences between the amounts shown in a taxpayer's financial statements and the figures reported in its income tax return.

- *Rev. Regulations No. 8-2007*

Reconciliation of Difference

Section F		Reconciliation of Net Income Per Books Against Taxable Income	
		Special Rate	Regular Rate
104	Net Income/(Loss) per books.....	.	.
105	Add: Non-deductible Expenses/Other Taxable Income		
	<input type="text"/>	.	.
	<input type="text"/>	.	.
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	<input type="text"/>	.	.
	<input type="text"/>	.	.
	<input type="text"/>	.	.
106	Total (Sum of Items 104 & 105).....	.	.
107	Less: Non-taxable Income and Income subjected to Final Tax		
	<input type="text"/>	.	.
	<input type="text"/>	.	.
	<input type="text"/>	.	.
	<input type="text"/>	.	.
	<input type="text"/>	.	.
	<input type="text"/>	.	.
108	Special Deductions:		
	<input type="text"/>	.	.
	<input type="text"/>	.	.
	<input type="text"/>	.	.
109	Total (Sum of Items 107 & 108).....	.	.
110	Net Taxable Income/(Net Loss) (Item 106 less Item 109)	.	.

Importance of Financial Records

- Audited financial statements are required to be submitted with ITR.
- Financial records are reviewed during tax examination
- Courts also rely on financial records in evaluating the completeness and correctness of tax information.

What should taxpayers do...

- Understand changes brought about by these standards and evaluate if they are contrary to existing tax rules
- **If not contrary** and will reflect true income, adopt them.



Comply with requirements relating to the adoption of such change!

1. Approval for changes in accounting methods
2. Tax ruling to confirm acceptability of accounting treatment for tax purposes

What should taxpayers do...

- If contrary, recognize that information shall be treated differently for tax purposes. Difference should be reported as reconciling accounts between tax and book income.



- Establish system to track and capture the differences
 - Track differences for every affected transaction
 - Calculate differences at the end of the year



New Standards Effective 2005

- PAS 1 Presentation in Financial Statements
- PAS 2 Inventories
- PAS 8 Changes in Accounting Policy, Prior Period Error's & Estimates
- PAS 10 Events After Balance Sheet Date
- PAS 16 Property, Plant and Equipment
- PAS 17 Leases
- PAS 19 Employee Benefits
- PAS 21 Effects of Changes in Foreign Exchange Rates
- PAS 24 Related Party Transactions
- PAS 27 Consolidated and Separate Financial Statements
- PAS 29 Investment in Associates

New Standards Effective 2005

PAS 31	Interest in Joint Ventures
PAS 32	Financial Instruments: Presentation and Disclosures
PAS 33	Earnings Per Share
PAS 36	Impairment of Assets
PAS 38	Intangible Assets
PAS 39	Financial Instruments: Recognition and Measurements
PAS 40	Investment Properties
PFRS 2	Share-based Payments
PFRS 3	Business Combinations
PFRS 5	Non-current assets held for sales

After 2005

Additional standards and interpretations issued by the IASB and the IFRIC

- 37 standards (8 x PFRSs; 29 x PASs)
- 24 interpretations (13 x IFRICs; 11 x SICs)

Understanding Differences

ACCOUNTING	TAX
Fair value	Cost
Substance	Form
Matching Income and Expenses	Contractual Rights and Obligations
Accounting Standards	Legal Provisions



Fair Value vs Cost

PAS 2 : Inventories

Inventories are required to be stated at the lower of:

- Cost or
- Net realizable value

NRV = Estimated selling price
Less: Estimated cost to sell



PAS 2 : Inventories

Accounting	Tax
<p>Inventory shall be adjusted to NRV if the latter is lower than cost.</p> <p>Write-down to NRV – expense during the period</p> <p>Reversal of write-down – reduction in inventories recognized as expense during the period</p>	<p>Inventory shall remain to be valued at cost</p> <p>Not valid additions to Cost of Sales.</p> <p>Reversals should not decrease COS.</p>

