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Problematic Aspects of the Connection between Financial Accounting Standards and Legal Entities' Taxation on Corporate Income

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The purpose of this article is to analyse and assess comprehensively, in theoretical and practical aspects, the theoretical and practical problems of application of financial accounting standards when imposing tax on corporate income of legal entities, provide potential solutions to the problems, thus identifying necessary changes in tax law in the Republic of Lithuania.

Keywords: financial accounting, corporate income tax, tax law, financial accounting law, taxation
JEL Classification: K 34, K33

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Introduction

Over the past decade, corporate income tax, as one of the most important revenue sources, has accounted on average for 8% of total revenue in the state budget of the Republic of Lithuania. In order to determine the corporate income tax rate payable (to fulfil properly taxpayer's tax obligation), it is necessary to access information on the real status of taxpayer's property and its financial condition, to identify which financial accounting comprehensively governed by legislation is required.

The subject of the research is application of financial accounting standards in the Republic of Lithuania when imposing tax on corporate profit of legal entities in accordance with the current Law on Corporate Income Tax of the Republic of Lithuania (Republic of Lithuania Official Gazette, 2001) (with amendments and additions, hereinafter called the LoCIT) and revealing expedient changes in the current LoCIT.

Corporate income tax base is a taxable profit, not a real company's activity result (financial profit, calculated on the basis of legislation regulating financial accounting), but an 'artificial amount', identified applying specific rules prescribed in the LoCIT. On the basis of the fact that not the 'artificial' result of companies but precisely a real financial result should be taxed, in this article the issue of application of financial accounting standards to the legal tax relations (when imposing tax on profits) is raised, this way nearing legal regulation of corporate income tax to financial accounting.

Nevertheless, the relevance of the publication topic cannot be evaluated in the context of finance (tax) law science only – issues on the relation between corporate income tax and legal regulations being analysed in the article partly could be developed and analysed further not in the context of law, but that of economic science (audit, financial accounting, public finance). Attention should be paid to the fact that while analysing the extent of research of the problem being investigated in this study in foreign countries, it has been noted that in these countries an increasing number of precisely legal researchers carry out their work related to this problem. For example, C. P. Mitran, D. Nerudova, H. Bohušova, L. Lehis, M. Bebeselea, P. L. Vesterdorf, P. Svoboda, R. Dorsey and others, recently have raised problematic issues concerning the relation between corporate income tax and financial accounting legal regulations increasingly actively; they emphasise the relevance of transfer of financial accounting provisions to the laws on corporate income tax in their countries. The topics being analysed by such authors justify the relevance of this topic to the research in the finance and tax law in the Republic of Lithuania as well. The following authors in the Republic of Lithuania have mentioned the relation between financial accounting and corporate income tax in their works: A. Ivanauskienė, B. Jefimovas, D. Pučkienė, G. Kalčinskas, J. Bikienė, J. Bukevičius, J. Mackevičius, K. Rudžionienė, K. Senkus, R. Budrionytė, R. Kanapickienė, R. Subačienė, V. Lakis and others, still, just generalising in the context of economic science (from the perspective of financial accounting), not going deep into the problems of corporate income tax and financial accounting legal regulations. Therefore, the publication topic is especially relevant in the sense of novelty and need to analyse such legal regulations through provision of proposals how to administer corporate income tax and fulfil taxpayers' obligations more effectively.

The aim of the publication is to analyse and assess comprehensively, in theoretical and practical aspects, the theoretical and practical problems of application of financial accounting standards when imposing tax on corporate income of legal entities, provide potential solutions to the problems, thus identifying necessary changes in the LoCIT. In addition to this, the purpose of the article is to describe the author's main research findings and to deduce the independent results at the end of the article. In order to achieve this aim, the following objectives of the article are raised:

1. To conduct analysis of competing attitudes and theories concerning the relation between corporate income tax and financial accounting legal regulations, overviewing the existing research cases and empirical data.
2. To introduce problems of corporate income tax accounting (tax accounting) as a legal phenomenon, presenting its legal definition and identifying its place in the systems of accounting and legal meaning.
3. To provide an answer to the question what principles of financial accounting are applied when imposing tax on profit in reality.

