SOME ASPECTS REGARDING NEW REGULATION IN TAX EXEMPTION FOR REINVESTED EARNINGS IN ROMANIA

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Abstract: OUG 19/2014 introduced new regulations for tax exemption of reinvested earnings. Beginning July 1st, 2014, the new fiscal measure is due to increase the worth for equipment's investment and is expected (in the long run) to improve technological equipment for production, transport and agriculture, or any form of manufacture. Although such measures are not innovative, to obtain tax exemption for reinvested earnings is now more appealing than previous attempts. Romanian legislators are convinced that such measures will have a significant effects on industrial manufacturers, while allowing an upgrade of fabrication facilities in any field of production.

This paper concentrates on some enhancements, amendments and barriers of the new fiscal regulations for these old regulations. As always, only the economic reality will show if Romanian companies will use and benefit from these newly introduced fiscal facilities.

Keywords: reinvested earnings, tax facilities, corporate income, fiscal measures, accounting profit

JEL Classification: H3

1. INTRODUCTION

Romanian legislators have an important goal: to change tax legislation in order to have a positive impact on the business environment, and as such, these measures had continued in 2014. A major tax change is the renewal of old idea for taxation of reinvested earnings and profits. This measure was adopted after promotion of holding companies structure. No arguing that Romanian equipment for production (in any fields of production) is far behind the European average and the cost of modernization is huge. So this measure is intended to increase the investments and equipment upgrades, based on the money allocated for taxation.

This measure is not new, but has been redesigned. The new regulation (OUG 19/2014 or GEO 19/2014) corrects some clumsiness provisions introduced in 2009, which did not have the anticipated effect, were unattractive for investors, companies and entrepreneurs, because in the end it did not offer any fiscal advantages.

Still, this fiscal facility will have a limited extend, starting 1st July 2014 and for equipment bought / purchased / manufactured only until December 31st, 2014.

2. SOME NEW CONDITIONS FOR THE FISCAL CHANGES

GEO 19/2014 repealed article 19st of the Tax Code, which had been introduced in 2009 by Law no. 32/2009 and concerned tax exemption of reinvested earnings and introduced a new article 19[4], similar to the repealed provision, while removing its major drawbacks that resulted in the entrepreneur's refusal to use the facility introduced in 2009.

According to this rule, earnings invested in technology – machinery and equipment – as provided for in subgroup 2.1 of the Catalogue on the classification and utility life of fixed assets (the Catalogue) subsequently used for business activities, are exempt from taxation. The tax exemption for investments may not exceed the corporate income tax due for the period.

Here are some examples for assets being purchased using the fiscal facility: equipment for extraction of coal and other metallic and nonmetallic ore; construction and agricultural equipment; transport and communication equipment; health and human care equipment; equipment for textile, paper, food, chemical and petroleum industries; electrical and wind energy production; other types of equipment working independently.

To qualify for the exemption, the equipment must be new. No exemption will be granted for the entrepreneurs who reinvest their earnings for the purchase of equipment not considered new under the implementing rules that will accompany these provisions. For example, we consider that the purchase of a state of the art, but second hand equipment will not involve the application of the exemption. That approach remains to be confirmed by implementing rules.

Investments in technology to be carried out over several consecutive years will qualify for the exemption in proportion to the equipment put into service each year.

These provisions define the invested earnings as the profit and loss account balance, i.e. the gross accounting profit from the beginning of the year, during which the equipment was commissioned. For the period from 1st of July to 31 December 2014, it must be taken into account only the gross accounting profit registered since 1st of July and invested in equipment put into service after that date.

Example 1. An asset purchased in June 2014 and put into operation in July 2014. Due to the fact that the fiscal facility is applied only for equipment achieved after 1st of July 2014, the company could not apply the tax exemption.

Taxpayers are required to pay corporate income tax on a quarterly basis and who invest in the previous quarters will subtract the previously invested earnings for which the facility was applied from the gross profit cumulated from the beginning of the year.

According to the provision, the amount of earnings that benefited from the tax exemption, less the part related to the legal reserve, will be distributed at the end of the fiscal year, primarily for the establishment of reserves up to the gross accounting profit recorded. The reserves are to be taxed at the time of using them in any form and also in case of reorganization operations conducted according to the law, if the recipient company does not take them over.

