PAS 19 and 21: Tax and Accounting Issues

Joel L. Tan-Torres

Partner, SyCip Gorres Velayo & Co.

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PAS 21 – THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

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Definitions (Accounting)

- Functional currency is the currency of the primary economic environment in which the entity operates.
- Foreign currency is a currency other than the functional currency of the entity.
- Spot exchange rate is the exchange rate for immediate delivery
- Closing rate is the spot exchange rate at the balance sheet date
- Monetary items are units of currency held, and assets and liabilities to be received or paid in fixed or determinable number of units of currency

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Initial measurement of foreign currency transactions

Accounting Treatment

The transaction is translated into the functional currency at the spot rate at the date of the transaction.

Tax Treatment

- For the conversion of US dollars to Philippine pesos, the prevailing interbank reference rate for the day of the transaction shall apply.
- If the foreign exchange rate above is impractical or not feasible, the average interbank reference during the year shall apply. ***(BIR Ruling 004-2003 dated June 3, 2003 citing RMC 26-85)***

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Measurement of foreign currency items at the balance sheet date

Accounting Treatment

- **Monetary items - at the closing rate**
- **Non-monetary items measured at historical cost - at the exchange rate ruling at the date of the transaction**
- **Non-monetary items measured at fair value - at the exchange rate at the date of the valuation**

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Measurement of foreign currency items at the balance sheet date

Tax Treatment

- **For the conversion of US dollars to Philippine pesos, the prevailing interbank reference rate for the day of the transaction shall apply.**
- **If the foreign exchange rate above is impractical or not feasible, the average interbank reference rate during the year shall apply. *(BIR Ruling 004-2003 dated June 3, 2003 citing RMC 26-85)***

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Treatment of exchange differences

Accounting Treatment

The following are included as income/loss for the period:

- **Gains or losses arising when monetary items are settled at amounts different from their carrying value**
- **Differences arising when monetary items held at the year end are retranslated at a different closing rate**

Tax Treatment

- **Foreign exchange gains and losses can only be recognized for tax purposes when they are actually realized**
- **For transactions originally in foreign currency, these should be converted to Philippine peso using the foreign currency conversion rules stated earlier**

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Realization of foreign exchange gains and losses (Tax)

BIR Ruling No. 144-85 dated August 26, 1985

Issue:
Whether foreign exchange losses accruing by reason of devaluation may be deducted for income tax purposes

Held:
"xxx the annual increase in value of an asset is not taxable income because such increase has not yet been realized. The increase in value, i.e. the gain, could only be taxed when a disposition of the property occurred which was of such a nature as to constitute a realization of such gain, that is, a severance of the gain from the original capital invested in the property. The same conclusion obtains as to losses. The annual decrease in the value of property is not normally allowable as a loss. Hence, to be allowable the loss must be realized.

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Realization of foreign exchange gains and losses (Tax)

BIR Ruling No. 144-85 dated August 26, 1985 (cont'd)
Held:
When foreign currency acquired in connection with a transaction in the regular course of business is disposed of, ordinary gain or loss results from the fluctuations. (Prentice Hall Federal Taxes, Vol. 1, par. 6261) The loss is deductible only for the year it is actually sustained. It is sustained during the year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in that year. (par. 6570, 34 Am Jur 2d 1976) A closed transaction is a taxable event which has been consummated (p. 231 Black's Law Dictionary, Fifth Edition)."

(Reiterated by BIR Ruling DA-166-04 dated April 5, 2004 and BIR Ruling DA-175-03 dated May 4, 2003.)

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Treatment of exchange differences

Recon items to net income per FS to determine taxable income:

1. **When there are realized gains or losses, NO RECON ITEM.**
2. **When there are unrealized gains, DEDUCT the unrealized gains.**
3. **When there are unrealized losses, ADD the unrealized losses.**

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Use of functional currency (Tax)

BIR Ruling 004-2003 dated June 3, 2003, DA 413-2003 dated November 17, 2004 and DA 622-04 dated December 8, 2004

FACTS:

Allowed the use of the US dollar and Japanese yen as functional currency (FC) in FS presentation and tax reporting.