A comparative method has been applied to the analysis of works by authors from abroad who have investigated differences between corporate income tax and financial accounting legal regulations and assessed them, together with different approaches and theories on the same topic.

The analytical method of law investigation has been applied when analysing the legal meaning of corporate income tax accounting (tax accounting), and what principles of corporate income tax computing based on the LoCIT are applied in reality, what BAS provisions should be transferred to the LoCIT.

Theoretical problems of the subject matter

The analysis of the theoretical problem of the subject matter of this publication indicates that the analysed topic has its own relevance, novelty and originality.

R. H. Coase, a British economist, pointed out that "lawyers themselves will take from the economics theory any experience beneficial to them and due to this, they will have a decisive advantage against economists when carrying out research in some specific fields they know better" (Posner, 2004, p. 310), for example, in tax law. R. A. Posner, who criticised the statements that law is a matter for persons with legal education only, and that economic science is a matter doctors of economic sciences are concerned about and nobody else, accepts this approach. Not only in the works by such authors but also by other scientists, such as F. A. von Hayek (1998, pp. 173–175; 1999, pp. 83–86), R. Dworkin (2005, pp. 291–293, 295) and H. J. Berman (1999, p.27), one can read that an interdisciplinary approach and application of specific knowledge of economic sciences to research in law is a feature of constructive legal regulation creation, to be encouraged and reasonable. It should be noted that in the theory of law one can meet even ideas maintaining that taxation, tax income collecting in the state budget and tax reallocation (hence application of financial accounting standards necessary to impose corporate income tax on legal entities, as after the provisions of financial accounting have been incorporated into the rates of tax on profits, they become tax provisions) are not a subject of economics but that of jurisprudence only. The latter statement is postulated by R. Nozick in the so-called libertarian theory (Internet Encyclopedia of Philosophy, 2020), and also it may be discernible in such a paradigm of law as utilitarianism (Davies, Holdcroft, 1991, pp. 205–212). Nevertheless, not making an absolute the validity of these theories, and not denying the interdisciplinary approach of the publication itself, it should be stressed that intellectual, technical and economic development of mankind is constantly affecting law, therefore, over the last decades, besides the traditional institutions regulating legal relations, new, complex and detailed legislations occur that regulate important fields of economic-legal relations (Didžulis, 2012, pp. 161, 168–169).[1] R. Van den Bergh points out that law experts that specialise in specific sub-branches of law not only must, but also are obliged to investigate economic science institutions, which is justified by both the results of the latest research conducted and their successful subsequent application to the practice of law (Van Den Bergh, 2014). Finally, it should be noted, without seeking to describe numerous statements made by academic legal community representatives and practitioners from the Republic of Lithuania and abroad regarding specific interdisciplinary research in law (especially in the law of finance and tax), that at present, there is a lack of research in legal regulations concerning certain taxes (for instance, corporate income tax) that would scrutinise problems of theoretical and especially practical discourse.

In the recent works by law scientists, a need for law science to "open its shutters completely at last" is stressed[2] and be not afraid to use knowledge of other fields (e.g. economic science) that assist in formulating comprehensively justified findings of investigation in such a specific branch of law as finance (tax) law, the more so, that in the modern mobile business world, the relevance of interdisciplinary research is obtaining an increasing value, and due to increasingly enhanced interaction between social sciences (especially between law and economics) it is not sufficient to limit themselves to the 'mere theory of law or economics.

It should be noted that in the works of the Lithuanian Republic law researchers, one can notice insights on the basis of which some links can be

[1] In this case, the analogous insights by the law researcher L. Didžiulis have been cited regarding complex and detailed legislation, regulating important fields of economic relations. The author also emphasises the signal from the market when applying substantive law to take into account a specific structure of the financial sector together with finance business features.

