

## ACCOUNTING FOR TAXATION ON CORPORATION – A NEW PERSPECTIVE

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### SINOPSIS

Kaedah perakaunan ke atas cukai syarikat perlulah membayangkan sistem percukaian yang diamalkan di dalam negara. Ini ialah untuk memastikan yang penyata-penyata kewangan dapat memberikan maklumat yang sehabis lengkap. Pendahuluan cukai syarikat menunjukkan jumlah kredit yang boleh digunakan untuk membayar dividen. Ia adalah merupakan satu jumlah belum terima kepada pemegang saham. Menunjukkan jumlah pendahuluan cukai pendapatan sebagai aset perniagaan dapat memberikan maklumat yang lebih jelas tentang kedudukan kewangan perniagaan. Bagaimanapun ia melanggar prinsip entiti berasingan di dalam perakaunan. Adalah difikirkan perlu untuk menunjukkan jumlah kredit yang wujud dalam bentuk pendahuluan cukai ini di dalam penyata kewangan, sekurang-kurangnya sebagai nota kepada penyata kewangan.

### SYNOPSIS

*The accounting treatment of corporate income taxes on corporation should reflect the system of corporate taxation used in the country. This is to ensure that the accounts would provide the fullest information possible. Advanced corporation tax shows the potential credit to be used for paying dividends. It is a receivable amount to the shareholders. Showing it as an asset in the financial statement will provide better information about the financial position of the corporation. It will however violate the basic principle of separate legal entity in accounting. It is thought that information about the total amount of available credit*

*should be disclosed in the financial statement, at least in the form of notes to the accounts.*

### I. Introduction

Income tax paid by corporation could be treated either

- (a) as an operating expense i.e. as tax on the corporation by itself,
- (b) as a distribution of income assuming the state is one of the shareholders, or as tax advanced made to the state where the corporation is treated only as a conduit.

The scope of accounting for taxes on income had however been confined to deferred taxation only. The International Accounting Standards no. 12 only deals with the treatment of deferred taxes which arises from differences between the accounting and the taxation treatment of certain items. The trend in the UK is a little bit different. The Statements of Standard Accounting Practice (SSAP) no. 15<sup>1</sup> which is on accounting for deferred taxation discusses extensively the difference between the accounting and taxation treatment of certain items.

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<sup>1</sup>SSAP 15 is a standard on deferred taxation. It was introduced by the Accounting Standards Committee in the UK. It was originally published in the form of exposure draft (ED 11) in 1973. ASC was set up in January 1970. It represents six accountancy bodies in the UK.

The SSAP 8<sup>2</sup> discussed taxation under the imputation system. The Malaysian Association of Certified Public Accountants (MACPA) plans to adopt the IAS 12 in 1982. It has been the policy of MACPA to adopt the IAS in toto but to attach an introductory with it.<sup>3</sup> The policy taken by the Malaysian Association of Certified Public Accountants to adopt each IAS in its entirety is not wise. This is considering that the IAS was developed in countries where the business environment were different. IAS is not universal enough to take into account the Malaysian local environment like the taxation and the legal systems. In this respect SSAP 8 is more appropriate provided we make some adjustments and modification to it.

## 2. Corporate Taxation System and the Implication on Accounting For Taxation

Corporation taxation system could be classified into two categories according to the treatment of corporation as an entity in taxation. Where the corporation is treated only as conduit or intermediary bodies between shareholders and the Inland Revenue Department, the corporate taxation system is in effect an imputation system. On the other hand, where the corporation is taxed as an entity by itself, the separate taxation system is said to be in effect.<sup>4</sup>

### 2.1 Separate Corporation Income Tax System

Under this system, income is taxed at source i.e. in the hands of the corporation. The corporation is treated here as a tax entity which is liable to tax just like an individual, a trust body, etc. When the company declares a dividend on the after tax income (retained earning), the shareholders will be taxed on the whole sums of dividend received. No credit will be available to the shareholders on the tax paid by the corporation.

