

THE TAX ADVANTAGES OF INCOME TAX PAYERS

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Abstract: *The paper analyzes the cost of financing through financial and operational leasing due to the deductibility of depreciation and interest. The shareholders of any company aim to obtain profit and to increase their ownership equity. In order for this to happen, the company must have profit, for which a corporate tax must be paid. A good management translates into choosing the most advantageous means of financing, which will lead to paying a lower corporate tax. Leasing and the non-taxation of reinvested profits are two means through which companies can obtain significant fiscal advantages, by increasing the deductible expenses, or by paying lower taxes.*

Keywords: corporate tax, financial leasing, operational leasing, fiscal economy.

JEL Classification: G32

1. Introduction and context

Given the frequent legislative changes regarding contributions and taxes, the aim of this article is to provide well documented information regarding corporate tax. Companies must know which is the taxable and tax free income, which is deductible, non deductible or with limited deductibility. In order to do this, they must pay attention to the changes that appear, and especially to how they implement them correctly. In Romania there are huge differences between the accounting and fiscal regulations, and companies are forced to retreat the accounting result. To obtain some superior results, companies must analyze the expenses permanently, and a significant role to this end is the optimization of fiscal cost. The fiscal cost contains the corporate tax, and also other expenses related to the duties, taxes, contributions and social funds paid by the client.

The aim of this study is to establish the cost of financing through leasing and to highlight the fiscal advantages offered by the economy of corporate tax as a result of deducing the expenses related to leasing, an aspect which has been insufficiently treated in the scholarly literature. The study also aims to look at another form of fiscal economy, namely at the non-taxation of reinvested profit.

2. Corporate tax

2.1 Payers of corporate tax

The complete cost of a product has multiple components: the cost of raw materials and used materials, the cost of processing, manpower, management expenses, expenses related to environmental protection, cost of loaned capital, fiscal cost. To reduce costs while maintaining quality means an increase of the profit. The fiscal cost greatly depends on the state's fiscal policy, but it can also be influenced by the fiscal strategies adopted by the company.

Corporate tax is an element of the financial cost and it is applied to the profit obtained as a result of carrying on an economic activity. It represents one of the main sources of income of the state's budget.

After 1989, the corporate tax in Romania has had the following evolution:

- a) In 1991 the corporate tax was established according to progressive quotas, between 2.5 and 77%, on 66 tranches of profit; tranches up to 25,000 lei were tax-free;
- b) between 1991-1994 proportional quotas were used in 2 tranches of profit: up until the taxable profit of 1.000.000 lei the quota was 30%, and above 1,000,000 lei the quota was 45%;
- c) between 1995-2001 there was a unique quota of 38% and payment exonerations were eliminated for the newly established traders;
- d) between 2002-2004 the quota was reduced to 25%;
- e) starting with 2005 there is a unique profit, salaries, income rate of 16%.

In 2003, the United Arab Emirates had the highest quota of direct taxes (55%), followed by the US (40%) and Japan (38%), while the lowest quota of profit tax was registered in Montenegro (9%), followed by multiple countries with a level of 10%, among which Serbia, Cyprus, Paraguay and Qatar.

The state, through its fiscal institutions, influences the existence and functioning of economic entities. Thereby, in the economic activity carried out by entities, there are cases in which economic decisions are influenced by fiscal decisions.

Accounting profit is the profit or loss during a period before subtracting the tax related expenses.

Taxable profit is the profit obtained during a certain period, determined according to rules established by the fiscal authorities, based on which the corporate tax is payable.

Tax expenses represent the total amount regarding the current and postponed taxes, included in determining the profit or loss for a certain period.

Corporate tax represents a direct tax which must be paid by some of the economic agents. The corporate tax takes into account the accounting result as well as the fiscal influences.