[2] For example, R. Van Den Bergh (2014).

found for the genesis of the article topic relevance and 'maturity' to launch investigation. One should agree with J. Galginaitis's precise observations dated 2002, maintaining that in order to comply with requirements set for positive law, such as reflexivity (an ability to show social life) and dynamics (an ability to keep pace with life, sometimes formally remaining unchanged), the positive law is forced 'to overstep itself' and its own dogmatic system; that not so much the system of positive law should be stressed, but the importance of a legal system that includes many more elements significant in the sense of social attitude than just legal norms and other parts of a legal text; that law becomes increasingly complex, in reality it becomes including everything and requiring specific professional knowledge (2002, pp. 35, 37) (for instance, specific financial accounting knowledge as means for creating justified substantive rates of taxation on profits). A. Vaišvila also agrees on the latter, he stresses the linkage between economic science and law science (2004, p. 217). In addition, E. Kūris specifies a tendency – an increasing influence of financiers and auditors (financial accounting specialists) on law, and is referring to these fields as "fields closely linked to law" (1997, pp. 395–396), while G. Užubalis highlights specifically that until there is no accounting of income, no corporate income tax could exist (2011, p. 171).

Practical cases research in the relationship between financial accounting standards and taxation on corporate income

As mentioned before, the publication topic is especially relevant in the sense of novelty and need to analyse such a legal regulation through provision of proposals how to administer corporate income tax and fulfil taxpayers' obligations more effectively. Consequently, the practical aspects of the connection between financial accounting standards and legal entities' taxation on corporate income are very important in this research.

It should be noted that, according to A. Linartas, director of the Audit and Accounting Authority (hereinafter the AAA), in the Republic of Lithuania 168 enterprises (LLC and PLLC) prepare financial statements on the basis of international legislation regulating financial accounting, and this accounts for just 0.3% of all enterprises. Other enterprises prepare financial statements on the basis of Business Accounting Standards (hereinafter the BAS) (Žeimantas, 2013, p. 14). The national legislation regulating financial accounting (the BAS) provides detailed provisions of international legislation regulating financial accounting that introduce guidelines and general principles, therefore, while analysing the application of financial accounting standards when imposing tax on corporate income of legal entities in the Republic of Lithuania, the relation between the LoCIT and financial accounting that is managed in accordance with the BAS is analysed[3] (thus, the 'financial accounting standards' wording, used in the title of the research, specifically means the BAS). In addition, the research has been carried out focusing on a group of corporate income tax payers most widely operating in the Republic of Lithuania– limited liability legal entities, i.e., limited liability companies (hereinafter – LLC (lith. AB) and private limited liability companies (hereinafter – PLLC (lith. UAB) (*Taxes paid by companies...*, 2020). It should be noted that financial accounting based on the BAS of other types of legal form corporate income taxpayers, for example, sole proprietorships, small partnerships, etc., is of a particular specificity. Therefore, the subject matter of the article should be named as follows: theoretical and practical problems of the application of provisions of financial accounting managed on the basis of the BAS to limited liability legal entities LLC and PLLC when they are taxed on their profit.

[3] In other words, the BAS implements international legislation regulating financial accounting, BAS provisions in their major part coincide with the provisions of international legislation regulating financial accounting or complement them, therfore, precisely the BAS perspective is analyzed.

The importance of practical cases research of the subject matter is also highlighted by the practice of the European Union (hereinafter – the EU) law. The results of working groups of tax law of European institutions clearly reveal the need to analyse the relation between corporate income tax and financial accounting legal regulations, thus transferring specific provisions of financial accounting to the regulation of imposition of tax on profit. The compromises, achieved by Member States in the meetings of the Direct Tax Working Group of the Council regarding the Council's directive for the common consolidated corporate income tax base, which was included in the European Commission Proposal dated March 16th 2011, and is analysed in a separate sub-topic of this publication, clearly illustrate valuation of financial accounting provisions as an integral phenomenon acting in the tax legal relations in the aspect that in the legal regulation of financial accounting there are some rules met, which, in the case of their incorporating into regulations of corporate income tax system, this phenomenon would be provided with more clarity and stability. It would cause the erosion in the corporate income tax base to stop (Taxationand Customs Union). This is justified by specific examples: the conditions of taxable income recognition in such a directive project *expressis verbis* have been transferred from the 14th Article (hereinafter – the Article) of the 18th IAS 'Income'[4] (OG, 2008, pp. 147–154), recognition of deferrals as the condition of allowable deductions – from the 37th IAS 'Deferrals, Indefinite Obligations and Indefinite Assets'[5] (OG, 2008, pp. 392–406), etc.[6] Inter alia, a working group of the European Commission that launched its activity on June 10th 2013 regarding aggressive tax planning and double taxation (Taxationand Customs Union), and an *Empirical Study of Applied Corporate Income Taxation for SMEs Compared to Large Enterprises*, organised by the European Commission (VVA-Europe Ltd.,2013, pp. 12–19) also implies simplification of the rules on imposition of tax on profits, thus nearing the basis of this tax to the accounting result.