Tax here is treated as franchise fee on the privilege of doing business in the corporate form. This is based on the notion that corporations enjoy special privileges and benefits from the state. Moreover the modern corporation has a separation of management and

ownership, thus generating income over which no shareholders can claim any particular economic control.<sup>6</sup> The tax on the shareholder upon the receipt of dividends on the other hand is a tax on investment income.

For purpose of accounting, corporation tax under this system of taxation could be treated in two ways. First as an operating expense. and secondly as a distribution of income.

#### 2.1.1 Taxation As An Operating Expenses

Conventionally, income tax paid by a corporation has been treated as an expense. However, in the published accounts taxation is not treated as a deductible expense to arrive at the profit from trading. Instead, it has always been shown as deduction from trading profit to arrive at the profit after taxation.

For income tax purposes, income tax is not treated as a deductible expense wholly and exclusively for the production of gross income.<sup>6</sup> The treatment of tax as an expense is based on the franchise fee concept as discussed above.

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<sup>2</sup>SSAP 8 is on the treatment of taxation under the imputation system in the accounts of companies. It was originally published in the form of exposure draft (ED 12) in 1973.

<sup>3</sup>Paul Anthony Phenix – "Accounting for taxes on Income" in seminars on the Development of Accounting Standards in Malaysia. "Some exposure drafts on International Accounting Standards and the implication" – University of Malaya.

<sup>4</sup>Richard A. Musgrave and Peggy B. Musgrave, **Public Finance in Theory and Practice**, McGraw-Hill, 2nd Ed. 1976. pp 291 – 293.

<sup>5</sup>D.A. Kahn and P.B. Gann, *Corporate Taxation*, 1979, pp. 36 – 58.

<sup>6</sup>Section 33 of the Income Tax Act 1967, specifies clearly the out going expenses allowable for the purpose of Income tax. Refer also case: Allan Vs. Farquharshon Bros. & Co. 17 TC 59.

Because of the difference in timing and treatment between the accounting and taxation on certain items, tax liability could not be determined accurately based on accounting net profit. Accountants could thereby provide only estimates of tax liability based on the accounting net profit. Estimated tax has to be made and reflected in the financial statement at end of financial year because the timing of tax payment is normally different from the date when the financial year ends. The tax is normally payable on the first of April every year on income of the previous year.<sup>7</sup>

These tax provision will normally be reflected as liability until the actual tax is known from the assessment made by the Inland Revenue Department. It is then, that tax payable will normally be paid to the department. The difference between tax provision and the actual tax will be carried forward as deferred tax balance in the balance sheet. Depending on whether it is a debit or a credit balance, it will be classified either as prepayment i.e. as asset) or as a current liability.

### 2.1.2 Taxation as a distribution of income

A countervailing school of thought considers taxation not as an expense but as a distribution of profit. Here, the state is considered as one of the shareholders or owners of the corporation. Part of the profit is therefore distributed to the state. Unlike distribution of income to the common shareholders, income tax is distributed to the state annually so long as the company make some taxable profit. It is more like a preferred dividend. The major difference between dividend distribution and the tax distribution is that tax distribution is only made out of current income. Dividends on common or preferred shares could be distributed out of current profit as well as retained earnings.<sup>8</sup>

When income tax on corporation is treated as distribution of dividends the accounting treatment should be as follows. On estimation of tax at end of accounting period a liability should be recognised just like in the circumstances of dividend declaration. Later, when

the actual tax is paid to the Inland Revenue Department, the tax liability account is set off against cash. Any difference between tax liability (provision) and the actual tax paid is carried forward as tax reserve fund (where balance is a credit) or deferred tax (where balance is a debit).

The two treatment of taxation will result in more or less the same result of disclosed items in the financial statements. It is therefore not very important that we should resort to only one of the method of treatments to achieve a standard in financial disclosures.

