TAX IMPLICATIONS OF NEW ACCOUNTING STANDARDS

NIRC Provisions

SECTION 43. The taxable income shall be computed in accordance with the method of accounting regularly employed in keeping the books of the taxpayer, but if no such method has been employed or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner clearly reflects the income

SECTION 44. All items of gross income shall be included in the gross income for the taxable year in which received

SECTION 45. The deductions shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed

SECTION 39(A)(1) and RR 7-2003

CAPITAL ASSETS shall refer to all **real properties** held by a taxpayer, whether or not connected with his trade or business, and which are not included among the real properties considered as ordinary assets

ORDINARY ASSETS:

1. Stock in trade/inventory; or
2. Held primarily for sale to customers in the ordinary course of his trade or business; or
3. Used in trade or business (i.e., buildings and/or improvements) subject to depreciation; or
4. Real property used in trade or business of the taxpayer.

KEY CHANGES

PAS 2 - Inventories

Changes	Accounting Implications	Tax Implications
LIFO no longer allowed Inventory needs to be carried at lower of cost of net realizable value (selling price less cost to sell/completion). Reversal of write-down now allowed by PFRS (not allowed by previous GAAP)	Inventories valued at LIFO need to be revalued using acceptable valuation method under IFRS.	LIFO also no longer allowed BIR approval for change must be secured within 90 days from start of taxable year

Measurement - Inventories

Example:

Carrying amount of Product A:
- Cost = P100,000
- NRV = P94,500 (P110,000 – P5,500 discount – P10,000)
- Lower of Cost and NRV = P94,500

Under the above, there is a charge to cost of sales for inventory write-down amounting to P5,500. This is not deductible for tax purposes, cost of sales under the tax rules represents the actual cost of producing/purchasing the inventory.

Similarly, any recovery in the value of the inventory will not be a taxable income.

KEY CHANGES

PAS 16 – Property, plant and equipment

Changes	Accounting Implications	Tax Implications
Asset retirement obligation (ARO) is required to be capitalized at the date of acquisition and/or installation Cost of commissioning/testing an asset, net of proceeds from selling any items produced while the asset is being tested such as sample products)	ARO asset to be recognized at PV in the balance sheet ARO asset will be depreciated over the estimated useful life of the related assets A corresponding liability (also at PV) is required to be recorded. The accretion cost (the amortization of the difference between the PV and the nominal amount of ARO) is charged to expense over the discount period (should be the same with the life of the asset)	Depreciation on ARO is not deductible for tax purposes Accretion cost (classified as finance cost) not deductible for tax purposes Upon ultimate disposal of an asset, unamortized balance of ARO will not be included in the determination of taxable income from disposal. Actual restoration costs deductible when incurred.

KEY CHANGES

PAS 16 – Property, plant and equipment		
Changes	**Accounting Implications**	**Tax Implications**
Component accounting Interest on qualifying asset may be capitalized as part of the asset account during the construction period (IAS 23 – Borrowing costs allowed alternative treatment)		Depreciation for each of the components of a large asset should be aligned with depreciation for tax purposes. {SEC.34(F)} Interest for tax purposes is deductible when paid/incurred or maybe capitalized as part of the asset. {SEC.34B(3)} Depending on the company policy, this may create temporary difference between accounting and tax base.

Fixed assets		
Example of tax treatment of ARO		
	IFRS	**Tax**
Acquisition cost: Purchase price Installation costs PV of ARO	P5,000,000.00 100,000.00 200,000.00	P5,000,000.00 100,000.00 -
Total Initial cost	P5,300,000.00	P5,100,000.00
Annual Depreciation (assuming a 10 year life)	P 530,000.00	P 510,000.00
The related accretion cost of ARO liability (treated as financing cost in the profit and loss) is also not deductible for tax purposes.		