Also, according to the provision, where is a year-end accounting loss, the corporate income tax related to the invested earnings is not recalculated and the taxpayer does not allocate the invested earnings to reserves.

Entrepreneurs benefiting from the facility are required to keep the respective technology assets for a period at least equal to half of their useful life as determined according to the application of accounting regulations, but not more than five years. In case of failure to observe that condition, the tax is recomputed for those amounts and accessory tax liabilities will be charged from the date of facility application.

The following are not covered by the provisions: equipment transferred during reorganization process, equipment disposed of during winding-up or bankruptcy procedures and those that are destroyed, lost or stolen.

Unlike the previous provision, taxpayers will be able to depreciate the equipment purchased through reinvesting earnings, but they will not be able to choose an accelerated depreciation for the equipment. During that minimum equipment holding period, taxpayers will be able to depreciate the equipment and therefore benefit from the tax deductibility of depreciation, leading to a double deduction during the investment period.

Upon the distribution of the reinvested earnings as dividends, the respective amounts will be subject to corporate income tax, but unlike under the previous regulations, without payment of interest and late payments penalties. Micro-enterprises becoming companies and paying corporate income tax during the year will take into account, upon application of the facility, the cumulated gross accounting profit from the beginning of the year, which were invested in equipment put into service beginning with the quarter in which they became corporate tax payers.

2.1. The potential effect of the fiscal changes

The adoption of the measure was strongly supported by Romanian business environment, especially the Business Association of Romania (AOAR) which recommended directly Romanian government to support the measure during the negotiations with the IMF. Romanian entrepreneurs hope that this facility will increase the upgrade of production equipment, outdated and old (comparing to the European average). It was a hope for boosting foreign investment in Romania. As reflected in the beginning of the GEO 19/2014, legislators hoped that the measure will have an extended effect over competitiveness and innovation, attracting investment, increasing employment and improving working conditions. Budgetary impact will rise to 137.5 ml. RON (41.7 ml. USD). We consider this figure rather optimistic then realistic.

2.2. What is reinvested earning

The reinvested earning represents the balance of the earnings and loss account, meaning the gross accounting profit, from cumulative from the beginning of the fiscal year, in the year of application (operation) of this equipment. The exemption for reinvested earnings had a limit to the amount of profit tax due to that year. The gross accounting profit cumulative from the beginning of the fiscal year is the accounting profit and the profit tax expenditures recorded in the quarter / year of operation for the equipment.

Example 2. An asset purchased in December 2014 and put into operation in February 2015, in value of 70.000 EUR. In which quarter will use the company the exemption? The regulation specifies clearly that the exemption is given only in the quarter in which the asset is put into operation.

3. THE DIFFERENCES BETWEEN THE NEW AND OLD FISCAL REGULATIONS

As outlined above, the old regulations concerning reinvested earnings, although not very different from the current provisions, have some features that made them very unappealing to the businesses. In 2009, the old regulation represented only a delay for profit taxation during the life expectancy of the investment.

The regulations concerned the same category of goods where a company could reinvest its earnings and included the same requirements to keep the assets at least for the period equal to half of their useful life, according to the Catalogue.

A major drawback of the previous regulation was related to the depreciation of the assets. It had been decided that, because there was tax deduction for the full value of the equipment, its value for tax purposes should be zero. Thus, the fixed asset depreciation expense was not-deductible when calculating the corporate income tax, and taxpayers recorded only an accounting depreciation (with no depreciation for tax purposes).

Another highly unpopular issue concerned the calculation of the obligation to pay interest and late-payment penalties upon the distribution of the reinvested earnings as dividends, which actually turned the fiscal facility into an additional tax burden. Basically, that facility was mere tax deferral with additional interest and late-payment penalties. In such conditions, it was preferable for the entrepreneurs to invest in the purchase of equipment without taking into account the former so called facility and this beside imposing restrictions on keeping the assets, also generated a higher tax for the taxpayer.

It is easy to understand why this so called exemption was not very popular among tax payers, being considered more of a burden than a facility. Like the new facility, it had limited duration, being applicable from 1st October 2009 to 31st December 2010. The new regulation, while not very innovative, often repeating the same wording of the previous regulations, has corrected the major weaknesses that turned the old one into a disincentive and legislators are very optimistic about its future positive effects.