PAS 36: Impairment of Assets

Accounting Policy	Tax Treatment / Issues
<p>Impairment loss is charged as an expense.</p> <p>A reversal of an impairment loss for an asset shall be recognized immediately as income (or reduction of expense).</p> <p>Any reversal of an impairment loss of a revalued asset is credited directly to equity under the heading revaluation surplus.</p>	<p>Losses recognized due to impairment are not deductible.</p> <p>Gains from reversal of impairment loss are not taxable.</p>

PAS 40 : Investment Property

- Applies to property (land or building) used to
 - Earn rentals or
 - For capital appreciation or
 - Both

Rather than for use in the production or supply of goods or for administrative purposes, or sale in the ordinary course of business.

PAS 40 : Investment Property

An entity is given the option to choose either:

- **a fair value model**, under which an investment property is measured at fair value with changes in fair value recognized in profit or loss
- **a cost model**, which requires an investment property to be measured after initial measurement at depreciated cost.

PAS 36 : Investment Property

Accounting	Tax
<p data-bbox="205 492 604 537">Fair value model</p> <ul data-bbox="205 607 863 938" style="list-style-type: none"><li data-bbox="205 607 863 721">■ Increase in FV property is reported as income<li data-bbox="205 824 863 938">■ Decrease in FV is reported as expense	<p data-bbox="898 492 1843 537">For tax, property shall be valued at cost.</p> <p data-bbox="898 607 1835 846">Income/expense recognized due to changes in the value of the property will not be considered as taxable income /deductible expense.</p> <p data-bbox="898 951 1881 1127">If a property is used in business, taxpayer can claim deduction for depreciation. Depreciation shall be based on cost.</p> <p data-bbox="898 1192 1850 1430">If the property is sold, gains or losses to be considered shall be based on the unadjusted carrying value (without adjustment of fair value effects).</p>



Substance vs. Form

Fundamental Principle - Accounting

Inventories are required to be stated at the lower of:

- Cost or
- Net realizable value



Measurement of Cost - Accounting

Includes:

- ✓ Cost of purchase
- ✓ Cost of conversion
- ✓ Other costs to bring inventories to present location and condition

Excludes:

- ✗ Abnormal waste
- ✗ Storage Cost
- ✗ Unrelated administrative overhead
- ✗ Selling costs
- ✗ **Deferred Payment cost**
- ✗ **Foreign exchange differences**



Example - Deferred payment

Buyer Side

Product was invoiced for P100, payable after a year. If cash payment, price will be P90.

Purchases	90	
Deferred Interest Expense	10	
Accounts Payable		100

Accounts Payable	100	
Interest Expense	10	
Cash		100
Deferred Interest Expense		10

PAS 2 : Inventories

Accounting	Tax
<p>Cash discounts and Settlement discounts are recognized when the purchase is booked.</p> <p>Contractual discounts shall be recognized once probable.</p>	<p>If the discount has not been granted at the time of purchase, the purchase price shall be recorded based on the invoice amount</p> <p>Only actual discounts are reported as reduction from gross sales.</p> <ul style="list-style-type: none">▪ Cash discount – time of purchase▪ Settlement discount – when received▪ Rebates – when granted

PAS 2 : Inventories

Accounting	Tax
If not availed, the foregone discount is recognized as finance cost.	<p>Such finance cost shall not be deductible.</p> <p>Useful to use a different account title to record</p> <ul style="list-style-type: none">– discounts recognized upon purchase but not yet granted under a different account title– finance costs relating to unavailed discounts.

PAS 18 : Revenue Recognition



Goods

- Transfer of risks & rewards
- Management involvement
- Substance of the transaction

Recognize revenue when:

1. Measured reliably
2. Flow of economic benefits probable
3. Costs measured reliably



Services

- Performance of obligations
- Percentage of completion method
- PAS 11 construction contracts

PAS 18 : Revenue Recognition

- **Multiple Element Arrangements (MEA)** - Arrangements involving the supply of multiple goods or services at different points in time
- Examples of MEAs include
 - Supply of goods with subsequent servicing
 - Certain customer loyalty/incentive schemes

PAS 18 : Revenue Recognition

Accounting	Tax
<ul style="list-style-type: none">■ Revenues shall be accounted for separately. ■ Amount for subsequent servicing that is identifiable from the selling price is deferred and recognized as revenue over the period during which the service is performed.	<p>Treat the components of a transaction separately if -</p> <ul style="list-style-type: none">➤ the contract explicitly describes these components and ➤ the stipulated payments are broken down according to the various parts of what is being provided under the contract.

