

MICRO BUSINESSES – A FISCAL AND ACCOUNTING „TRAP” FOR THE TAX PAYER

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ABSTRACT

The micro business is an economic category which constitutes a common practice in Romania. The majority among entities are categorized upon their foundation as micro businesses by the Registrar of Companies/Trade Registry. This obligation essentially works against new companies, as they will pay income tax even if they report financial and fiscal loss. This trap is introduced by law out of a wish to collect taxes from start-up companies and discourage young entrepreneurs. Our suggestion is that the law-makers should at least allow companies to choose their tax system, as these constraints lead to sales unaccompanied by invoices and in this manner, the national budget is affected. For instance, many entities registered as small companies do not issue receipts, and the money cashed in are avoiding tax. At a national level, this type of tax avoidance is blossoming and the lawmakers should be more flexible with the options for taxation. As such, there is no difference between the communist system and the so-called capitalist system. When comparing the taxation method for the same company (corporate tax and income tax) the advantage of income tax is clearly visible. At the level of the tax-payer, the 3% rate leads to paying a higher income tax than a corporate tax would be. Yes, the tax-payer primarily compares the two rates: 3% and 16%. And in its essence the 3% rate will determine a much higher resource output.

Key Words: *micro business, income tax, accounting, tax base.*

1. Introduction

Accounting is an activity that must reflect the economic reality of any company. Company managers are interested in cash flows and cash equivalents. From this point of view we need to speak about accrual and cash accounting: „*Accrual accounting is adequate and compatible, first of all with a stable and healthy economy, in which capital flow, including the settlement of liabilities and receivables, is carried out under normal circumstances. In other words, their payment and cash-in is performed as a rule, without difficulties. In contrast with this situation, the Romanian economy is constantly facing financial blockage problems, arrears ... and finally cash-basis accounting is accounting meant for reality and not promises and expectations*” (Horomnea, 2008).

At present, from the point of view of taxation Romanian companies can be split into:

- Companies paying corporate tax;
- Companies paying income tax.

Companies paying a corporate tax will make the difference between income and expenses for taxing purposes, by taking into account deductible expenses and non-taxable income.

Companies that pay an income tax are generically called "micro businesses". They pay an income tax based on a rate applied on a tax base. The category of "tax on micro business income" is governed by Law 571/2003 of the Fiscal Code with subsequent modifications.

The fiscal code defines micro business as a Romanian legal entity that meets all following requirements, on 31 December of the previous fiscal year:

- have earned income, apart from: activities in the banking field; activities in the field of insurance and reinsurance, capital market, with the exception of companies that carry out intermediate activities in these fields: gambling activities;
- have earned income, outside consultancy and management activities, of over 80% of the total income;
- have earned income under the equivalent in RON of 65.000 euro;
- Its equity is held by others than the state or local authorities;
- is not in a process of liquidation, registered at the Trade Registry or at a court, according to the law.

The above mentioned requirements, stipulated by law 571/2003 are under permanent change, a fact which highlights a fiscal instability and a series of personal interest from certain individuals that are part of the law making unit.

The purpose of this article is to prove the disadvantage of the 3% rate to the 16% rate. The result of this article is presented as a launching point for the new laws regarding taxing options at start-up. From this „apparently small” rate companies will be affected through channelling money towards the state budget, even though in the first months at start-up, all companies report accounting and financial loss.

One complex issue in practice is the tax base. Most tax bases are subject to interpretation and the lawmaker allows permanent contradictions between accountant and fiscal authority regarding this subject. The establishment of a tax base is accomplished more easily for micro businesses and more difficult for corporate tax paying companies.

2. Micro business – a seemingly advantageous entity from a fiscal perspective

The following steps need to be taken in order to determine the net profit of micro businesses:

1. calculating the total income of the micro business as the sum of all income categories earned within a quarter.
2. determining the tax base for the income:

$$V_i = V_t - V_n - V_{cm} \quad (1)$$

where:

V_i - tax base;

V_t - total revenues;

V_n - tax free income;

V_{cm} - acquisition cost of the electronic cash registers in the quarter they were put into service.

The tax base will be determined through an extra-accounting method, as it will not be recorded in the micro business accounting records.