### 2.2 Imputation System of Corporate Taxation

Under this system, corporation is treated as a conduit (or intermediary bodies) to collect tax in advance on behalf of the state. This position is similar to the practice of withholding tax on personal income, interest etc. The justification here is because the corporation is simply the aggregate of its owners and can best be characterised as a conduit through which income earned in the corporation is passed to shareholders as dividends or retained earnings.<sup>9</sup> A corporation here cannot be said to have tax paying ability beyond that of its shareholders. This system eliminates the conflict with the vertical equity and ability-to-pay principles of taxation found under the separate taxation system. Separate taxation on corporation is said to have violated both horizontal and vertical equity between individuals.<sup>10</sup>

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<sup>7</sup>*Income in basis year 1981 for example will be assessed in the year of assessment 1982. The Department of Inland Revenue will send a tax return to the corporation in April asking for payment.*

<sup>8</sup>*In the United States, corporations could even distribute cash to shareholders out of their paid-up capital, which amount to capital reduction.*

<sup>9</sup>*This treatment is similar to those in the case of Partnerships.*

<sup>10</sup>*Horizontal equity is simply tax fairness amongst tax payers of similar categories. Vertical equity on the other hand is tax fairness amongst different categories of tax payers.*

The practice of collecting tax at source i.e. taking income at the corporations hand is to ensure that all income distributed to the shareholders bears tax with them. This could reduce the tax avoidance practice of taxpayers. If tax were to be collected only on the shareholders hand, some profit of a corporation might not be taxed at all when it is kept in the corporation and later realised as capital gains.<sup>11</sup> It is therefore important that the Inland Revenue Department collect some advance corporation tax at an average tax rate of the shareholders concerned. When dividend distribution is finally made out, the corporation tax advanced is returned to the shareholders in the form of tax credits. Shareholders will therefore receive a gross dividend and will be taxed on the gross amount. Tax credit will be used as an offset against tax liability. In the Malaysian context some complications however arise because of the existence of the development tax and the excess profit tax. Development tax is levied on the development income at 5%.<sup>12</sup> Excess profit tax is levied on the profit in excess of 25% of shareholders funds or \$200,000 whichever is greater.<sup>13</sup> These taxes are levied on the corporation as a separate tax entity. Consequently, these tax is not refundable to the shareholders in the form of tax credit.

The accounting treatment for taxation under this imputation system should be different from those treatment under the separate taxation as described above.

In SSAP 8, this advanced corporation tax is treated as a current liability of the corporation. When actual tax is subsequently paid out, the tax liability account is offset against cash. The company will have to declare dividends on the net income after tax (advance corporation tax). The SSAP 8 is of the opinion that the advanced corporation tax is a tax on the corporation's profits and not cost of dividends. The fact that the dividend will carry a tax credit is a matter affecting shareholders' rather than the corporations' method of accounting for dividend. Tax liability is therefore treated as a liability of the corporation. Tax credit will not come into the picture at all either in the

financial statements or in accounting records of the corporation.

This treatment is in contradiction with the tax treatment of equating corporation with the shareholders.<sup>15</sup> The treatment would also mislead readers of financial statements especially those who are ignorant of the Malaysian Taxation system.

It should be noted that the advanced corporation tax is being preserved by the Inland Revenue Departments. The Inland Revenue Department maintains an account called the Compared Aggregate accounts as specified in the act.<sup>16</sup> The tax credit will always be available whenever the company decide to distribute dividend to the shareholders.

The advanced corporation tax should be treated differently in order to reflect the tax credits and actual dividends paid to the shareholders. Estimates on advanced corporation tax determined at end of the financial year should be treated as tax reserve fund — i.e. part of the reserve balance in the retained earnings account. When the Inland Revenue

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<sup>11</sup>If the shares of corporation is listed in the stock exchange for example and the market perfectly reflect the company's performance and position, the shareholders would be able to dispose their shares and realise some capital gains. In Malaysia, Capital gains on investment and securities is not taxable as yet.

<sup>12</sup>Development tax is levied on development income at the rate of 5%, under section 13 of the supplementary ITA 1967 — development tax defined development source.

<sup>13</sup>The methods of calculation is described in the supplementary ITA 1967 — Excess profit tax.