Substance vs. Form - MEA

Example : Supply of goods with subsequent servicing

Entity G runs a promotion in which customers sign a twelve month airtime contract with minimum monthly spend of P 30 per month, entitling them to 60 minutes of usage each month, and receive a "free" phone.

- The phone is also sold separately for P100 (assume there are regular sales at this price).
- Under the promotion customers also pay a one-off connection fee of P50.

Substance vs. Form - MEA

Analysis:

- The arrangement includes two separately identifiable components - the phone and the airtime service.
- The total consideration for the arrangement is P410 (50 + 12x30). The fair value of the phone is P100. The fair value of the airtime revenue is P360.
- Using a relative fair value approach, the total revenue of P410 is allocated proportionately to the fair values of the two separately identifiable components as follows:
 - Phone: $P410 \times (100/460) = 89$
 - Airtime: $P410 \times (360/460) = 321$

PAS 18 : Revenue Recognition

Accounting	Tax
<p data-bbox="157 537 877 867"><i>Recognized as sale of goods:</i> The phone revenue of P89 is recognized on delivery of the phone, along with associated costs.</p> <p data-bbox="157 984 894 1403"><i>Recognized as sale of services:</i> The airtime revenue of P321 is recognized on a straight line basis over the 12 month contract period.</p>	<p data-bbox="961 537 1766 591"><i>Recognized as sale of services</i></p> <p data-bbox="961 683 1276 737">Income tax :</p> <ul data-bbox="1052 769 1919 1101" style="list-style-type: none">– Connection fee of P50 is recognized as revenue in the first year. Airtime revenue of P360 is recognized over the 12 month contract period. <p data-bbox="961 1192 1087 1245">VAT:</p> <p data-bbox="1052 1278 1913 1403">Taxable sales is the amount actually received during the year.</p>

PAS 17 : Leases

Classification of Leases

1. **Finance Lease** is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred.
2. **Operating Lease** is a lease other than the finance lease.

Definition – Tax (RR 19-86)

1. **Lease** – an agreement between the lessor and lessee giving lessee possession and use of a specific property upon payment of rentals over a period of time.
2. **Conditional Sale** – one of the parties obligates himself or transfer ownership of and deliver a determinate thing while the other pays a price certain.

PAS 17 : Leases

Accounting	Tax
Operating Lease	Operating Lease
Finance Lease	Operating Lease
Finance Lease	Conditional Sale

PAS 32: Financial Instruments: Presentation and Disclosures

Financial Liability



When issuer is or can be required to deliver either cash or another financial asset to the holder (presence of contractual obligation)

Equity Instrument



When it represents a residual interest in the net asset of the issuer

PAS 18 : Revenue Recognition

Accounting	Tax
The substance of a financial instrument governs its classification rather than its legal form	Based on LEGAL FORM Treated as obligation if covered by PN, Loan agreements and etc. Treated as equity if representing ownership in company. Normally covered by shares of stocks.

Financial Liabilities vs. Equity Instruments

Instrument	Classification For Accounting	Treatment For Tax	Payout
Common shares	Equity	Equity	Dividends
Redeemable preferred shares with 50% fixed dividend each year subject to availability of distributable profits	Liability	Equity	Accounting: Interest Tax: Dividends
Convertible bond which converts into fixed number of shares	Liability for bond and equity for option	Liability	Accounting: Interest and Dividend Tax: Interest
Convertible bond which converts into shares to the value of the liability	Liability	Liability until converted to shares	Interest

PAS 32: Financial Instruments

Presentation and Disclosures

Financial Liabilities vs. Equity Instruments

Example:

Company A issued on May 5, 2005 preferred shares with 10% dividend per year and are redeemable in May 2010.