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SEC Memorandum Circulars

- ***Memorandum Circular 14-2003 dated December 11, 2003 - prescribes presumptive level of at least 70% of revenue and costs/expenses in functional currency for corporations to be entitled to elect FC reporting; needs prior approval from SEC***
- ***Memorandum Circular 1-2006 dated January 11, 2006 provided the following:***
  - ***eliminated the 70% presumptive level threshold***
  - ***prescribed mere notification of SEC by the CEO or CFO of the corporation***
  - ***notification must be made within 45 days after the end of the year when FC reporting is adopted***

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Revenue Regulations 6-2006 dated March 8, 2006

- Prescribes the rules and conditions for the use of functional currency in FS that will be submitted to the BIR
- Stipulates the method for maintaining the books of accounts in functional currency and the subsidiary ledgers in both functional and peso currency
- Prescribes the manner of reporting in the tax returns
- Allows the payment of tax in functional currency

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Rules for the use of functional currency

- tax filer should consider the "dominant currency" that most faithfully represents the economic effects of transactions
- taxpayer has the option of using this functional currency (FC) for tax purposes
- corporate taxpayer electing to use the FC must submit to the BIR office a copy of the notification to the SEC within 30 days from filing of the notification
- notification should be attached to the ITR
- individual taxpayer can also elect to adopt FC upon submission of an application, under oath, to the BIR within 30 days after the taxable year in which the FC is to be adopted
- the change in FC can be allowed upon substantial change in the underlying transactions and upon submission to the BIR a copy of the notification of change submitted to the SEC
- as a rule, taxpayers shall not be allowed to change it FC in the middle of the year, or adopt one for a period of less than one year

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Books of accounts to be maintained

- books of accounts to be maintained in FC
- subsidiary ledgers for transactions subject to other taxes, aside from income tax, to be maintained both in functional currency and in Philippine peso using historical cost or actual conversion (PDS) rate prevailing on transaction date
- all books/ledgers must be registered with the BIR

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Reporting in the tax returns

- income tax returns to reflect peso declarations, with translation as follows:
  - quarterly ITR (first three quarters) should reflect translation on a monthly basis using the PDS exchange rate for each of the three months
  - annual ITR should be reconciled with the amounts in the subsidiary ledgers
- audited FS reported under the FC to be attached to the ITR
- reconciliation schedule showing the quarterly income and expenses and the reconciliation of the annual total figures to be attached to the ITR
- tax credits applied against the income tax should be the same as shown in the supporting documents
- unused NOLCO and excess MCIT to be used should using historical cost
- all other tax return shall reflect peso declarations based on PDS rate on transaction date
- computation of capital gains/loss on sale of investment allowed using FC; however in the investor makes the investment in Philippine peso, the computation of gain/loss based on peso actual costs/price

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Payment of taxes

- Peso tax liability can be paid using FC
- Conversion rate to use is the FC buying rate of the collecting bank at the time of payment

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PAS 19 – EMPLOYEE BENEFITS

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PAS 19 – Employee benefits

Definition of employee benefits

- All forms of consideration given by an enterprise in exchange for service rendered by employees
  - Employees may be full-time or part-time, permanent, temporary, or casual.
  - Benefits may be those given under formal plans or agreements, legislative or industry requirements, or under informal practices which give rise to a constructive obligation.

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PAS 19 – Employee benefits

Main kinds of benefits addressed by the standard:

- The standard's main focus is on pensions and other similar post-employment benefits.
- It also addresses these other kinds of benefits:
  - Other long-term employee benefits
  - Termination benefits
  - Short-term benefits

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PAS 19 – Key principles

An enterprise should recognise:

- A liability when an employee has provided service in exchange for employee benefits to be paid in the future
- An expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits

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PAS 19: Generally, two types of pension benefit

Defined contribution

- The pension ultimately received by the former employee is a function of the contributions that have been made.
- The cost to the employer is therefore fixed and predictable.
- No legal or constructive obligation to meet shortfall.