Example 3. (Valid for October 2009 – December 2010) At the end of the quarter, a company presents the following accounting information:

- Accounting profit is 40.000 Euro, purchased equipment is in value of 28.000 Euro (useful duration 10 years);
- Accounting profit is 30.000 Euro, purchased equipment is in value of 41.000 Euro (useful duration 10 years);

The fiscal value of the assets in those examples is:

- Accounting profit of 40.000 Euro covers the investment, tax exemption is 28.000 x 16% = 4.480 Euro; Fiscal value is 28.000 - 28.000 = 0 Euro. For every year of the following 10 year the company will register amortization expenditure of 2.800 Euro, amount of which could not be deduced from the profit taxation. So, in the purchase year, the company gained 4.480 Euro (deduced from taxation) and in the following 10 years will lose for each year 448 Euro (2.800 x 16%). As we already seen before, this fiscal measure was only valid for tax delay and not an avoidance of the payment.
- Accounting profit of 30.000 Euro is not covering the investment, tax exemption is 30.000 x 16% = 4.800 Euro; Fiscal value is 41.000 - 30.000 = 11.000 Euro. For every year of the following 10 year the company will register amortization expenditure of 4.100 Euro (41.000/10), amount of which could be deduced only for 1.100 Euro (11.000/10) from the profit taxation. So, in each year, will be a non deductible expenditure of 3.000 Euro. In the purchase year, the company gained 4.800 Euro

(deduced from taxation) and in the following 10 years will lose for each year 480 Euro (3.000 x 16%).

For July 2014 – December 2014, to apply the facility will be useful to consider gross accounting profit registered starting July 2014 and invested in equipment purchased / produced and put into production after that date. The exemption is computed quarterly or annually. The amount of profit exempt from taxation (minus legal reserve) will be allocated at the end of fiscal year, until it reaches the amount of accounting profit registered. The formed reserve will be taxed if it will be distributed under any conditions or in the case or company's reorganization, if the new company will not assume this reserve.

Example 4. Accounting profit covers the investment. In November 2014, the company purchased one equipment in value of 100.000 Euro. Gross accounting profit obtained in January – December 2014 is 650.000 Euro, from which 220.000 Euro represent the profit of July – December 2014. The value of the joint stock is low, only 200 Euro and there are no reserves constituted. At the end of quarter 4, the company registered 500.000 Euro as taxed profit and the tax is 45.000 Euro. To compute the amount of exemption for reinvested profit we follow these steps:

1. Computing the tax owed for the entire year: 500.000 x 16% = 80.000 Euro
2. Computing the tax owed for reinvested profit (the profit covers the investment): 100.000 x 16% = 16.000 Euro (tax exempted)
3. Computing profit tax owed after application of the facility: 80.000 – 16.000 = 64.000 Euro. Profit tax for quarter 4 = 64.000 – 45.000 = 19.000 Euro
4. Allocation for reserves of the amount exempt, without legal reserve: a) Computing legal reserve: 5% x 650.000 = 32.500 Euro; 20% x 200 = 40 Euro. The company will allocate for legal reserve only 40 Euro; b) Computing exempt profit, allocated to reserves: We will take into account the rate of gross accounting profit (exempt from taxation of total profit) = 100.000 / 650.000 = 15.38%. Legal reserve is 40, but the share allocate for legal reserve is = 40 x 15.38% = 6 Euro). As so, the exempt profit allocated to other reserves is 99.994 Euro.

This measure is very useful for companies with profit, while the investment exceed the level of accounting profit, the company could not use the whole amount, only the lesser sum.

Example 5. Accounting profit does not cover the investment. In November 2014, the company purchased the equipment in value of 90.000 Euro. Gross accounting profit obtained in January – December 2014 is 650.000 Euro, from which 60.000 Euro represent the profit of July – December 2014. The value of the joint stock is low, only 200 Euro and there are no reserves constituted. At the end of quarter 4, the company registered 400.000 Euro as taxed profit and the tax is 33.000 Euro. To compute the amount of exemption for reinvested profit we follow these steps:

1. Computing the tax owed for the entire year: 400.000 x 16% = 64.000 Euro
2. Computing the tax owed for reinvested profit (the profit covers the investment): 60.000 x 16% = 9.600 Euro (tax exempted)
3. Computing profit tax owed after application of the facility: 64.000 – 9.600 = 44.400 Euro. Profit tax for quarter 4 = 54.400 – 33.000 = 24.400 Euro
4. Allocation for reserves of the amount exempt, without legal reserve: Computing exempt profit, allocated to reserves: 60.000 Euro

4. SOME NEGATIVE ASPECTS OF THE NEW REGULATIONS

Despite the optimistic estimates of the government the conditions imposed for the application of the facility are considered to be too restrictive to generate massive investments in production equipment upgrade.