The category of taxable income not includes:

- revenue corresponding to the cost of product stock. These types of incomes registered in accounting are tax free, as they represent potential revenue and compensate some of the costs incurred previously to obtaining goods;
- revenues from the production of tangible and intangible assets. The reason for not taxing these incomes is similar to the one from the previous category;
- income from provisions. Revenues in this category are not subject to taxation because they do not represent economic benefits;
- income from cancellation of interest rates and late payment penalties which are not tax deductible;
- amounts received as compensation from insurance companies for damages registered in the micro business's portfolio. These are not subject to taxation because it is believed that events such as those presented here are unusual in Romania;
- the amounts resulting from the transfer of income from government grants towards financial investments.

3. determining the income tax for micro businesses:

$$I_{vm} = V_i \times c \quad (2)$$

where:

I_{vm} - income tax for the micro business;

c - the 3% tax rate applied by every micro business.

4. determining the net profit of the micro business

$$P_{net} = V_t - C_t - I_{vm} \quad (3)$$

where:

P_{net} - net profit;

C_t - total expenses without the income tax.

Even though expenses are not taken into account for determining income tax of micro businesses, the amortization expenses have to be highlighted, so that when passing to a corporate tax system there will be clear rules regarding the deduction of these expenses.

In the following paragraphs we will present a few practical examples that involve certain characteristics of taxation for micro businesses.

Example 1. A micro business has the following information, year N:

Table-1: Information for quarter 1 and 2 at a micro business, year N

No.	Parameters	Amounts on 31.03.N	Amounts on 30.06.N
1	Rent income	1.193,97	3.557,70
2	Merchandise sales income	111.762,82	328.772,64
3	Finished goods sales income	6.983,89	43.798,59
Total		119.940,68	376.128,93

The total expenses for the first and second quarter amount to 340.358,69, and the total revenue is RON 376.128,93.

For the first and second quarter, deductible expenses amount to 6.702 RON:

- Insurance premiums 183 RON;
- Expenditure on other services provided by third parties 464 RON;
- Expenditure of exchange differences 83 RON;
- Other financial expenses 2.374 RON;
- Income tax expense for the first quarter of 3598 RON.

Calculate the income tax and corporate tax for quarter 1 and quarter 2.

Key:

For the 1st quarter the income tax will be:

Income tax = Tax base x 3%

Income tax = 119.940,68 x 3% = 3.598 RON

For the second quarter, the income tax to be paid by the micro business is:

Cumulative income tax = 376.128,93 x 3% = 11.283,87 RON

Income tax to be recorded (quarter 2) = 11.283,87 - 3.598,22 = 7.685,65 RON

As the company has surpassed the 65.000 EUR turnover in the second quarter, it will have to file a notification to the state authorities, through statement 010" Tax Registration / Declaration for legal persons, associations and other entities without legal character" regarding the change from income tax payer to corporate tax payer starting with the second quarter (namely 01.04.N).

For the second quarter, the company will become a corporate tax payer and the amounts will be:

Gross result = Total revenue - total expenses (4)

Gross result = 376.128,93 – 340.358,69 RON = 35.770,24 RON

Taxable result = Gross result + Non-deductible expenses - Tax free income (5)

Taxable result = 35.770,24 + 6.702 = 42.472,24 RON (6)

Corporate tax = Taxable result x 16%

Cumulative corporate tax = 42.472,24 x 16% = 6.796 RON

- registration of the income tax for quarter 1 into the accounting journal :

<u>698</u> „Other taxes not listed above”	=	<u>4418</u> „Income tax”	3.598
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- at the same time account 698 „Other taxes not listed above” is closed:

<u>121</u> „Profit and loss”	=	<u>698</u> „Other taxes not listed above”	3.598
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- payment of the income tax :

<u>4418</u> „Income tax”	=	<u>5121</u> „Bank accounts in RON”	15.000
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The recorded income tax is 3.598 RON, and for the second quarter the corporate tax will be 3.198 RON resulting from the accounting formula (6.796 – 3.598=3.198; only the income tax for the first quarter will be taken into account, as from quarter 2 the company will start to pay corporate tax):

<u>691</u> „Expenses with corporate tax”	=	<u>4411</u> „Corporate tax”	3.198
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The following conclusions can be drawn from the present case :

- the tax base is recalculated in the second quarter based on other stipulations of the Fiscal Code. These changes, throughout a financial exercise, causes problems at the level of a professional accountant in terms of calculations, filling in statement 101 at the end of the financial exercise. But the lawmaker does not consider, and in fact does not have knowledge of these aspects. This matter represents a negative aspect in the mentality of the Romanian lawmaker: he does not care about effects, only about momentary personal interest.

