

INTERPLAY OF ACCOUNTING AND TAXATION PRINCIPLES

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I. GENERAL

All taxable transactions must necessarily be supported by sound accounting principles. Taxing authorities generally follow the accounting treatment of events and transactions that give rise to the realization of revenue and recognition of expenses.

Even while taxable income is based on the method of accounting used by the taxpayer, however, it will almost always differ from accounting income. This disparity is due to the fundamental difference in the ends the two concepts serve. While accounting and tax principles are necessarily intertwined, they diverge in their objectives, focus, and bases.

Financial accounting seeks to provide useful quantitative financial information about a business enterprise to statement-users, particularly owners and creditors, in making economic decisions. This includes providing information that can be used in evaluating management's effectiveness in fulfilling its stewardship and other managerial responsibilities. Hence, financial accounting attempts a match between cost and revenue to effectively reflect the risks and rewards of the business.

Tax rules, on the other hand, are primarily aimed at collecting revenue. Thus, tax rules are generally quick to treat an item as income and slow to recognize deduction or losses.

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In the Philippines, there are a number of specific tax rules that treat particular items of income and expense differently from accounting and that may provide an opportunity for tax planning. Philippine tax rules also recognize that there are different generally accepted accounting treatments for certain items of income and expense, and allow the taxpayer to make a choice as to which accounting treatment to apply. In most, instances however, a choice once made by the taxpayer binds the taxpayer and applicable for the succeeding taxable years.

Accounting Method

Tax regulations require a taxpayer to post and record his expenses in accordance with sound accounting principles in order to reflect his true income. He must likewise maintain such accounting records as will enable him to report his true income.

Affiliated companies should maintain separate and distinct accounting records by virtue of their separate legal personalities. Thus, inconsistencies in the accounting treatment of items of revenue and expenses among the different affiliates, whether local or international, are irrelevant to taxing authorities, except in case of "related party" transactions.

There is no uniform method of accounting prescribed for all taxpayers in computing their taxable income. The law contemplates that each taxpayer shall adopt such forms and systems of accounting which, in his judgment, are best suited to his purpose. Thus, the taxpayer may employ any method of accounting, provided that said method correctly reflects the income of the taxpayer for each taxable year.¹

The adopted method of accounting should at least have the following features:

7. Classification of capital and income expenditures - Costs incurred in a business may relate either to the acquisition of an asset (capital expenditure) or to the revenue of a particular accounting period (income expenditure). For instance, expenditures for items of plant, equipment, etc., which have a useful life extending substantially beyond one year, should be charged to a capital account.

¹ TAX CODE, § 43.

2. *Where the cost of capital assets is being recovered* - Where cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses;

Such expenditures should be capitalized when they appreciably extend the life, increase the capacity, or improve the efficiency or safety of the property. For expediency, many companies adopt policies specifying the minimum cost for capitalization of-a property unit. These policies are acceptable as long as the minimum is reasonable and, when necessary, exceptions are made to recognize that such policies are merely conventions.

3. *Inventories* - In all cases in which production, purchase, or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials and supplies) should be taken at the ----- beginning of the year and used in computing the net income of the year.

The principal methods of accounting expressly or impliedly recognized by the 1997 Philippine National Internal Revenue Code (NIRC)² are:

- Cash receipts and disbursement method or cash basis: where income is regarded as the difference between the cash receipts and cash outlay; method under which income, profits and gains earned by the taxpayer are not included in gross income until received and expenses are not deducted until paid within the taxable year. Cash-basis accounting is used mostly in small entities. Cash-basis accounting is *not* permitted by generally accepted accounting principles.

The cash basis method is allowed under the NIRC in very limited instances:

- Those who keep records under cash receipts and disbursement methods (e.g. representative office and regional area headquarters, non-stock non-profit organizations and other entities who do not derive income from their activities); and

²TAX CODE.

- Those who do not keep books and records.
- *Accrual basis*: measures income as the difference between revenues and expenses; method under which income, gains and profits are included in the gross income when earned, whether received or not, and expenses are allowed as deduction when incurred, although not yet paid. The effects of transactions and other events on the assets and liabilities of a business enterprise are recognized and reported in die time periods to which they relate rather than only when cash is received or paid.

In the following cases, however, the taxable income may be computed in such manner as in the opinion of the Commissioner of Internal Revenue clearly reflects his income:

- Where the taxpayer has not employed any method of accounting; or
- Where the method of accounting employed by the taxpayer does not clearly reflect his income.