Accounting: The preferred shares are to be presented in the B/S of Company A as liabilities because they represent contractual obligations of the company to deliver cash at a fixed maturity date.

Tax: The preferred shares are treated as equity. Payout is dividend not interest.

Tax Treatment: Interest vs. Dividend

	Interest	Dividend
Deductibility	Deductible	Non-deductible
Withholding Tax	Interest paid to foreign creditor is subject to 20% FT or tax treaty rate, if applicable	-0% if intercorporate -32% if NRFC unless Treaty rate - 15% if Resident if tax-sparing provision applies

Tax Rules – Thin capitalization

- BIR to examine whether there is a true debtor-creditor relationship. Excessively large liabilities in relation to capital stock (especially in the case of a new company) may indicate a thin capitalization situation.
- In the absence of rules prescribing guidelines and presumptions as to what constitute thin capitalization (unlike other countries), there is a necessity to determine the reasonable ratio of debt over equity considering all factors surrounding the case.

- *Rev Audit Memo Order 1-98*



Matching Income and Expenses VS. Contractual Rights and Obligations

PAS 18 : Revenue Recognition

Fair value of consideration received or receivable

$$= \frac{\$X}{(1+r)^t}$$

If consideration is receivable in the future, use **present value** and recognize interest income as discount unwinds

0% Finance

buy
now
**PAY
LATER**

PAS 18 : Revenue Recognition

Example: Seller Side

Product was invoiced for P100, payable after 18 months.
If cash payment, price will be P90.

Accounts Receivable	100	
Sales		90
Deferred Interest Income		10

Cash	100	
Deferred Interest income	10	
Accounts Receivable		100
Interest Income		10

PAS 18 : Revenue Recognition

Accounting	Tax
<p>When inventories are sold with deferred settlement terms, the difference between the sales price for normal credit terms and the amount received is recognized as interest income over the period of financing.</p>	<p>Taxpayer should report as sales the full invoice amount, both for income and VAT purposes.</p> <p>Implicit interest income on transaction is not taxable.</p> <p>For tracking purposes, a different account may be used to record this type of interest.</p>

PAS 16: Property, Plant and Equipment

PPE are initially measured at cost.

Components of the cost of PPE:

- Purchase price, including import duties
- Directly attributable costs
- **Initial estimate of the costs of dismantling and removing the item and restoring the site**

Excludes interest and financing cost to acquire property, except for qualifying assets.

PAS 16: Property, Plant and Equipment

Accounting	Tax
<p>Cost shall include initial estimate of</p> <ul style="list-style-type: none">➤ cost of dismantlement or removal or➤ cost of restoration incurred to install an item.	<ul style="list-style-type: none">■ Not qualified as part of the cost of PPE. This difference affects:<ul style="list-style-type: none">- Depreciation- Book value of PPE when disposed■ Such costs are deductible only when actually incurred (upon dismantling, restoration)

PAS 16: Property, Plant and Equipment

Accounting	Tax
<p>Cost shall include initial estimate of</p> <ul style="list-style-type: none">➤ cost of dismantlement or removal or➤ cost of restoration incurred to install an item.	<p>Withholding tax - based on actual acquisition cost of PPE.</p> <p>VAT - purchase should be reported at acquisition cost.</p>

Example: Accounting for Estimated Dismantling and Restoration Costs

	FS	Tax
Acquisition cost:		
Purchase price	P 1,500,000	P 1,500,000
Installation cost	100,000	100,000
PV Est. dismantling cost	250,000	-
Total Acquisition Cost	P 1,850,000	P 1,600,000
Annual Depreciation	P 370,000	P 320,000

*Useful life = 5 years

PAS 17: Leases

Operating Lease : Lessor

Accounting Policy	Tax Treatment / Issues
<p>Lease income from operating leases shall be recognized as income on a straight-line basis over the lease term, even if the receipts are not on such a basis.</p>	<p>Income to be reported shall be the amount to be received by the Lessor based on the provisions of the agreement. Hence, the income to be reported by the lessor is just the rent actually earned.</p>