The economic entities (trading companies, national companies, autonomous administration, cooperating companies), are obliged to pay a tax, according to diagram no. 1:

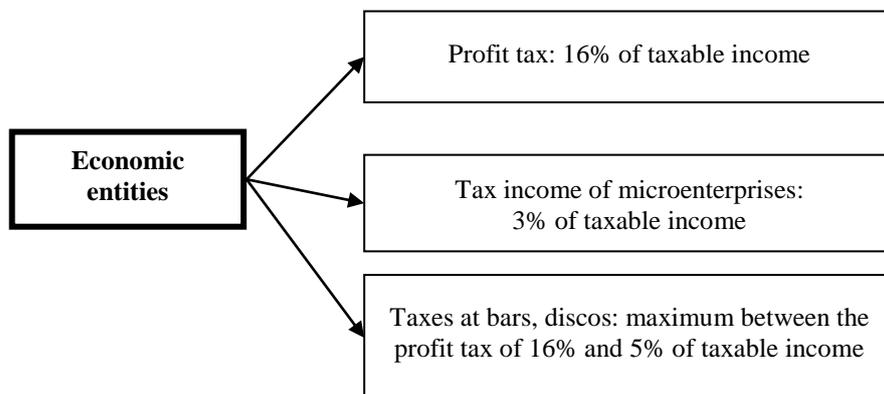


Diagram 1 Taxation according to results for economic entities in 2014

Payers of corporate tax are legal persons who are Romanian and who have the headquarters in Romania, foreign legal persons who carry out their activity through a permanent centre in Romania, and which do not fall into the micro-enterprises category.

The country's treasury, public institutions, legal Romanian persons who pay the tax based on the income of micro-enterprises, Romanian foundations, religious cults for some categories of income, accredited private educational institutions, owners associations **are exempted** from paying the corporate tax.

The corporate tax quota which is applied to the taxable profit is 16%. There are **2 exceptions** from this rule: activity of night clubs and non-profit organizations.

The contributors with **night clubs, discos, casinos and sports betting places**, including legal persons who receive income based on an association contract, and in case the owed corporate tax is less than 5% of that income, must pay a corporate tax of 5% applied to the registered income.

The method used to establish the tax owed by these contributors is the following:

- a) establish the income related to bars (Ibar);
- b) establish the expenses related to bars (Ebar);
- c) establish the tax for bars (Tbar) as the maximum between the taxable profit from the aforementioned activities and 5% of the income of those activities:

$$Tbar = \text{maximum between } (Ibar - Ebar) \times 16\% \text{ and } Ibar \times 5\%$$

Non profit organizations, union trade organizations and employer's organizations are **exempted from the payment of the corporate tax** for the following categories of **income**: dues and registration taxes, contribution in cash or in kind, registration taxes, income obtained from visas, taxes and sports penalties, donations in cash or goods received from sponsors.

Non-profit organizations, union trade organizations and employer's organizations are exempted from the payment of the corporate tax also for the income that comes from economic activities (commercial) up until the equivalent of 15,000 Euros, in one fiscal year, but not more than 10% from the total income exempted from the payment of corporate tax.

The tax-free commercial income (Itfc) is established as the minimum between 2 values: the equivalent in lei of 15,000 Euros and 10% of the total of tax-free income commercial income

$$Itfc = \min (15,000 \text{ Euros; exempted income} \times 10\%)$$

The taxable income (It) is established as the difference between the income from commercial activities (Ica) and tax-free commercial income (Itfc):

$$It = Ica - Itfc$$

The commercial expenses related to the taxable income (Ecti) are established according to the formula:

$$Ecti = \text{commercialexpenses} \times \frac{\text{taxable commercialincome}}{\text{commercialincome}}$$

The income of non profit organizations from the transfer of sportmen is taxable income.

2.2 Calculation of corporate tax

With the help of accounting, the accounting result is established as a difference between the income and the expenses. This result must be restated taking into account the fiscal aspects regulated by the fiscal code.

The taxable profit (fiscal profit) is calculated as the difference between the income from any source and the expenses done with the aim of making income, in a fiscal year, from which the tax free income is subtracted, and to which the non-deductible expenses and the fiscal deductions are added:

$$\text{Taxable profit} = \text{total income} - \text{tax free income} - \text{total expenses} + \text{non deductible expenses} - \text{fiscal loss from previous years}$$

The corporate tax (CT) represents 16% of the taxable profit (Pt):

$$CT = Pt \times 16\%$$

The structure of the company's expenses from a fiscal point of view is shown in diagram 2:

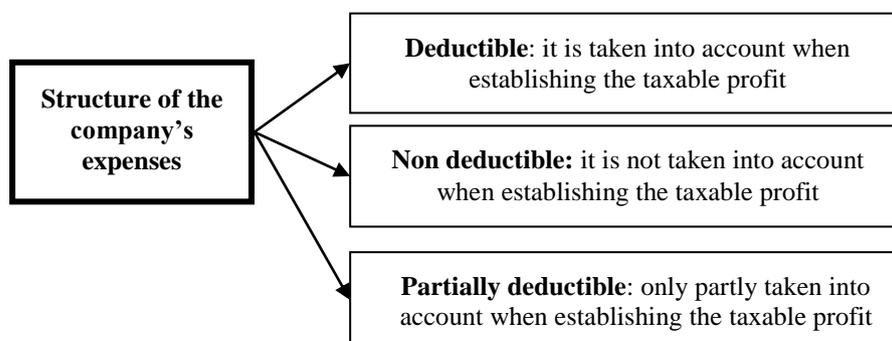


Diagram 2 Fiscal policy of the company's expenses

The main expenses with limited deducibility are:

a) Protocol expenses up until 2% applied to the difference between the total of taxable income and the total of expenses related to taxable income, other than protocol expenses and corporate tax expenses.

The basis for calculation to which the 2% is applied to represents the difference between the total of registered income and expenses, which has fiscal adjustments. From the total of expenses, one must subtract the expenses with the current and postponed corporate taxes, protocol expenses, expenses related to tax free income, and from the total of the income one must subtract the tax free income.

The formula to establish the basis for calculating the deductible protocol expenses (Bdpe) is the following:

$$\text{Bdpe} = \text{Gross result} - \text{tax free income} + \text{expenses related to tax free income} + \text{expenses with corporate tax} + \text{protocol expenses}$$

Within the protocol expenses, when calculating the taxable profit one must include also the expenses with the output value added tax for the gifts offered by the contributor, having the value of 100 lei or more.

- b) Social expenses up until 2%, applied to the value of expenses with the employees' salaries.
- c) Outages, within the limits established by the specialized organs.
- d) Expenses with the provisions and reserves.
- e) Expenses with the interest and differences in the exchange rate. The expenses with the interest are fully deductible if the capital's degree of indebtness is lower or equal to 3.

$$\text{Degree of indebtness} = \frac{\text{Capital borrowed at the beginning of the year} + \text{Capital borrowed at the end of the period}}{\text{Equity at the beginning of fiscal year} + \text{equity at the end of period}}$$

Non-deductible expenses are found in the profit and loss account, but from a fiscal point of view, they are not recognized, thus they do not influence the company's taxable profit. Examples of expenses that are not deductible:

- a) expenses with the owed corporate tax;
- b) interest rates/increases caused by delays, fines, seizures and penalties owed to the Romanian/foreign authorities;
- c) expenses related to the stocks or tangible assets found missing from the administration or degraded, non-imputable, which are insured;
- d) expenses registered in accounting, which are not based on a supporting document;
- e) expenses with management, consulting, assistance and other types of services, for which the contributors cannot justify their necessity in their company's activity;
- f) losses registered when outlining the uncertain tax positions and receivables in litigations, not yet collected, for the share that is not covered by the provision;
- g) expenses for sponsorships and/or patronage; the amounts between 3 per thousand from the turnover and 20% from the corporate tax are deductible from the corporate tax.

Example:

In the second trimester of the year 2014, the following income and expenses were recorded:

- income from services: 68,700 lei;
- income from selling goods: 55,500 lei;
- income from different activities: 21,400 lei;
- income related to the cost of products' stocks: 13,200 lei;
- income from the production of tangible assets: 33,900 lei;
- income from adjustments for the devaluation of assets: 7,600 lei;
- expenses with commodities: 14,000 lei;
- expenses with electricity and water: 4,200 lei;
- expenses with consumables: 16,000 lei;
- expenses related to goods: 38,400 lei;
- expenses with maintenance and repairs: 17,800 lei;
- expenses with salaries: 21,300 lei;
- expenses related to insurances and social protection: 5.300 lei;
- expenses with sponsorship: 3.300 lei;
- expenses with fines: 4.000 lei;
- expenses with penalties established in economic contracts: 1.800 lei;
- expenses with corporate tax: 580 lei.