II. RECOGNITION OF INCOME AND EXPENSES

A. Gross Income

In general, gross income for tax purposes coincides with accounting gross income, except in the following instances:

- For purposes of Minimum Corporate Income Tax (MCIT), "*gross income*" means gross sales less sales returns, discounts and allowances, and cost of goods sold. Passive incomes, such as interest on bank deposits and royalties, which have been subject to a final withholding tax at source, shall not form part of gross income for purposes of the minimum corporate income tax. "*Gross sales*" shall include only sales contributory to taxable income. In the case of sales of services, the term "*gross income*" means gross receipts less sales returns, allowances, discounts and cost of services. The term "*gross receipts*", means the amounts actually or constructively received during the taxable year.³
- "Gross income" for purposes of 5% gross income taxation under the Omnibus Investments Code and Special Economic

³ TAX CODE, § 27 (E) (4); Revenue Memorandum Circular No. 4-2003.

Zone Act of 1995, refers to the gross sales or revenues derived from the business activity within the Ecozone, net of sales discounts, sales returns and allowances, and minus cost of sales or direct costs, but before any deduction is made for administrative expenses or incidental losses during a given taxable period.⁴

- "Gross Income" for purposes of 5% gross income taxation under the Bases Conversion and Development Act, refers to gross sales or gross revenues derived from any business activity, net of returns, discounts and allowances, less costs of sales, cost of production, or direct costs of services (depending on the nature of business), but before any deduction for administrative expenses and incidental losses during a given taxable period.⁵

B. Capital and Revenue Receipts

Capital and revenue receipts must likewise be distinguished for tax purposes. Receipts arising from mere return of capital or investment may or may not trigger tax consequences. The reimbursement of expenses paid by the corporation on behalf of its affiliate or client, for instance, will not have any tax consequences. On the other hand, the difference between the liquidation and acquisition price of an investment arising from the liquidation of an investment would result in either a taxable gain or a deductible loss for the corporation. In practice, where receipts are concerned, tax examiners tend to inquire into the nature of receipts treated for accounting purposes as a return of capital.

Revenue receipts or receipts arising from the profit-directed activity of an enterprise, however, are generally taxable events. Revenue is generally recognized when both of the following conditions are met: (a) the earning process is complete or virtually complete and (b) an exchange has taken place.

⁴ Rules and Regulations Implementing (IRR) Republic Act 7916, § 2 (nn).

⁵ IRR on the provisions of the Subic Special Economic and Freeport Zone, § 57 (b).

C. Prepaid Income

Pre-payment of income items not yet accrued for accounting purposes shall not be considered as part of gross income upon its receipt except for purposes of withholding tax⁶ and Value-Added Tax (VAT) in the sale of services⁷.

Under the regulations governing withholding of taxes, 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 payer's books, whichever comes first. Thus, prepaid income is recognized as gross income of the payee for purposes of withholding tax, although not yet recognized in the books of the payee as income.

D. Timing of Revenue Realization

Sale of goods may be outright or deferred. Outright sales are those executed and consummated within the taxable year. Income from outright sales is immediately recognized in the same taxable year.

Deferred sales of real or personal property, on the other hand, contemplate (a) agreements of purchase and sale where a conveyance is not to be made at the outset, but only after all or a substantial portion of the selling price has been paid, and (b) sales in which there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

Deferred sales may be classified as follows:

- * *Sale of property on installment plan: sale in which the initial payment⁸ does not exceed 25% of the selling price.*
- *Deferred-payment sales not on installment plan: sales in which the initial payment during the tax year in which the sale was*

⁶ Revenue Regulations 2-98 as amended by Revenue Regulation 6/12-2001, § 2.57.4.

⁷ TAX CODE, §108.

⁸ Initial payments: payments received in cash or property other than evidences of indebtedness of the purchaser during the tax year in which the sale or other disposition is made.

made exceeds 25% of the selling price.

In case of sales on installment^a a proportionate amount of income is recognized and reported for tax purposes on each installment payment received. On the other hand, in case of deferred payment sales not on installment, income on the entire transaction is reported for tax purposes in the taxable year when the sale was made.

E. Expenses

In General

Expenses recognized under financial accounting are likewise recognized as deductions from gross income for taxation purposes, provided that these expenses satisfy the criteria for deductibility laid down by Philippine tax laws, rules and regulations. Taxing authorities generally respect the taxpayer's accounting treatment of its expense items.