KEY CHANGES

PFRS 17 – Leases		
Changes	**Accounting Implications**	**Tax Implications**
Capital Leases A lease is capital lease if following indicators exist: a) Transfer of ownership of assets to the lessee at the end of the lease term b) Lessee has the option to purchase the asset at a price that is lower than fair value of the asset c) The lease term is for the major part of the economic life of the asset d) Present value of minimum lease payments amounts to or substantially equal to the fair value of the asset e) Leased assets are of such a specialized nature that only lessee can use the asset without modification.	Lessee The leased asset will be recorded as asset measured at present value of minimum lease payments Lessor Will treat the lease as outright sale at the inception of the lease.	• Capital lease shall be treated as sale (conditional) • Amounts to be received by lessor/vendor will be considered to be payments of sales price to the extent such amounts do not represent interest and other charges (RR 19-86) • The gain on sale of asset=total lease payments receivable net of interest component less carrying value • Lessee/Vendee shall be allowed to claim depreciation plus interest (if not capitalized) • For GRT, gross receipts of banks and NBFI: interest income (RR 9-04) • For VAT, tax base is the total amount to be paid by the lessee/vendee (RR 16-05)

KEY CHANGES

PFRS 17 – Leases		
Changes	**Accounting Implications**	**Tax Implications**
Operating Leases Lease income/cost, including lease incentives such as free rent, to be recognized under the straight-line method over the term of the lease	Impact of lease escalation and free rent will have to be amortized under the straight-line method over the term of the lease Straight-lining of lease income/cost will create temporary difference between the actual amount of cash received/paid and actual amount of income/expense recorded in the accounts.	Gross inc. of lessor: • Rent actually earned and • Advance rentals received No rent income to be recognized during rent-free period Allowable deductions to lessee • Rent paid or accrued including all expenses for the account of the lessor • Advance payment to be amortized Amount arising from straight-lining of lease cost/expense not taxable income/deductible expense

Finance leases – tax considerations

PFRS	Tax impact
Lessee – Lease payments Each payment will be allocated between lease and interest. The lease payment will be applied against the liability under capital lease. The lessee will also record a regular depreciation expense for the leased asset.	Deduction for tax purposes shall be the depreciation expense on leased asset and interest payments. (Taxpayer has option to expense or capitalize interest). Open tax issue: Implicit interest expense on non-interest bearing agreements – deductible for tax purposes?

Finance leases – tax considerations

PFRS	Tax impact
Lessor – Lessor shall recognize assets held under a finance lease in their balance sheets and present them as a receivable at an amount equal to the net investment in the lease. Income from the sale of the asset is the difference between the total lease payments receivable, excluding interest charges, and the cost of the asset	Lessor shall recognize a gain on the sale of the asset and deferred interest income. Taxable income from sale of asset consistent with PFRS

Leases – sale and leaseback tax considerations

PFRS	Tax
Lessor	
Sale/leaseback transactions – If finance lease, any excess of selling price over the carrying amount shall be deferred and amortized over the lease term.	Gain/Income from the sale shall already be taxed in full at point of sale. Similar to ordinary sale.
If loss is compensated by future lease payments at below market price, it shall be deferred and amortized in proportion to the lease payments over lease term.	Loss shall be deductible, regardless of the impact of future lease payments.

KEY CHANGES

PAS 19 – Employee benefits (focus on pension plans)

Changes	Accounting Implications	Tax Implications
Annual pension cost charge now composed of: 1) Current service cost 2) Interest cost on liabilities 3) Return on plan asset 4) Recognized actuarial gains and losses 5) Past service costs 6) Amortization of transition liability, if any Past service costs need to be amortized over the vesting period (used to be amortized over the average remaining lives of employees Allows only projected credit method as acceptable valuation model Profit sharing and bonus can be recognized if present legal or constructive obligation exists	Past service cost amortization is effectively higher compared to previous GAAP. Transition liability need to be recognized at IFRS transition date and can be amortized over a maximum period of five years Transition asset can be recognized at transition date if the asset exceeded the present value of defined benefit obligation.	Deductible pension costs: Actual contribution for pension liability for current year - One-tenth of reasonable amount paid to the trust to cover pension liability for prior years or to place the trust on sound financial basis All other components of pension cost charge not deductible Transition liability – not deductible for income tax purposes Transition asset – not taxable for income tax purposes. Future refunds from the fund are taxable when refunds are received. Deferred tax liability , however needs to be recognized on recognized pension asset arising from future refund.

KEY CHANGES

PAS 21 – Effects on changes in foreign exchange rates		
Changes	**Accounting Implications**	**Tax Implications**
Requires that functional currency be determined by an entity. The functional currency is the basis of recording transactions. Capitalized foreign exchange losses no longer allowed.	General ledger supporting the financial statements need to be maintained using the function currency. Foreign exchange losses previously capitalized need to be written-off or adjusted against the opening balance of retained earnings.	Taxable income – translate monthly functional currency income and expenses using average exchange PDS rates then adding all the 12 monthly peso equivalents All other taxes – historical or actual conversion peso amounts or actual conversion/prevailing PDS rates on transaction days Capitalized forex loss written off – if actual loss: - continue claiming depreciation, or - change accounting/tax treatment If loss is not realized, write-off upon realization.