Establish the corporate tax for the second trimester of 2014.

Answer:

a) Determine the corporate tax before deduction of sponsorship-related expenses

Total income = 68,700 + 55,500 + 21,400 + 13,200 + 33,900 + 7,600 = 200,300 lei

Total expenses = 14,000 + 4,200 + 16,000 + 38,400 + 17,800 + 21,300 + 5,300 + 3,300 + 4,000 + 1,800 + 580 = 126,680 lei

Accounting result = 73.620 lei

Taxable result = Accounting result– tax-free income + non-deductible expenses = 73,620 – 7,600 + 3,300 + 4,000 + 580 = 73,900 lei

The corporate tax before the deduction of sponsorship-related expenses= 73,900 x 16% = 11,824 lei

b) Tax reduction related to the expenses with the sponsorship

Deduction conditions:

- turnover x 0.3% = 145,600 x 0.3% = 437 lei

Turnover = 68,700 + 55,500 + 21,400 = 145,600 lei

- 20% from the corporate tax before the deduction of sponsorship related expenses = 20% x 11,824 = 2,265 lei

The amount to be subtracted from the corporate tax is 437 lei.

The corporate tax to be paid for the first trimester is 10,807 (11,824 – 437 - 580) lei.

Highlighting the corporate tax:

691	=	4411	10.807
„Expenses with the corporate tax”		„Corporate tax”	

2.3 Non-taxation of reinvested profits

According to Government Emergency Ordinance no. 19/2014, the reinvested profit in new technological equipments is not taxed. The non-taxation of profits is applied to the reinvested profit in technological equipments produced and/or bought after the 1st of July 2014, and put into operation until the 31st of December 2016 inclusive.

Contributors which benefit from this provision cannot chose the method of accelerated amortization for those technological equipments.

The reinvested profit represents the gross accounting profit accumulated since the beginning of the year, in the year in which the technological equipments were put into operation. The tax exemption is given within the limit of the owed corporate tax for that period.

The gross accounting profit accumulated since the beginning of the year is the accounting profit to which the expenses with the corporate tax is added, registered in the trimester/year in which the technological equipments were put into operation.

The exemption of the corporate tax is given in the trimester in which the asset is put into operation.

The exemption is calculated quarterly or yearly. The amount of the profit exempted from taxation, with the exception of the part related to legal reserve, is distributed at the end of the financial year with priority for the constitution of reserves, until the level of the accounting profit registered at the end of the financial year.

Example: A legal person buys and puts into operation, in October 2014, a machine with the entry value of 150,000 lei. The accounting gross profit between 01.01 – 31.12.2014 is 520,000 lei, out of which the gross accounting profit between 01.07 – 31.12.2014 is 280,000 lei. The share capital is 10,000 lei, and the legal reserves are constituted.

At the end of the fourth trimester, the company registers a taxable profit of 430,000 lei, and the corporate tax at the end of the third trimester in 2014 is 30,900 lei.

Establish the value of the exemption for the corporate tax and how much corporate tax should be paid for the fourth trimester of the year 2014.

Answer:

1) Establish the corporate tax for the year 2014:

$430,000 \times 16\% = 68,800$ lei.

2) Calculate the corporate tax according to the invested profit:

Because the accounting profit between 01.07 – 31.12.2014 is 280,000 lei, this covers the 150,000 lei investment. Thus, the exempted corporate tax is 16% of the investment's value:

$150,000 \times 16\% = 24,000$ lei.

3) Calculate the corporate tax after the exemption:

$68,800 - 24,000 = 44,800$ lei.

The corporate tax for the fourth trimester = $44,800 - 30,900 = 13,900$ lei

2.4 Fiscal economy obtained through leasing

Any major development of a company cannot be done without an adequate financing. It is important for companies to develop through financing at the lowest cost possible, and without concentrating all the financial resources for the acquisition of assets. When considering all the opportunities, one must take into account the advantages and disadvantages offered by the financing through one's own means (ownership equity), through loans or through leasing.

Financial leasing is the leasing operation which transfers the major part of the risks and advantages related to the property right to the assets. It represents a form of financing of goods being used by the lessee throughout the whole life of the rented object. Financial leasing is related to the capital, because it is registered in the balance sheet, and the user will be the one to calculate the amortization of that asset. At the end of the financial leasing contract, the user can buy the goods, at a pre-established price.