Where certain expenditures are income payments that are subject to withholding tax, tax authorities inquire into whether the appropriate withholding taxes have been withheld and remitted to the Bureau of Internal Revenue (SIR). Where taxes have not been withheld, the expense items would be disallowed as tax deductions.

While taxing authorities generally respect the accounting treatment adopted by the taxpayer, the fundamental difference between accounting and taxation principles in the recognition of expenses and the allowance for deductions precludes the allowance of all expenses as deductions from gross income.

In accounting, costs are generally recognized as expenses on the basis of a presumed direct association with specific revenue. Cost may likewise be allocated in a systematic and rational manner among the periods in which the benefits are provided. But, some costs, under the immediate recognition principle, are recognized as expenses in the period in which they are paid or accrued because:

- costs incurred during the period provide no discernible future benefits;*
- costs recorded as assets in prior periods no longer provide*

discernible benefits; or

- allocating costs either on the basis of association with revenue or among several accounting periods is considered to serve no useful purpose.⁹

An example of the above is ransom money paid to secure the release of a kidnapped corporate officer. While this may be reported as expense for accounting purposes, it cannot be allowed as a deduction from gross income because the NIRC only allows deductions for expenses which are directly attributable to the development, management, operation and/or conduct of the trade, business, or exercise of a profession.

Moreover, provisions for probable future contingencies, which are recognized as expenses under accounting principles, are not deductible from gross income for tax purposes. Tax laws will not recognize deductions for contingent future losses. Good accounting, on the other hand, requires this recognition.

Pre-paid Expenditures

The taxpayer's classification of its prepaid expenditures into either capital or revenue expenditures are normally respected by taxing authorities, and accordingly, amortization of the prepaid capital expenditures and outright deduction of revenue expenditures are tax deductible.

Depredation

The taxpayer may adopt any of the following depreciation method recognized under the NIRC:

- *Straight-tine method*
- *Declining balance method*
- *Sum of the jean digit method*
- *Other method prescribed by the Secretary of Finance*

The taxpayer may likewise adopt its own depreciation rate based on the desired service life of its assets. While the kw specifies the life of certain

⁹ Statement of Financial Accounting Standards No. 1, § E, \ 20-30.

intangibles for purposes of depreciation, (e.g., pre-operating expenses—not less than 5 years¹⁰, patent—20 years¹¹), taxpayers are still given discretion to adjust the useful life of the intangible in light of new developments. Taxing authorities respect the taxpayer's depreciation schedule, provided that the same is reasonable and consistent in application.

Write-downs of Inventory, Receivables, and Marketable Securities

Financial accounting dictates the need for setting aside provisions for inventory obsolescence, for doubtful accounts, and for the decline in the market value of marketable securities in anticipation of probable future contingencies and to reflect the present value of the assets under the concept of relevance and conservatism.

Under the NIRC, however, provisions for future contingencies can only qualify as deductions when the taxpayer has actually realized losses sustained in trade, business or profession without having been compensated for by insurance or other forms of indemnity and evidenced by a closed and completed transaction.

For instance, provision for bad debts may be recognized as expense under accounting, but only bad debts complying with the following conditions¹² can be deductible from gross income under the NIRC:

- The taxpayer should be able to prove that he has a right to enforce the collection of a valid and legally demandable debt;
- The debt was incurred in connection with the taxpayer's trade, business, or practice of profession;
- The debt was not made by the taxpayer with a related party¹³
- The debt is considered worthless and uncollectible at the end of the taxable year.

Strong proof is needed to show that a debt has become worthless or uncollectible. It must be shown that the borrower is in no financial position to repay the loan. An independent collection lawyer can also submit a written statement under oath that there are major legal obstacles in collecting payment

⁰ Revenue Regulations No. 2, § 120.

¹ Republic Act No. 8293, § 54.

² TAX CODE, § 34(E); Revenue Regulation No. 05-99.

³ TAX CODE, § 36 (B), Related parties:

for the loan. Proof must also be shown by the taxpayer that all available means to collect payment for the loan were exhausted but all proved unsuccessful.