<sup>15</sup>The Income Tax Act 1967 in Malaysia use imputation system and treat corporation only as conduit.

<sup>16</sup>Section 108 of Income Tax Act 1967.

— specified that beside the Compared Aggregate accounts, a compared Total accounts will also be kept which records the tax applicable on dividend declared. The two accounts will always be compared to make sure corporation do not over distribute profit.

Department has arrived at their final assessment, sometimes in April the next year and the actual tax paid out, the amount of tax paid should be treated as an advanced corporation tax. Actual tax paid will however need to be classified into three parts i.e. income tax on corporation 40%, development tax at 5%, and the excess profit tax at 5%. Only the amount of income tax on corporation should be treated as advanced corporation tax. The amount of development tax and excess profit tax will be written off as expenses since it is not recoverable in the form of tax credits. This advanced corporation tax is a receivable amount classified under current assets. The difference between the actual tax paid and the tax estimated previously will be treated as tax reserve carried forward only when it has a credit balance. Any debit balance in the tax reserve account will be included as part of the advanced corporation tax.

When subsequently the corporation declares dividends, it will have to declare dividends at gross i.e. the net income plus advance corporation tax. Dividends payable account will have to be credited with the amounts of net dividend.

The advanced corporation tax will have to be credited with the total tax credit available on the amount of dividends payable. The debit will be to the retained earnings account. On payment of cash dividend, the dividends payable account will be debited and cash credited. A credit will be made to the section 108 Tax Credit — in the Inland Revenue Department accounts.

In the financial statement, taxation will be divided into three categories:

One as Advanced Corporation Tax classified as current assets in the balance sheet. This is the amount of 40% actual tax paid on corporation income.

Next, as Tax Reserve classified as part of retained earnings in the balance sheet. This is the excess between the tax provision made at end of financial year and the actual tax paid.

Finally, as Tax Expenses classified under operating expenses in the profit and loss accounts. This is the total development tax, the excess profit tax and other non-refundable tax.

Some accountants would argue that this system of tax treatment is not consistent with the conservatism doctrine as tax liability account is not being used. Furthermore, the tax paid to the state is treated as advances to the state while there is no guarantee on the recoverability of the amount. Some argue that without deducting taxation from the retained earnings, the shareholders could be misled as to the amount of retained earnings available for dividend distribution.

It should however be noted that the tax credit is guaranteed as a recoverable amount specified in the act.<sup>16</sup> There is therefore very little risk involved in treating it as advance made to the state. The Inland Revenue will normally require that the corporation has some balance in the section 108 account<sup>17</sup> before they could even declare their dividends. This will act as a check on the management in their action on dividend distribution at any time. Where a corporation did not have any section 108 balance but wish to declare dividend, they will have to first pay tax on the proposed dividends payment. It is therefore not possible that a company would overpay dividend to the shareholders without taking into account the tax payable on it.

### 3. Illustration on the differences in accounting treatment on corporation taxation

The differences in the treatment of corporation taxation is illustrated in the following example:

(figure from a hypothetical case)

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<sup>16</sup> See section 108, Income Tax Act 1967.

<sup>17</sup> i.e. The compared aggregate account must be equal to or greater than the compared total accounts.

Net Profit before tax	\$2,000,000
Estimated tax at 45%	900,000
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Net Profit after tax	<u>\$1,100,000</u>

Common shares outstanding (\$1 par)  
\$5,000,000

Actual tax paid could be classified as follows:

Corporation income tax	\$700,000
Development tax	120,000
Excess profit tax	40,000
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Total	<u>\$860,000</u>

The Board of Directors had proposed a dividend payment of 20% gross (before tax) or 12.2% net of tax.<sup>18</sup> The various methods of tax treatment is shown in appendix I.

#### 4. Conclusion

Malaysia applies the imputation system in the taxation of corporation income. Recoverability of tax is however confined to the income tax on corporation at 40% rate. The other two taxes levied on corporation namely Development Tax at 5% and excess profit tax also at 5% are not recoverable.