Operating Lease with unequal rental payments

Annual rental:

Y1 - P1,000;

Y2 - P1,100;

Y3 - P1,200;

Y4 - P1,300;

Lease term = 4 yrs

Total rent for 4 years = P4,600;

Average annual rent = P1,150

Accounting entry upon receipt/payment of rent: Years 1 and 2

Lessor's Books		Lessee's Books	
Year 1			
Dr. Cash	P1,000	Dr. Rent Expense	P1,150
Dr. Receivable	150	Cr. Payable	150
Cr. Rent Income	1,150	Cr. Cash	P1,000
Year 2			
Dr. Cash	P1,000	Dr. Rent Expense	P1,150
Dr. Receivable	150	Cr. Payable	150
Cr. Rent Income	1,150	Cr. Cash	P1,000



Standards vs. Laws

PAS 8 : Changes in Accounting Policy

Accounting	Tax
Accounting error should be adjusted retrospectively.	<p>Tax return in affected year should be amended to report true income or expense.</p> <p>However, this can only be done within three years from the date of filing of such return and provided no notice for audit or investigation has been served to the taxpayer.</p> <p>- Sec. 6, NIRC, as amended</p>

PAS 16 : Property, Plant and Equipment

- Interest and financing charges relating to acquisition of property are treated as **period expense**, unless said interest are opted to be capitalized for being related to acquisition of **qualifying assets**.
- Qualifying asset – pertain to a property that necessarily takes a substantial period of time to get ready for its intended use or sale.
 - Manufacturing plant
 - Power generation facilities
 - Buildings
 - Warehouse

PAS 16: Property, Plant and Equipment

Accounting	Tax
<p>Interest and financing charges relating to acquisition of property</p> <ul style="list-style-type: none">❖ Non-qualifying – treated as an expense▪ Qualifying – option to either recognize as period expense or to capitalize as part of the cost of the asset.	<p>If incurred in connection with the acquisition of property used in business, taxpayer is given the option to either :</p> <ul style="list-style-type: none">▪ Treat interest as part of the cost of the property (and thereof be part of the depreciable base) or▪ Claim interest as deduction in the year incurred. <p style="text-align: right;"><i>- Sec. 34(B)(1), NIRC as amended</i></p>

PAS 36 : Impairment of Assets

Accounting	Tax
<p data-bbox="163 558 569 607">Impairment loss</p> <ul data-bbox="163 711 716 818" style="list-style-type: none"><li data-bbox="163 711 716 818">▪ Charged to profit and loss.	<p data-bbox="764 558 1913 672">Gain or loss is recognized only when the asset is sold or disposed.</p> <p data-bbox="1394 776 1944 824"><i>- Sec. 96, Rev. Regs. 2</i></p> <ul data-bbox="764 928 1892 1036" style="list-style-type: none"><li data-bbox="764 928 1892 1036">▪ Non-deductible losses. Gains from reversal of impairment loss are not taxable. <p data-bbox="1373 1140 1944 1263"><i>- BIR Ruling DA-403-03, Nov. 10, 2003</i></p>

PAS 38 : Intangible Assets

Accounting	Tax
<p data-bbox="176 597 800 651">Expenditure on research</p> <ul data-bbox="176 711 1003 824" style="list-style-type: none">- Recognized as an expense when it is incurred. <p data-bbox="176 927 856 980">Development expenditures</p> <p data-bbox="176 1040 394 1094">Option to</p> <ul data-bbox="197 1117 1024 1247" style="list-style-type: none">- Expense in the year incurred, or- Capitalize as an intangible asset.	<p data-bbox="1066 597 1285 651">Option to</p> <ul data-bbox="1066 748 1898 1273" style="list-style-type: none">• Deduct in the year incurred or• Deferred expenses and claim as deduction ratably distributed over a period of not less than 60 months, beginning with the month in which the taxpayer first realizes benefits from such expenditures. <p data-bbox="1220 1370 1940 1424"><i>-Sec. 34(I), NIRC as amended</i></p>