IV. TAX-EXEMPT ACCOUNTING TRANSACTIONS

The State, through the legislature, has exempted certain accounting transactions for which gain or loss may be realized in order to promote certain industries/investments through grant of incentives and to effect social justice through redistribution of income. Examples of revenue specifically exempted under the NIRC are:

- 1) Gains realized from the sale or exchange or retirement of bonds, debentures, or other certificate of indebtedness with maturity of more than five (5) years¹⁴;
- 2) Gains realized by the investor upon redemption of shares of stock in a mutual fund company¹⁵; and
- 3) Philippine-sourced income specifically exempt under provisions of tax treaties entered into by the Philippine government with other countries.¹⁶

V. TAXABLE IMPUTED GAINS

Philippine tax laws impose a tax on presumed gains from the disposition of real property and shares of stock traded in the exchange.

A 6% final tax shall be imposed on the capital gains presumed to have been realized from the sale, exchange, or other disposition of real property

- Members of the family;
- A corporation which is owned and controlled by the taxpayer (Le. he owns or controls more than fifty percent (50%) of the value of the outstanding stock.);
- Personal holding company or a foreign personal holding company of the taxpayer;
- Grantor and a fiduciary or trustee of any trust;
- Fiduciary or trustee of a trust and the fiduciary or trustee of another trust if the same person is a grantor with respect to each trust; or
- Fiduciary of a trust and a beneficiary of such trust

¹⁴ TAX CODE, § 32 (B) (7) (g).

¹⁵ TAX CODE, § 32 (B) (7) (h).

¹⁶ TAX CODE, § 32 (B) (5).

located in the Philippines classified as capital assets.¹⁷ The disposition includes pacto de retro sales and other forms of conditional sales, such as a mortgage foreclosure sale. The 6% capital gains tax is imposed on the gross selling price or the current fair market value of the property sold, whichever is higher. For purposes of computing any internal revenue tax, the value of the property shall be, whichever is the higher of: (1) the fair market value as determined by the Commissioner of Internal Revenue; or (2) the fair market value as shown in the schedule of values of the Provincial and City Assessors.

The tax is imposed on individuals, including estates and trusts, and domestic and resident corporations. The tax shall be imposed in lieu of the (net) income tax imposed on individuals and corporations. Hence, the capital gains from the sale of real property shall no longer be included in the gross income of the individual or corporation for purposes of computing income tax liability.

However, if the sale or disposition of the real property is made to the government or any of its political subdivisions or agencies or to government-owned or controlled corporations, the individual taxpayer may choose to pay the capital gains tax or to include his gain in his gross income subject to the graduated rates for individuals. This option provides the taxpayer an opportunity for tax planning. Should the exchange result in a loss for the seller, the seller may include his loss in the computation of his gross income. Should the exchange produce enormous gains for the seller, the seller may opt to pay the presumed capital gains tax which is pegged at 6%.

Likewise, a stock transfer tax equivalent to $\frac{1}{2}$ % of the gross selling price or gross value in money of the shares of stock shall be imposed on the sale barter, exchange, or other disposition of shares listed and traded in the stock exchange, except for sales by a dealer in securities. Any gains derived from the sale of the shares of stock listed and traded in the stock exchange shall neither be included in the computation of the gross income of the individual or corporate seller. The seller may avoid the presumed gains from the disposition of stocks listed and traded in the exchange by trading his shares outside the stock exchange and instead be subjected to a final tax based solely on his actual gains from the disposition of the shares in the following manner:

¹⁷ TAX CODE, § 24 (D) (1), § 27 (D) (5). UST

- first P100,000 of the actual net gains 5%
- actual net gains in excess of P100,000 10%

Under the generally accepted accounting principles in the Philippines on current marketable equity securities, the acquisition cost of shares of trading stocks is determined by the purchase price of the security, the fair value of the asset given up in exchange, or the fair value of the security received by gift or donation. Incremental cost directly related to the purchase may likewise be capitalized, provided the total cost does not exceed the fair value of the investment acquired. The carrying amount of the current portfolio of marketable equity securities shall be the lower of its aggregate cost or market value, determined at the acquisition date.

The securities portfolio are stated at the lower cost or value due to the recognition of losses that may be sustained by the company from adverse fluctuations of the market in the course of its trading activities. These losses are charged to the earnings and classified as trading gains and losses in the income statement. Subsequent recoveries in market value may be recognized only up to the extent of any previous write-down. Recoveries beyond the original historical cost are not recognized for tax purposes until the securities are sold or otherwise disposed of.