It is important that the basis of taxation be reflected in the accounting treatment for corporate taxation. This could provide a full disclosure of information regarding the taxation of the corporation income and the availability of tax credit upon dividend distribution to the shareholders.

The limitation of this accounting treatment is in treating Advanced Corporation Tax (ACT) as receivable or advanced payment to the Inland Revenue Department are as follows. It should be clearly understood here that this advanced corporation tax paid could not be claimed back by the corporation. It is only recoverable in the hand of the shareholders upon dividend distribution. If shareholders do not declare the dividend received as their taxable income, no tax credit will be given to them. Similarly, if the corporation decides to

wind up their operation,<sup>19</sup> and no dividend could be declared, the tax credit is gone forever. This assumption of winding up situation is however in contradiction with the going concern principle in accounting. Treating advanced corporation tax as receivable in a way violates the generally accepted accounting principle of separate legal entity. Advanced Corporation tax is only related to the shareholder's affairs as owners of the business. It is not related directly with the entity (corporation). Showing advanced corporation tax as receivable to the corporation will only mislead the readers as the amount could not be recovered by the corporation but the shareholders. We should therefore separate the affairs of the corporation from its shareholders.

Nevertheless, the amount of advanced corporation tax could still be shown as additional information to the financial statement. This could be in the form of notes to the accounts or a statement by the auditors.<sup>20</sup>

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<sup>18</sup> Income after tax	\$1,100,000
Corporation income tax	700,000
Income applicable of	<hr/>
corporation tax	<u>\$1,800,000</u>
∴ Tax rate for purpose of tax credit is	
700,000 = 38.89%	
<u>1,800,000</u>	

<sup>19</sup>Because of the current losses etc.

<sup>20</sup>i.e. especially in countries like USA, Canada, United Kingdom, and, European countries.

Appendix I – Treatment of Taxation in Accounting  
(based on the hypothetical example above)

Transaction related to corporate taxation	Corporation tax as a tax on corporation as an entity	Corporation tax as a distribution of income	Corporation tax as an Advanced Corporation Tax
1. At end of financial year-estimation of taxation based on accounting income 45% on \$2,000,000	Dr. Profit & loss a/c 900,000 Cr. Tax Payable 900,000	Dr. Profit & Loss a/c 900,000 Cr. Tax reserve fund 900,000	Dr. Profit & Loss a/c 900,000 Cr. Tax reserve fund 900,000 Dr. Tax reserve fund 860,000 Cr. Profit & Loss a/c 860,000
2. In April the next year actual assessment made by IRD and tax payment made in cash	Dr. Tax payable 860,000 Cr. Cash 860,000	Dr. Tax reserve fund 860,000 Cr. Cash 860,000	Dr. Advanced Corporation Tax 700,000 Dr. Development and excess profit tax 160,000 Cr. Cash 860,000
3. When the Board of Directors proposed a dividend payment of 20% gross or 12.2% net of tax i.e. \$511,100	Dr. Retained earnings 611,100 Cr. Dividend payable 611,000	Dr. Retained earnings 611,100 Cr. Dividend payable 611,100	Dr. Retained earnings 900,000 Cr. Dividend payable 900,000
4. When dividend is paid	Dr. Dividend Payable 611,000 Cr. Cash 611,000 Dr. Dividend Payable 611,000 Cr. Cash 611,000	Dr. Dividend payable 900,000 Cr. Advanced Corporation Tax 388,900 Cr. Cash 511,100	Note: Advanced corporation tax is calculated as follows: $38.8\% (20\% \times 5,000,000) = \$388,900$
<b>Presentation</b>			
1. In the Profit and Loss Accounts (and retained earnings statements)	Corporate taxation \$900,000	Taxation (as a deduction from retained earning) \$860,000	Taxation – development and excess profit tax 160,000 (as deduction from Profit before tax)
2. In the balance sheet	Deferred taxation \$ 40,000 (Credit balance)	Tax reserve fund \$ 40,000 (credit balance)	Tax reserve fund (credit balance) Advanced corporation Tax (debit balance) 311,000