Defined benefit

- The pension is based on a formula that is not simply based on the contributions made, and the employer retains a risk that they will not be enough to pay the pensions.
- The eventual cost to the employer is therefore more difficult to predict.

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PAS 19: Accounting for defined contribution plans

- Recognize contributions to a defined contribution plan when an employee has rendered service in exchange for those contributions.

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PAS 19: Accounting for defined benefit plans – balance sheet

- The approach is essentially one of valuing the plan in the balance sheet, at:
  - The fair value of the plan assets (if any), *less*
  - The present value of the obligation to pay pensions

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PAS 19: Accounting for defined benefit plans – income statement

- Recognize as expense the sum of:
  - The current service cost for the period
  - The interest cost for the period
  - The expected return on any plan assets or reimbursement rights
  - Any actuarial gains and losses recognised
  - Any past service cost recognised (over the expected remaining working lives of employees)
  - The effect of any curtailments or settlements

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Post-employment Benefits (Tax)

The term 'reasonable private benefit plan' means a pension, gratuity, stock bonus or profit-sharing plan maintained by an employer for the benefit of some or all of his officials or employees, wherein contributions are made by such employer for the officials or employees, or both, for the purpose of distributing to such officials and employees the earnings and principal of the fund thus accumulated, and wherein it is provided in said plan that at no time shall any part of the corpus or income of the fund be used for, or be diverted to, any purpose other than for the exclusive benefit of the said officials and employees. [RA 4917 and Section 32(B)(6)(A) of the Tax Code]

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Post-employment Benefits (Tax)

Requirements of Plan:

- The plan must be reasonable and actuarially sound (actuarial valuation)
- The plan must be approved by the BIR.
- To be approved by the BIR, plan must comply with requirements of RR 1-68 and RR 1-83

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Post-employment Benefits (Tax)

What can be deducted as expense?

- Actual contributions to the Fund
- Deductions will be allowed as follows:
  - Amount that covers normal cost – current deduction
  - Amount in excess of NORMAL cost not previously allowed as a deduction – 1/10 of contribution [amortized over 10 years]

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PAS Difference - Example

Accounting Treatment:

- Recognition of net unfunded defined benefit obligation in the balance sheet, with a charge to Retained Earnings

Accounting entry:

Retained Earnings	xxx	
Unfunded Liability		xxx

Tax Treatment:

- Actual funding is required subject to rules for contributions to be deductible.

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Insured Benefits - Accounting

- An entity may pay insurance premiums to fund a post employment benefit plan.
- The entity shall treat such plan as a defined contribution plan unless the entity will have (either directly, or indirectly through the plan) a legal or constructive obligation to either:
  - a) pay the employee benefits directly when they fall due; or
  - b) pay further amounts if the insurer does not pay all future employee benefits relating to employee service in the current and prior periods.
- If the entity retains such a legal or constructive obligations, the entity shall treat the plan as a defined benefit plan.

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Deductibility of the premiums paid to an insured / non-trusteed plan

BIR Ruling [UN 373-95] dated October 11, 1995

- Various life insurance companies have began to consider life insurance as the source of funding of the retirement plan
- The scheme provides that the employer will insure the life of its employees (usually, under an endowment plan), will pay the premiums, and use the plan's cash benefits (maturity proceeds/cash values/dividends) as source of retirement benefits.
- Alternatively, other arrangements include companies paying the retirement fund requirements to a group plan offered by insurance companies which are in turn deposited with a trustee bank (BIR Ruling DA 388-04 datedJuly 20, 2004)

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Deductibility of the premiums paid to an insured / non-trusteed plan

- The premiums paid by the employer/company for the life insurance plans under the aforementioned schemes can be claimed by the employer/company as a deductible business expense under Section 29 (a)(1)(A) of the Tax Code [now Section 34 (A) (1)], as amended.
- This was reiterated in BIR Ruling [DA-432-04] dated August 11, 2004.