The taxpayer's "mark to market"¹⁸ practice in its trading stock is an acceptable accounting treatment under Philippine GAAP, provided that the taxpayer adopts a consistent treatment of its shares. Such treatment, however, is not acceptable under the tax regulations because a taxpayer cannot deduct from his gross income any amount claimed as a loss merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. Such loss can only be allowed as a deduction upon disposition of the shares of stock.

If the shares of stock become worthless, the taxpayer may deduct its cost in the taxable year in which the stock became worthless, provided a satisfactory showing of its worthlessness can be made.

¹⁸ "Mark to Market" :In a financial futures exchange, the adjustment of a customer's account to allow for profits or losses arising from open contracts (contract that has been bought or sold in a financial futures market but has not been closed by making an offsetting transaction or taking delivery of the financial instrument involved) during the previous year's trading.

VI. FILING ISSUES

Corporations, companies, partnerships, or persons whose gross quarterly sales, earnings, receipts, or output exceed one hundred fifty thousand pesos (Php 150,000.00) shall have their books of accounts audited and examined yearly by the independent Certified Public Accountant (CPA).¹⁹

The taxpayer shall reconcile the taxable income reported in the Annual Income Tax Return (ITR) with the accounting income reported in the accompanying financial statements by enumerating the reconciling items in the ITR. These reconciling items stem from the difference in treatment of items of revenues and expenses for tax and accounting purposes.

The taxpayer may engage an independent CPA to certify the extent of his compliance with his tax obligations. In the event that an independent CPA discovers any substantial deviation by the taxpayer-client from the applicable rules and regulations, he shall qualify his opinion or make a general statement to this effect. A tax return accompanied by an independent CPA's unqualified certification shall be given last priority in the audit of tax returns, subject to certain exceptions determined by the Commissioner of Internal Revenue.²⁰

VII. OPPORTUNITIES FOR TAX-PLANNING

A. Financing and Interest

The taxpayer has several options available to him in financing the acquisition of the assets in his business. The taxpayer may choose to either purchase or rent the assets necessary for his business. Should he decide to merely rent the assets, he may just enter into an operating lease so he can claim outright its rental payments as deduction for tax purposes. On the other hand, should he decide to purchase the assets, the taxpayer may make an outright purchase or avail of financing lease, where he would be entitled to an additional deduction for interest expense.

The most common technique of minimizing the tax impact on a business enterprise is the deferral of cost or expense to benefit future periods. The

¹⁹ TAX CODE, §232.

²⁰ Revenue Regulation No. 3-90

State realizes that a business entity incurs most of its expenses upon establishment or before its actual operations. The benefits of the expenses incurred, however, may not be immediately realized. Thus, under the NIRC, the State affords the taxpayer, in certain instances, the option either to deduct the entire amount of the expense or to amortize it over a specific period of time.

The taxpayer is given the option to treat interest expense incurred to acquire property used in trade, business, or exercise of profession either as an outright deduction or a capital expenditure²¹. The enterprise may opt to claim the interest expense as an outright deduction from gross income if it would be more beneficial than capitalizing the interest. For instance, a taxpayer may deduct the entire interest if he foresees a substantial one-time gain from sale or disposal of assets in the same year he incurred the interest. A taxpayer may choose to capitalize the interest as part of the asset if it projects a loss at the end of the taxable period and, therefore, deduction of additional interest expense would have no taxable benefit.

Note, however, that Philippine tax laws recognize interest arbitrage and accordingly reduce the taxpayer's otherwise allowable deduction for interest expense by an amount equal to 38% of his interest income that has been subjected to a final tax.²² If the taxpayer, however, opts to capitalize his interest expense related to an asset constructed or acquired, the resulting amortization is not subject to the aforementioned limitation, thereby allowing the taxpayer to avail of the full benefit of the interest expense for a longer period.

Moreover, Philippine tax laws apparently do not encourage loans between certain specified related parties due to the disparity in the treatment of income interest and expense arising from said loans. "Related parties"²³

¹ TAX CODE, § 34 (B) (3).

² Certain passive income, such as interest on bank deposits and royalties, are subject to final withholding tax.