- The tax is calculated differently for the two quarters. The Romanian lawmaker introduced the principle of consistency of the method. But why does he not want it to be respected in practice? Because in Romania, principles are not taken into account; the only thing that matters are the rises, the taxes in need to be paid. Another conclusion derives from this, namely that true managers are missing from the administration. At present, the destabilization caused by the Government to the staff in Fiscal Administration causes a great deal of moral and psychological damage to state employees as well as tax payers. Educated staff in the government migrates towards the private sector and this can lead to: uncollected taxes, tax fraud, corrupt tax inspectors and finally, a disappointed population.

Example 2. A small business present, during the first quarter, year N, the following information: total revenue 700.000 RON, out of which 200.000 RON own production income and 100.000 RON own production sales income (these numbers have been takes out of the trial balances). Also, an electronic cash register was purchased with a tax invoice during the same quarter, acquisition cost 900 RON. The electronic cash register was used starting with April 1, year N.

- a) determine and record in the general ledger, the income tax corresponding to the first quarter;
- b) the due date for the income tax payment;
- c) register in the accounting the income tax payment.

Key : a) determining total income

$$V_t = 700.000 \text{ RON}$$

- Determining the taxable amount:

$$V_i = 700.000 - 200.000 = 500.000 \text{ RON}$$

- calculating the income tax :

$$I_{vm} = 500.000 \times 3\% = 15.000 \text{ RON}$$

- recording the income tax in the general ledger:

698 „Other tax expenses not listed in the above elements”	=	4418 „Income tax”	15.000
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- simultaneously the account no. 698 "Other tax expenses not listed in the above elements" is closing

121 „Profit and loss	=	698 „Other tax expenses not listed in the above elements”	15.000
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b) the income tax payment of 15.000 RON must be completed by April 25 for the first quarter.

c) registering the 15.000 RON income tax payment in the general ledger based on the payment order and the banking statement issued by the bank that administers the micro business's account:

4418 „Income tax”	=	5121 „Bank accounts in RON”	15.000
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3. Conclusions

First conclusion: the micro business will pay the income tax to the state budget, even if it reports loss in the profit and loss account. And currently in Romania, any company is established at the Trade Registry and has the status of micro business.

Second conclusion: the micro business will pay a higher tax by applying the 3% rate compared to the 16% rate on taxable income. A cash transfer takes place from the micro business to the state budget and the taxpayer has the impression that he has an advantage through the income tax system. The taxpayer does not essentially make these calculations, but only compares the two rates: 3% and 16%. And psychologically, he believes the state favours him by 13%, but reality shows the opposite. Before the 3% rate, the lawmaker used a 1.5% rate. If uniformity is not desirable in terms of taxation we recommend the 1% rate for all income tax paying entities so that both the taxpayer and the state budget will be favoured, as there is no temptation to reduce the tax base .

Third conclusion: we recommend the Romanian lawmaker come back upon the law and consider all types of entities as corporate tax payers (at the time of registration at the Trade Registry, the companies are listed as income tax payers by default). In this manner, controlling authorities would mould onto this type of check and would force companies to control their costs and track profitability. In the case of micro businesses, the state is only interested in cashing in the money, not in the longevity of the company. In the case of micro businesses, the state is at a loss for the future, as many companies face insolvency and finally bankruptcy.

Fourth conclusion: by introducing a single type of taxation, a cleansing process would be achieved in the fiscal records; certain fiscal statements could be eliminated (statement 010, for instance, which is now filed when passing from income tax to corporate tax). The chaos provoked by the introduction of separate tax systems seems to be deliberate, as within an organized chaos certain hindering taxpayers can no longer be checked upon. Moreover, the state needs to know, that not all tax payers are criminals and there are honest companies that wish to pay their social and fiscal contributions.

References

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