

STUDY ON THE IMPACT OF TAX REGULATIONS ON A COMPANY'S FINANCIAL EXPENSES

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Abstract: Fiscality is a reality of nowadays' economic life, an important factor in the management of a company's revenues and expenses, appearing under the form of taxes, fees and contributions paid by a company to public budgets. For these reasons, all owners or managers are interested in managing their tax flows and tax accounting so that the costs required thereby are minimal and tax law is not violated. Considering the above, this paper aims at determining and showing the way how tax regulations in force influence the financial expenses of Cereacom S.A. Dolj and, hence, the level of the company's main performance indicators.

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1. INTRODUCTION

Fiscality is a reality of current economic life, as companies' economic and financial performances are influenced by it. Within a context of a tax system which complies with the principle of neutrality of tax measures, in relation to various categories of investors and capitals, which ensures equal conditions to investors, the influence of taxes on the companies' economic and financial performances should have the same effect on all companies, at least in theory.

This smoothing of the way of operations of taxes on companies' financial and economic performances is based on the idea that law is the same for everybody. This is absolutely true, but not everybody understands the idea the same way, not all companies may benefit of certain facilities provided by law, as such facilities aren't always easily noticeable or, in connection with other economic and financial features of the company in question, these facilities may result in different effects.

Even though, theoretically, the tax system acts upon all companies, so that the influence on economic and financial performances is obvious in all companies, the latter do not operate identically in the decisions regarding the performance of economic activity, which is why differences may arise in the actions of taxes on a company's expenses.

Expenses incurred by a company represent reductions of the economic benefits recorded during a financial exercise and are grouped, depending on the activity generating them, into operating expenses, financial expenses and extraordinary expenses.

For a proper tax management of a company's total expenses, such expenses should be divided according to their components, studying and quantifying the implications of all tax provisions on expenses and, thereby, choosing and applying the regulations with the highest positive tax effect on a company's results.

2. OBJECTIVES

In the present paper, we aim at showing the impact of tax regulations on financial expenses, in theoretical and practical terms, through the example of the company S.C. Cerealcom S.A.

3. METHODOLOGY

Financial expenses refer to those expenses incurred by a company in relation with financing decisions, exposure to currency fluctuations or provisions. Such expenses include: losses from participation-related receivables, expenses with assigned securities, expenses with foreign currency differences, interest expenses, expenses for amortisation and provisions.

Therefore, financial expenses are connected to the way in which a company covers its requirements, for developing its activity. To this purpose, companies use both equity, whose cost is given by the rate of return required by shareholders and borrowed capital, whose cost is given by the interest payable to credit institutions.

Indebtedness has two main characteristics for a company: on the one hand, the obligation of regularly paying certain interests, which involves financial expenses, decreasing earnings, and on the other hand recurring to loans may determine extra profitability, which is an advantage for the company if higher than the cost of borrowed equity.

Miller and Modigliani have shown that, in the context of taxes, a company's value increases by recurring to loans, as the interest paid for borrowed capital can be deduced from taxable profit and determine a reduction in the tax.

The two have reached the conclusion that, in comparison to a company without debts (U) which calculates and pays tax for the entire operating profit, a company with debts (L) shall have to pay a lower tax. The deduction of the tax from the operating profit shall result in the reduction of the profit tax and, therefore, tax savings. Otherwise said, for companies which have debts, the state takes over a part, equal to tax savings, from the interest to be paid to creditors. Under these conditions, the total cost of the capital of the company with debts is lower, a part thereof being borne by the state, by admitting a lower tax.

For confirming such hypotheses, we may start from the method of formation of net profit in companies and, especially, from the consequences of taxation on the profit of the two types of companies: without (U) and with (L) debts.

The influence of taxation on net profit is the following:

Table no. 1

| Indicators | Company without debts (U) | Company with debts (L) |
|--------------------------------|---------------------------|------------------------|
| Gross operating result (EBIT) | EBIT | EBIT |
| Interest (Int = DEBT * k_d) | 0 | Int |

| | | |
|----------------------------|--------------|----------------------|
| Current gross result (EBT) | EBIT | EBIT - Int |
| Net profit (NP) | EBIT (1 - T) | (EBIT - Int) (1 - T) |

Therefore, indebtedness results in the increase of a company's value, pursuant to tax savings obtained through the deductibility of interests from taxable profit. The higher the increase in the company's value, the higher the debt (DEBT) and the tax rate (T) are. In other words, the higher the tax rate is, a company is more interested in borrowing.

Expenses with interests and foreign currency differences

Expenses with interests represent costs of indebtedness. The concept of cost of indebtedness is dealt with both in the national accounting and tax framework and the international accounting guideline IAS 23 "Indebtedness costs". With a status of indebtedness costs, companies must comply with the accounting and tax regime.

This international accounting guideline mentions two accountancy methods, in terms of interest expenses, as follows:

- method no. 1, through which interest expenses are considered expenses for the period, without capitalisation, influencing, in a descending trend, the financial result of the exercise and, implicitly, profit tax;

- method no. 2, through which interest expenses are considered expenses for the period, with capitalisation, without influencing the financial result of the exercise, as they were integrated into the production cost financed by a loan. The interest is the cost of such loan, of the company's indebtedness for financing the good in question.