First, the requirement to keep the acquired assets for a period not shorter that the life span of the asset as provided in Catalogue, is considered to be too restrictive. The estimated useful life of the equipment listed in the Catalogue is no longer valid in many cases, as they not reflect the rapid technological progress which has reduced considerably the economic life of the assets.

Furthermore, the Catalogue established in 2004 and updated in 2008 does not provide a whole range of modern equipment, especially in the field of renewable energy, additionally restricting the actual applicability and effectiveness of the facility. Entrepreneurs who want to benefit from the facility will risk being required to keep assets that will be outdated and ineffective in a few years or pay interest and late-payment penalties if they choose to get rid of the outdated equipment.

Surely this requirement will not hinder business operating in areas where technological progress is slower (such as agriculture) from benefiting from the facility. Other companies active in areas depending on state-of-the-art high tech will not be attracted to the facility. We must not forget that companies producing IT and telecommunications goods have emerged in Romania in recent years, and they should be better supported against a very tough foreign competition, and the measure is not very favorable to them.

We think that the obligation to keep the purchased equipment for so long goes against the spirit of the provision, which should promote the technological modernization of the Romanian manufacturers and ultimately defeats the purpose of supporting their performance's increase. Since the condition forces manufacturers to keep the equipment until after they became obsolete, it creates a vicious circle in which manufactures have periods with modern equipment followed by periods in which they have to use underperforming and obsolete technological assets.

Another problem could be related to the limitation of depreciation, as tax-payers may not choose the accelerated depreciation method for the equipment purchased in that manner. Although the obstacle related to depreciation was corrected, the correction was not carried through. Given the positive aspects and the several barriers imposed by the provision, it remains uncertain if Romanian entrepreneurs would choose to take advantage of the facility. In any case, the measure is certainly positive and a step forward to increase Romania's fiscal attractiveness for foreign investors.

Another great disadvantage is the circumstance when the quarterly accounting profit not covers the value of the investment, and thus the company could not "use" the difference for diminishing future quarterly profits.

> Example 6. Accounting profit does not cover the investment, while profit is made in next quarters. In January 2015, the company purchased the equipment in value of 20.000 Euro. Gross accounting profit obtained in first quarter is 14.000 Euro, and the fiscal profit is 40.000 Euro. The value of the joint stock is low, only 200 Euro and there are legal reserves constituted. At the end of quarter 2, the company registered

70.000 Euro as gross accounting profit. To compute the amount of exemption for reinvested profit we follow these steps:

1. Computing the tax owed for the first quarter: 40.000 x 16% = 6.400 Euro
2. Computing the tax owed for reinvested profit (the profit covers the investment): while gross accounting profit is 14.000 Euro and not covers the investment (20.000 Euro), tax exempted is 14.000 x 16% = 2.240 Euro.
3. Computing profit tax owed after application of the facility: 6.400 – 2.240 = 4.160 Euro.
4. Allocation for reserves of the amount exempt, without legal reserve: Computing exempt profit, allocated to reserves: 14.000 Euro

When, at the end of the year, the company registers accounting loss, recalculation for reinvested profit tax will not be made, and the company will not distribute to the reserves the amount of reinvested profit. In this particular case, the company could gain while the amount was exempt from taxation, still it had not the obligation to create reserves, while it register accounting loss.