Example – Impact of Impairment on Depreciation

Calculation of the Impairment loss at the end of 2005

Carrying amount before impairment loss	P 150,000
Impairment loss	<u>(P 28,872)</u>
Recoverable amount	<u>P 121,128</u>
Depreciation each year (straight line basis)	P 12,113
Deductible depreciation	P 15,000

PAS 19: Employee Benefits

Accounting	Tax
<p>DCP = expense / accrued liability is the amount of required contribution under the plan.</p> <p>DBP = use of actuarial assumptions to measure the net expense (income) and the retirement benefit obligation (asset).</p>	<p>Only contributions paid during the year to a BIR-qualified trusteesd plan are deductible</p> <p>Rule on deductibility:</p> <ul style="list-style-type: none">• Contributions for present service cost – full deductible;• Contributions for past service cost, 1/10th of the contribution paid. <p>- Sec 34(J), NIRC</p>

Reconciling Tax and Book Income

Reconciling Items to be shown in ITR

- Non-deductible loss on write-down of inventory to net realizable value (PAS 2)
- Non-deductible/non-taxable implicit interest expense/income recognized on purchase of inventory on deferred installment term (PAS 2)
- Non-taxable/non-deductible gains/losses arising from the recognition of biological assets/agricultural produce at FV less point-of-sale costs (PAS 41)
- Difference between the gains/loss on disposal of biological assets/agricultural produce computed using stated at FV less point-of-sale costs vs. unadjusted costs (PAS 41)
- Non-deductible depreciation on dismantlement, restoration costs and/or revaluation increment (PAS16)
- Non-deductible impairment losses (PAS 16,38,17,36,40,PFRS 5)

Reconciling Items - Additional

- Non-deductible depreciation on dismantlement, restoration costs and/or revaluation increment (PAS16)
- Non-deductible impairment losses (PAS 16,38,17,36,40,PFRS 5)
- Non-taxable gain on reversal of impairment loss (PAS 16, 38, 17, 36, 40, PFRS 5)
- Additional depreciation on proceeds from samples deducted from the cost of equipment (PAS 16)
- Difference between the gain/loss on disposal of property computed using the carrying value vs. BV based on cost (PAS 16,17,36,40, PFRS 5)
- Non-deductible loss on assets de-recognized (PAS 16,36,40, PFRS 5)
- Amortization of research costs capitalized for tax purposes (PAS 38)

Reconciling Items - Additional

- Loss on write-off of research costs (PAS 38)
- Difference between the lease expense per contract and per expense recorded (PAS 17)
- Difference in depreciation expense per accounting and per tax on capitalized leased assets (PAS 17)
- Gain/loss on assets sold through sale-leaseback agreement (PAS 17)
- Amortization of gain/loss on assets sold through sale-leaseback agreement (PAS 17)
- Non-taxable/non-deductible revaluation gains/loss (PAS 38,32)

Reconciling Items - Additional

- Non-deductible/non-taxable implicit interest expenses/income recognized on financial instruments (PAS 32)
- Interest expense financial instrument recorded as dividends (PAS 32)
- Non-deductible/non-taxable interest expense/income pertaining to dividends declared/received (PAS 32)
- Non-taxable/non-deductible gains/losses in changes in fair value of financial assets at FVTPL (PAS 32)
- Non-taxable/non-deductible gains/losses on remeasurement of derivatives/hedging (PAS 32)
- Non-deductible accrual of employee benefits (PAS 19, PFRS 2)
- Employee benefits paid in the current taxable year but accrued in previous year/s (PAS 19, PFRS 2)

Challenge for business entities

- Are their accounting personnel familiar with the differences with tax and accounting rules to be able to make valuable suggestions to management?
- Did their employees who are responsible for the preparation of income tax return undergo training on the impact of the new accounting standards on tax reporting?
- Has the entity reviewed its information system to determine if it effectively captures the relevant tax and accounting differences to ensure availability of correct information when required?
- Does the entity maintain records to support these differences are retained and will be readily available in case of a BIR tax audit?

Thank You...