Operational leasing represents simply an activity of loaning assets for which the user will pay a lease, but from a legal and accounting point of view the asset belongs to the lessor (owner). This type of leasing refers to not only to the lease of an asset, but also to maintenance services and insurance for that asset.

Leasing contracts offer advantages for both the lessor and the lessee. The **advantages of the lessor** are the following:

- transferring the majority of risks to the buyer (in case of financial leasing);
- a faster recovery of assets in case of the lessee's bankruptcy;
- fiscal advantages in case of operational leasing (the lessor calculates the amortization): paying a lower corporate tax.

The **advantages of the lessee** are:

- financing the investment activities with external funds;
- the payment of leasing instalments is done gradually, as the lessee starts obtaining benefits from the exploitation of the leased assets;
- faster and more accessible financing than in case of bank loans;
- unlike bank loans, there is no need for other guarantees;
- the deductible expenses with the amortization in case of financial leasing, or with the lease in case of operational leasing; in fact, in case of operational leasing there is a double deductibility: the lesser has a deductible expense with the amortisation, and the lessee has a deductible one with the lease;
- increasing the rate of economic return in case of operational leasing.

The cost of leasing is influenced by the following factors:

a) The value of the leased asset, which represents indirectly, the size of the loan gotten by the company from the leasing company. The interest or the benefit to be paid for the lesser will be calculated in the contract, starting from this value.

b) The paid lease, net of tax. The company's tax economy due to the deductibility of the lease from the taxable profit will be taken into consideration.

c) The residual value of the leased asset, established by the parties, in case of financial leasing.

The cost of leasing is established as follows:

$$V_0 = \sum_{t=1}^n \frac{L_t}{(1+k_L)^t} + \frac{VR}{(1+k_L)^n} - \sum_{t=1}^n \frac{TE_t}{(1+k)^t}$$

V_0 = the acquisition cost of the leased asset

L_t = the annual lease which must be paid according to the leasing contract

VR = residual value at which the transfer will be made to the lessee (in case of financial leasing)

TE = the annual corporate tax economy obtained as a result of the deductibility of expenses related to the leasing instalments (lease)

n = duration of the leasing contract

k_L = cost of leasing

k = the discount rate of the economy of corporate tax

The fiscal advantages offered by financing through leasing are shown in the following **case study**:

A company wants to expand, and in order to do this it purchases in leasing an asset worth 120,000 lei, for which it pays constant annual instalments (lease) of 27,553 lei, for 6 years.

The cost of leasing with the annual paid interest is 10%, the residual value is 9,140 lei, the profit before the leasing expenses is 38,000 lei, the corporate tax quota is 16%, and the discount rate of the economy of corporate tax is 12%. Establish the economy of corporate tax in case of:

a) a financial leasing

b) an operational leasing.

a) Financial leasing

The bills payable book and breakdown of payments are presented in table 1:

Table 1 Breakdown of payments in financial leasing

Year	Leasing instalments	Paid interest 10%	Amortisation of leasing	Non-reimbursed leasing
0				120,000
1	27,553	12,000	15,553	104,447
2	27,553	10,445	17,108	87,339
3	27,553	8,734	18,819	68,520
4	27,553	6,852	20,701	47,819
5	27,553	4,782	22,771	25,048
6	27,553	2,505	25,048	0
Total	165,318	45,318	120,000	

The annual expenses with amortization will be 120,000 / 6 years = 20,000 lei/year.

The tax economy in case of financial leasing is presented in table 2:

Table 2 Corporate tax economy in financial leasing

Year	Profit before leasing expenses	Amortisation expenses	Interest expenses	Gross profit	Corporate tax	Net profit	Economy of tax	Updated value of tax economy
1	38,000	20,000	12,000	6,000	960	5,040	5,120*	4,655**
2	38,000	20,000	10,445	7,555	1,209	6,346	4,871	3,883
3	38,000	20,000	8,734	9,266	1,483	7,783	4,597	3,272
4	38,000	20,000	6,852	11,148	1,784	9,364	4,296	2,730
5	38,000	20,000	4,782	13,218	2,115	11,103	3,965	2,250
6	38,000	20,000	2,505	15,495	2,479	13,016	3,601	1,824
Total	228,000	120,000	45,318	62,682	10,030	52,652	26,450	18,614