³ TAX CODE, § 36 (B), Related parties:

- Members of the family;
- A corporation which is owned and controlled by the taxpayer (i.e. he owns or controls more than fifty percent (50%) of the value of the outstanding stock.);
- Personal holding company or a foreign personal holding company of the taxpayer;
- Grantor and a fiduciary or trustee of any trust;
- Fiduciary or trustee of a trust and the fiduciary or trustee of another trust if the same person is a grantor with respect to each trust; or
- Fiduciary of a trust and a beneficiary of such trust.

contemplate a situation where an individual taxpayer owns or controls a corporate entity. Interest arising from indebtedness between related parties cannot be claimed as a deduction for interest expense by the taxpayer even when such interest was incurred in connection with the taxpayer's business. On the other hand, the taxpayer-lender should report his interest income arising from loans extended to related parties, whether interest was actually charged or not.²⁴

Similarly, taxes on importation may be fully deductible upon importation, or carried as part of the cost of the asset. When a taxpayer imports goods for sale or machinery for use in his business, he has to pay VAT, excise or ad valorem taxes, import duties, and fees. Under the NIRC, these taxes (except VAT) paid or incurred within the taxable year in connection with the taxpayer's profession, trade or business are allowed as deduction from income, but under GAAPs, these costs will form part of the carrying cost of the inventories or property. Again, the enterprise will have to examine and analyze if it would benefit tax-wise from the outright claim of taxes and duties deduction from gross income, or as part of the carrying cost of the asset that will also benefit future periods.

B. Depreciation

The service lives of property subject to depreciation are based on estimates of the period over which the assets will be of economic benefit to the enterprise. Service lives are usually based on the physical lives of the assets but are frequently pegged at shorter life. Under accounting practices, the estimate on the service life is based on informed judgment, historical experience of a company or industry, manufacturer's estimates, engineering, or appraisal evaluation.

Estimates on the service life can be amended or changed for tax planning purposes to either prolong or shorten the life of the assets to benefit future years or can be accelerated to claim the benefit of depreciation in a shorter period of time. The amendment in the service life is allowed for taxation without need for prior approval from the taxing authority, provided that the taxpayer has not entered into an agreement with the taxing authority as regards the useful life or depreciation method to use.

²⁴ Revenue Audit Memorandum Circular No. 01-98, (An arm's length interest shall be imputed to the corporate lender)

²⁵ TAX CODE, § 40 (C).

The taxpayer may likewise write-off obsolete inventory or idle assets with a carrying value to increase expense or loss in the period when the enterprise projects a substantial income or revenue. Write-offs, however, are subject to examination by taxing authorities that the taxpayer's representations are true and correct. Taxing authorities must duly certify write-offs.

C. Carry-Over Provisions

Corporations may also take advantage of certain carry-over provisions for tax deductions. In the case of the Minimum Corporate Income Tax (MCIT), which is a tax on gross income, the definition of gross income for purposes of the tax has been modified.

The Tax Reform Act introduced the concept of Minimum Corporate Income Tax (MCIT) to make tax collection more administratively feasible. The imposition of the tax seeks to minimize discretion of revenue officers in their examination of books and records of corporate taxpayers. Corporations shall be subject to MCIT of two percent (2%) of the gross income as of the end of the taxable year whenever the MCIT is greater than tax computed under normal corporate income tax rates. To avoid unduly burdening the corporate taxpayers, taxing authorities softened the impact of MCIT on corporations by modifying the meaning of "gross income" for MCIT purposes, to gross sales less sales returns, discounts and allowances, and cost of goods/ services. Cost of goods or services has been limited to direct costs incurred to produce the goods and to bring them to their present location and use, or to provide the services required by the customer or client. Moreover, any excess of the MCIT over the normal corporate income tax can be carried forward and credited against the normal income tax for the three (3) immediately succeeding taxable years. Any amount of the excess minimum corporate income tax, which has not or cannot be so credited against the normal income taxes due for the 3-year reglementary period shall lose its creditability.

The MCIT shall be imposed on a corporation, beginning on the 4th taxable year immediately following the year in which it commenced its business operations.

The net operating loss carry-over (NOLCO) is an innovation likewise reintroduced by the Tax Reform Act. Under the NOLCO provision, the net operating loss of a business or enterprise for the taxable year immediately preceding the current taxable year, which was not previously offset as deduction from gross income, shall be carried over as a deduction from gross income for the next three (3) consecutive taxable years immediately following the year of such loss. Any net loss incurred in a taxable year during which the taxpayer was exempt from income tax, however, shall not be allowed as a deduction. The NOLCO carry-over is generally not transferable or assignable and limits its applicability to instances where ownership of the business or enterprise has not substantially changed in that - (a) not less than 75% in nominal value of outstanding issued shares, if the business is in the name of the corporation, is held by or on behalf of the same persons; or (b) not less than 75% of the paid-up capital of the corporation, if the business is in the name of the corporation, is held by or on behalf of the same persons. However, such limitation shall not apply where the taxpayer is the surviving entity in case of mergers of 2 or more corporations.