The decision to choose one of these accounting methods depends on the management and the business plan proposed by the company, as follows:

- a lower profit and, implicitly, a lower profit tax shall be recorded in the case of the first accounting method;

- a higher profit shall be recorded and a consequent profit tax shall be paid in the case of the second instrument.

However, if lower profits and lower taxes are recorded, a lower value shall be attributed to dividends as well, which is why the option for one of these treatments is more a management decision, not an accounting or tax.

In tax terms, the two alternatives are reduced to the following rule: "*Expenses with interests are fully deductible in case the degree of indebtedness of equity is lower than or equal to three.*" The degree of indebtedness of capital shall be determined as a ratio between capital borrowed with payback within one year and equity, as an average of the values existing at the beginning of the year and at the end of the period, for which profit tax shall be determined as follows:

$$\begin{aligned} \text{Degree of indebtedness} &= \\ &= \frac{\frac{\text{Borrowed capital (beginning of the year)} + \text{Borrowed capital (end of the year)}}{2}}{\frac{\text{Equity (beginning of the year)} + \text{Equity (end of the year)}}{2}} \end{aligned}$$

By borrowed capital we understand the total of credits and loans with payback within one year, according to contract clauses.

Expenses from currency rate differences to which this system is applied are the ones proceeding from loans contracted in foreign currency and, with the payback of the capital rate and the interest for the financial exercise in which such payment is made, foreign currency differences are also recorded.

In case the expenses from foreign currency differences of the taxpayer are higher than incomes from foreign currency differences, such difference shall be treated as an interest expense and the deductibility of this difference shall be subject to the limit provided for under interest expenses.

Interests and foreign currency losses related to loans obtained directly or indirectly from international development banks and similar organisations and those guaranteed by the state, those associated to loans obtained from Romanian or foreign credit institutions, non-banking institutions, legal entities granting loans according to the law, as well as those obtained on basis of bonds admitted for trading on the regulated market are not subject to the provisions of the Tax Code article limiting the deductibility of such expenses.

In the case of loans obtained from other entities, except the above-mentioned, deductible interests are limited to:

a) the level of the reference interest rate of the National Bank of Romania, corresponding to the last month of the quarter, for loans in lei;

b) the level of the annual interest rate in the percentage at the moment in question, for loans in foreign currency. The level of the interest rate for loans in foreign currency is updated through a government decision.

Thus, in case the indebtedness of a company's capital is higher than three, expenses with interests and the net loss from foreign currency differences are not deductible. The latter are reported in the following period, until full deductibility.

4. ANALYSES

For determining the impact of tax regulations regarding interest expenses and foreign currency differences on a company's results, we calculated, for the company Cerealcom S.A. Dolj, the tax savings obtained pursuant to the deductibility of interest expenses from the taxable profit, interpreting the obtained results.

The data required for performing the analysis were taken over from the company's financial statements for 2008, presented on the site of the Bucharest Stock Exchange, and the results are mentioned in the table below:

Table no. 2

| Explanations | Recorded values (lei) | |
|---|-----------------------|-----------------|
| | Beginning of the year | End of the year |
| Borrowed capital | 518,883 | 1,555,654 |
| Equity | 66,413,981 | 83,756,082 |
| Degree of indebtedness | 0.0138 | |
| Fully deductible interest expenses | 2,138,817 | |
| Foreign currency revenues | 131,161 | |
| Foreign currency expenses | 174,221 | |
| Foreign currency net loss (7=6-5) | 43,060 | |
| Total deductible financial expenses (8=4+7) | 2,181,877 | |
| Profit tax savings (9=8*16%) | 349,100 | |

Based on this data, we may say that S.C. Cerealcom S.A., as it has a lower degree of indebtedness than the minimal limit imposed by the legislation in force ($0.01 < 3$), has full deductibility of interest expenses (2,138,817 lei) and for the net loss from foreign currency differences (43,060 lei), with profit tax savings of 349,100 lei.

According to the presented items, fiscality results in a decrease of the cost of borrowed capital, which also has implications on the company's optimal financial structure. Given the possibility of deducing financial expenses with indebtedness, the cost of borrowed capital is lower than the cost of equity, which justifies the idea of recurring to indebtedness as a possible means of increasing the rate of return.

5. CONCLUSIONS

Starting from the above, we may say that the reduction of the tax cost represents one of the main concerns of any company. This decrease may be done through good information on tax regulations in force, but, especially, by using tax mechanisms, for increasing a company's rate of return.

Almost all tax systems in the world (including the Romanian one) are asymmetrical in taxing the revenues obtained by investors. Both interests and dividends are revenues which pay the capital invested by creditors and shareholders. However, their tax treatment is different. Interests are fully paid without being taxed, while dividends result pursuant to the calculation and deduction of profit tax. Hence, tax asymmetry refers to the deductibility of interests from taxable profit and the non-deductibility of dividends. In other words, profit tax shall not be calculated for all the revenues (operating tax, including expense = EBIT), but for the operating profit minus interest: $EBIT - Int = EBT$.

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