KEY CHANGES

PAS 32/39 – Derivative financial instruments and hedging		
Changes	**Accounting Implications**	**Tax Implications**
Requires measurement and recognition of the fair value of derivatives, including embedded derivatives Financial assets/liabilities need to be measured initially at FV less cost of transaction. Subsequently, assets must be measured at FV as follows: 1) Assets/liabilities at FV through profit and loss – at FV (market) 2) Held to maturity investments – at amortized cost using the effective interest method 3) Loans and receivables – same as 2 above 4) Available for safe financial assets – at FV (market)	Mark to market/derivative losses and gains (unrealized in nature) need to be measured at each reporting date Fair value adjustments of financial assets and liabilities will be charged/credited to operations (except available for sale financial assets which is part of the equity accounts) Application of effective interest method will create temporary difference between actual amount of interest received/paid and amount reported under effective interest method. Tax impact Timing differences and fair value adjustments taxable income/deductible losses?	Temporary differences and fair value adjustments are not taxable income/deductible losses Gain or loss to be recognized upon realization Necessary to determine whether realized gain or loss is capital or ordinary Capital loss deductible only from capital gains Loans to employees without interest or (rate below 12%) will give rise to taxable fringe benefit

KEY CHANGES

PAS 32/39 – Derivative financial instruments and hedging		
Changes	**Accounting Implications**	**Tax Implications**
Some preferred shares now classified as liability rather than equity	See separate examples	See examples
Equity and liability elements of compound instruments need to be valued and treated separately in the balance sheet	See examples	See examples
Long term financial assets and liabilities which are non-interest bearing need to be stated at present value by discounting the balance using a rate that is implicit to the agreement/balance.	Portion of the non-interest bearing assets/liabilities will be treated either as an interest expense or income using the effective interest method	Accretion income/expense arising from discounting of long term assets and liabilities are not taxable. Note however interest maybe imputed by BIR on non-interest bearing inter-company advances/loans

Financial Liabilities vs. Equity Instruments -example

Instrument	PFRS	Tax	Dividend vs. Interest
Common shares	Equity	Equity	Dividends
Redeemable preferred share with fixed dividend each year subject to availability of distributable profits	Liability	Equity	Accounting: Interest Tax: Dividends
Convertible bond which an option to convert 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 equal to the value of the liability	Liability	Liability until converted to shares	Interest Upon conversion, dividend

Compound Instruments: Measurement

PFRS:

(1) The liability component is to be valued first; and
(2) The difference between the liability and the fair value of the entire instrument is assigned to the residual value of equity component.

Tax:

FI is either a liability or equity. Tax rules do not recognize hybrid instruments.

Discounting of financial assets - example

Case: Non-interest bearing notes receivable of P45,000 due in the three yearly installment of P15,000. Imputed interest rate is 10%

Face amount of Notes	P45,000
Less: Present value of NR (P15,000 x 2.4869)	37,304
Discount on Notes	P 7,696

Under PFRS, the discount will be amortized under the effective interest method for 3 years. For tax purposes, imputed interest income is not taxable (the transaction has been taxed at the date of the underlying sales transaction.

Derivatives – tax aspects

PFRS	Tax
Derivatives are measured at fair values Gains or losses on re-measurement to fair values are included in profit and loss unless the derivatives designated as cash flow hedges or hedge of net investment in a foreign operation which is recognized as part of equity.	Income/losses from derivatives and hedging instruments shall be recognized only when the underlying transaction/commodity covered by the instrument has been settled. Fair value adjustments (i.e. mark to market losses) at balance sheet date on outstanding derivatives not a taxable income/deductible expense (i.e. unrealized).

Short term benefits – tax considerations

PFRS	Tax
Profit-sharing and Bonus Plans (due within 12 months after the end of the period in which the employee rendered the related benefits) A liability shall be recognized if the entity has a present legal or constructive obligation to make such payments as a result of past events, and a reliable estimate of the obligation can be made.	Deduction to be claimed in the year when bonus is paid or the expense incurred/obligation determine (although BIR may raise issue on withholding tax)

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Thank you