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Time of Withholding (Tax)

- Where income is not yet paid or payable but the same has been recorded as an expense or asset whichever is applicable in the payor's books, the obligation to withhold shall arise in the last month of the return period in which the same is claimed as an expense or amortized for tax purposes (RR 2-98 as amended)

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Other employee benefits addressed by PAS 19

- Other long-term employee benefits
- Termination benefits
- Short-term employee benefits

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Termination benefits (tax)

- Section 32(B)(6)(b) of the Tax Code provides that any amount received by an official or employee or by his heirs from the employer as a consequence of separation of such official or employee or from the service of the employer because of death, sickness or other physical disability or for any cause beyond the control of the said official or employee is exempt from taxes regardless of age or length of service. The phrase "for any cause beyond the control of said official or employee" connotes involuntariness on the part of the official or employee. The separation from the service of the official or employee must not be asked for or initiated by him (BIR Rulings DA 346-05, DA 425-05, DA 464-05)

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Short-term Employee Benefits

Short term employee benefits include items such as:

a) Wages, salaries and social security contributions;

b) Short-term compensated absences (such as paid annual leave and paid sick leave) where the absences are expected to occur within twelve months after the end of the period in which the employees render the related employee service;

c) Profit-sharing and bonuses payable within twelve months after the end of the period in which the employees render the related service; and

d) Non-monetary benefits (such as medical care, housing, cars and free or subsidized goods or services) for current employees (PAS 19 par. 8)

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Short-term Employee Benefits

Accounting Treatment

All short term employee benefits shall be recorded as:

a. A liability (i.e., accrued expense)

b. Expense, unless another standard requires or permits the inclusion of the benefits in the cost of an asset

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Short-term Employee Benefits

Tax Treatment

- **Both actual and accrued expense are deductible pursuant to Sec. 34(A)(1)(a)(i) of the Tax Code which provides that a reasonable allowance for salaries, wages, and other forms of compensation for personal services actually rendered, including the grossed-up monetary value of fringe benefit furnished or granted by the employer to the employee.**
- **These expenses are deductible provided that the related WTW and FBT have been paid.**

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Time of Withholding (Tax)

- Under Section 2.78 of RR No. 2-98, the withholding of tax on compensation income is a method of collecting the income tax at source upon receipt of the income.
- This finds support in BIR Ruling No. 555-88 dated November 23, 1988, where the BIR held that the obligation to withhold the tax arises only at the time of actual payment of bonus.
- However, upon effectivity of RR No. 12-2001 further amending RR No. 6-2001, the obligation of the payor to deduct and withhold the tax arises at the time the income payment is paid or payable, or the income payment is accrued or recorded as an expense or asset whichever is applicable in the payor's books, whichever comes first. The term "payable" refers to the date the obligation becomes due, demandable or legally enforceable.

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Short-term Employee Benefits

Profit sharing and bonus plans

Accounting Treatment

An entity shall recognize the expected cost of profit-sharing and bonus payments only when:

a. the entity has a present legal or constructive obligation to make such payments as a result of past events; and

b. a reliable estimate of the obligation can be made. (PAS 19, Par. 17)

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Short-term Employee Benefits

Profit sharing and bonus plans

Tax Treatment

- **Accrued profit sharing and bonus payments should be subjected to withholding taxes in the year these are determinable and claimed as deductions for income tax purposes. *[ING Bank N.V. Manila Branch vs. Commissioner of Internal Revenue (CTA Case No. 6187 dated August 9, 2004)].***
- **If these are not subjected to withholding taxes, these may not be deductible for income taxes pursuant to Section 34 (K) of the Tax Code.**

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- **For further information, contact:**

Mr. Joel L. Tan-Torres

SyCip Gorres Velayo & Co.

Tel. no. 8948159

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