The following entities, however, are specifically disqualified from claiming NOLCO as a deduction:

- Offshore Banking Units (OBU) and Foreign Currency Deposit Unit (FCDU) of a domestic or foreign banking corporation
- Board of Investments (BOI) registered enterprises enjoying Income Tax Holiday (ITH)
- Philippine Economic Zone Authority (PEZA) registered enterprises
- Enterprises registered under the Bases Conversion and Development Act (BCDA)
- Foreign corporations engaged in international shipping or air carriage business in the Philippines
- Other persons enjoying exemption from income tax, pursuant to NIRC provisions or any special laws

E. Dividend Declaration

Under the Philippine Corporation Code, stock corporations are prohibited from retaining surplus profits in excess of 100% of their paid-in capital, except in the following instances:

- The corporation plans to undertake expansion projects or programs approved by its board of directors;
- The corporation is prohibited under any loan agreement with a financial institution/ creditor to declare dividends without the tatter's consent and such consent has not been secured; or
- Retention of the earnings is required by special circumstances obtained in the corporation.

Absent these special circumstances, an improperly accumulated earnings tax (IAET) equivalent to 10% of the improperly accumulated taxable income shall be imposed on corporations formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting the earnings and profits of the corporation to accumulate instead of dividing them among or distributing them to the shareholders. The tax is being imposed in the nature of a penalty to the corporation for the improper accumulation of its earnings, and as a form of deterrent to the avoidance of tax upon shareholders who are supposed to pay dividends tax on the earnings distributed to them by the corporation.

The crucial test for liability for the tax is the purpose behind the accumulation of the income and not the consequences of the accumulation. Thus, a corporation would not be liable for the tax if the failure to pay dividends was due to the use of die undistributed earnings and profits for the reasonable needs of the business. In order to determine whether profits are accumulated for the reasonable needs of the business to avoid the IAET imposition, the controlling intention of the taxpayer is that which is manifested at the time of accumulation and not subsequently declared intentions, which are merely the product of afterthought. Definiteness of plans, coupled with actions taken towards its consummation, are essential. Thus, the sub-classification of retained earnings in the balance sheet into "appropriated" and "unappropriated" could be influential in the determination of whether income is being improperly accumulated.

E Exchanges of Properties Pursuant to a Merger or Consolidation

A merger or consolidation under tax law is understood to mean an ordinary merger or consolidation or the acquisition by one corporation of all or substantially all the properties of another corporation solely for shares of stock. The term property shall be taken to include the cash assets of the transferor.

Upon the sale or exchange of property, the entire amount of gain or loss shall be recognized except in pursuance of a plan of merger or consolidation where:

- A corporation, which is a party to a merger or consolidation, exchanges property solely for stock in a corporation, which is party to the merger or consolidation; or
- A shareholder exchanges stock in a corporation, which is a party to the merger or consolidation, solely for stock or another corporation also a party to the merger or consolidation; or
- A security holder of a corporation, which is party to the merger or consolidation, exchanges his securities in such corporation, solely for stock or securities in another corporation, a party to the merger or consolidation.^a

Also, no gain or loss would be recognized if the property is transferred to a corporation by a person in exchange for stock or unit of participation in such corporation of which, as a result of such exchange, said person, alone or together with others, not exceeding four (4) persons, gains control of said corporation.

Tax laws exempt gains and losses pertaining to mergers and consolidations to encourage consolidation of resources, finances, and personnel to achieve maximum operating efficiency. Under existing accounting principles, however, any gain or loss resulting from the above-enumerated transactions are recognized in the books for financial accounting purposes.

VIII. CONCLUSION

The treatment and computation of the net profits under the NIRC is distinguishable from that under the generally accepted accounting principles. As such, in order to minimize tax risks, it is necessary for a taxpayer to be aware of such distinction. Differences between accounting and tax treatment mostly exist in terms of expenses because the NIRC provides relatively strict criteria on deductibility and limitations to the amounts deductible for tax purposes. The success of tax planning carried out by the application of accounting principles is dependent on how far such accounting principles are acceptable under the NIRC or to the taxing authority.