Example 7. At the end of the fiscal year, the company registered accounting loss. In February 2015, the company purchased the equipment in value of 80.000 Euro. Gross accounting profit obtained in first quarter is 120.000 Euro, and the fiscal profit is 170.000 Euro. The value of the joint stock is low, only 200 Euro and there are legal reserves constituted. At the end of quarter 4, the company registered 40.000 Euro as accounting loss. To compute the amount of exemption for reinvested profit we follow these steps:

1. Computing the tax owed for the first quarter: 170.000 x 16% = 27.200 Euro
2. Computing the tax owed for reinvested profit (the profit covers the investment): while gross accounting profit for first quarter is 120.000 Euro and covers the investment (80.000 Euro), tax exempted is 80.000 x 16% = 12.800 Euro.
3. Computing profit tax owed after application of the facility: 27.200 – 12.800 = 14.400 Euro.
4. At 31 December 2015, due to the fact that the company registered loss there will be no obligation for allocation for reserves and the profit tax will not be recalculated. But, the fiscal value of the equipment will be 80.000 Euro, depreciation will be linear or digressive, and not accelerated.

The exemption for the reinvested profit is granted in limit of profit tax owed, for the year of putting in use of the investment. As such, in our opinion it represents a fiscal credit. Even the gross accounting profit is big enough for covering the investment, if fiscal result is not as large, then the company could not use the entire facility.

Example 8. Fiscal profit is smaller than accounting profit. In October 2015, the company purchased the equipment in value of 30.000 Euro. Gross accounting profit obtained in 2015 is 40.000 Euro, and the fiscal profit is 18.000 Euro. The value of the joint stock is low, only 200 Euro and there are legal reserves constituted. At the end of quarter 3, the amount of profit tax was 600 Euro. To compute the amount of exemption for reinvested profit we follow these steps:

1. Computing the tax owed for 2015: 18.000 x 16% = 2.880 Euro

2. Computing the tax owed for reinvested profit (the profit covers the investment): while gross accounting profit for first quarter is 40.000 Euro and covers the investment (30.000 Euro), but fiscal result was smaller and so the tax exempted is only 2.880 Euro.

The company will declare zero annual profit tax, and if during the year tax declared and paid was, for instance 600 Euro, there will be a reimbursement for this amount. As such, from the investment of 30.000 Euro, the company will deduce only 18.000 Euro, representing the fiscal result for that year.

5. CONCLUSIONS

As a general conclusion, new equipment is defined as those used for the first time. The companies could not use accelerated depreciation. For equipment acquired in leasing and put into use between July 2014 and December 2016, tax exemption is applied by lessee.

The provision is applied for reinvested profit for technological / technical equipment produced or purchased after 1st of July 2014 and put into function until 31st of December 2016.

The requirement to keep the acquired assets for a period not shorter that the life span of the asset as provided in Catalogue, is considered to be too restrictive. The estimated useful life of the equipment listed in the Catalogue is no longer valid in many cases, as they not reflect the rapid technological progress which has reduced considerably the economic life of the assets. Furthermore, the Catalogue established in 2004 and updated in 2008 does not provide a whole range of modern equipment, especially in the field of renewable energy, additionally restricting the actual applicability and effectiveness of the facility. Entrepreneurs who want to benefit from the facility will risk being required to keep assets that will be outdated and ineffective in a few years or pay interest and late-payment penalties if they choose to get rid of the outdated equipment. Surely this requirement will not hinder business operating in areas where technological progress is slower (such as agriculture) from benefiting from the facility. Other companies active in areas depending on state-of-the-art high tech will not be attracted to the facility. We must not forget that companies producing IT and telecommunications goods have emerged in Romania in recent years, and they should be better supported against a very tough foreign competition, and the measure is not very favorable to them.

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Another problem could be related to the limitation of depreciation, as tax-payers may not choose the accelerated depreciation method for the equipment purchased in that manner. Although the obstacle related to depreciation was corrected, the correction was not carried through. Given the positive aspects and the several barriers imposed by the provision, it remains uncertain if Romanian entrepreneurs would choose to take advantage of the facility.

In any case, the measure is certainly positive and a step forward to increase Romania's fiscal attractiveness for foreign investors.

Another great disadvantage is the circumstance when the quarterly accounting profit not covers the value of the investment, and thus the company could not "use" the difference for diminishing future quarterly profits.

6. REFERENCES

OUG 19/2014, M. Of. Nr. 308/25.04.2014 regarding tax exemption for reinvested earnings;

HG nr 421/2014,M. Of. Nr. 384/23.05.2014 regarding some examples of tax exemption for reinvested earnings.