*5120 = (20,000 + 12,000) x 16%

** 4,571 = 5,120 / 1.12 (discount rate)

The tax economy in case of operational leasing is presented in table 3:

Table 3 Corporate tax economy in operational leasing

Year	Profit before leasing expenses	Leasing instalment	Gross profit	Corporate tax	Net profit	Tax economy	Updated value of tax economy
1	38,000	27,553	10,447	1,672	8,775	4,408	3,936
2	38,000	27,553	10,447	1,672	8,775	4,408	3,514
3	38,000	27,553	10,447	1,672	8,775	4,408	3,138
4	38,000	27,553	10,447	1,672	8,775	4,408	2,802
5	38,000	27,553	10,447	1,671	8,776	4,409	2,501
6	38,000	27,553	10,447	1,671	8,776	4,409	2,233
Total	228,000	165,318	62,682	10,030	52,652	26,450	18,124

The cost of financial leasing (k_{LF}) is established as follows:

$$120,000 = \frac{27,553}{(1+k_{LF})} + \frac{27,553}{(1+k_{LF})^2} + \frac{27,553}{(1+k_{LF})^3} + \frac{27,553}{(1+k_{LF})^4} + \frac{27,553}{(1+k_{LF})^5} + \frac{27,553}{(1+k_{LF})^6} + \frac{9,140}{(1+k_{LF})^6} - \frac{5,120}{(1+k_{LF})} - \frac{4,871}{(1+k_{LF})^2} - \frac{4,597}{(1+k_{LF})^3} + \frac{4,296}{(1+k_{LF})^4} + \frac{3,965}{(1+k_{LF})^5} + \frac{3,601}{(1+k_{LF})^6}$$

For $k_{LF} = 6\%$ one can establish the equality:

$$120,000 = 25,993 + 24,521 + 23,134 + 21,825 + 20,589 + 19,423 + 6,443 - 4,830 - 4,335 - 3,860 - 3,403 - 2,962 - 2,538 \text{ meaning } 120,000 = 120,000$$

The cost of operational leasing is established according to the formula:

$$120,000 = \frac{27,553}{(1+k_{LO})} + \frac{27,553}{(1+k_{LO})^2} + \frac{27,553}{(1+k_{LO})^3} + \frac{27,553}{(1+k_{LO})^4} + \frac{27,553}{(1+k_{LO})^5} + \frac{27,553}{(1+k_{LO})^6} + \frac{9,140}{(1+k_{LO})^6} - \frac{4,408}{(1+k_{LO})} - \frac{4,408}{(1+k_{LO})^2} - \frac{4,408}{(1+k_{LO})^3} + \frac{4,408}{(1+k_{LO})^4} + \frac{4,409}{(1+k_{LO})^5} + \frac{4,409}{(1+k_{LO})^6}$$

The equality is valid for $k_{LO} = 6.1\%$.

The actual cost in case of financial leasing is of 6%, and in case of operational leasing the actual cost is of 6.1%, so the company should choose a financial leasing contract.

Even though the interest rate for leasing is 10%, the actual cost of financing this operation is of 6%, and the fiscal economy is of 4%, in case of financial leasing and an actual cost of 6.1%, respectively 3.9% if the leasing is operational.

3. Conclusions

Companies must find the best solutions to reduce expenses by optimizing them from a fiscal point of view. If we analyze this aspect on a short term, it can be beneficial for the company, because the expenses are reduced, but for the country this means lower budgetary income. On a long term, the growth of the companies will lead to an accumulation of resources to the state's budget, through the application of correct policies. In current conditions, the optimization of the fiscal cost becomes a necessity for medium and big companies, because of the spectacular increase of the impact of taxation on the company's results.

I believe that by using the financial and operational leasing, but also by using the opportunities due to the non-taxation of reinvested profit, important fiscal advantages can be obtained, thus paying a lower corporate tax. In order to benefit from these facilities, it is necessary for the management to know the opportunities offered by the financing sources and after a thorough analysis, to choose the variant which minimizes costs, and where risks are at an acceptable level.

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