What is more, the practice of institutions dealing with tax disputes interpreting the BAS application to tax legal relations declares the importance of practical research of the subject matter: mostly resolutions and decisions issued by the Supreme Administrative Court of the Republic of Lithuania (hereinafter the LSAC) and the Tax Appeals Commission under the Government of the Republic of Lithuania (hereinafter the TAC). To sum up the question of resolutions and decisions,[7] it shall be underlined that for taxable income recognition using the accrual principle there must be followed these conditions: 1) the selling entity has transferred to the buyer the risks and rewards of the ownership of goods; 2) it is probable that the economic benefits associated with the transaction will flow to the entity and the amount of revenue can be measured reliably; 3) the costs related to the sale transaction can be measured reliably. Consequently, costs recognition terms for taxation purposes are: 1) only that portion of expenses of the previous and reporting periods that

[4] Approved on November 3rd 2008 by Commission regulation (EC) No. 1126/2008, which adopts specific international accounting standards in accordance with European Parliament and Council regulation (EC) No. 1606/2002 (with amendments and additions, hereinafter– 18th IAS).

[5] Approved on November 3rd 2008 by Commission regulation (EC) No. 1126/2008, which adopts specific international accounting standards in accordance with European Parliament and Council regulation (EC) No. 1606/2002 (with amendments and additions, hereinafter– 37th IAS).

[6] *Presidency to Working Party on Tax Questions – Direct Taxation* (2020), pp. 15–16; *General Secretariat of the Council to Delegations* (2020), pp. 14–16.

[7] For example, Supreme Administrative Court of the Republic of Lithuania (2013) decision in administrative case No. A-556- 2311/2013; Supreme Administrative Court of the Republic of Lithuania (2013) decision in administrative case No. A-602- 1718/2013; Supreme Administrative Court of the Republic of Lithuania (2013) decision in administrative case No. A-602- 462/2013; Supreme Administrative Court of the Republic of Lithuania (2012) decision in administrative case No. A-602- 1161/2012; Supreme Administrative Court of the Republic of Lithuania (2012) decision in administrative case No. A-438- 92/2012.

is related to the income earned during the reporting period is recognised as costs; 2) the costs related to the sale transaction can be measured reliably. In addition to this, there is a special term for the appropriate executing of tax burden – to answer the question whether the Law on Corporate Income Tax does not provide otherwise. It is important to explain that the conditions for the recognition of income and costs explained in the case law clearly show that the taxation of corporate income tax is based on financial accounting rules. Precisely, the recognition of income and costs for corporate income tax purposes is taken literally from the financial accounting rules. This example shows that legal regulations of taxation on corporate income were developed in accordance with financial accounting rules. Consequently, this example of case law has been chosen with caution to illustrate the impact of financial accounting on the regulation of corporate income taxation.

As a consequence, the mentioned decisions issued by the LSAC disclose that the comparison between costs and income (the matching requirement) cannot be described as self-dependent principle. The core subject matter should be identified as one of the term following the accrual principle application for the purpose to tax on corporate income. According to the matching principle (requirement), costs related to different tax periods should be recognised in tax periods in which taxpayers gain income as it shall not be reversed (income shall not be recognised in different tax periods as relating to incurred costs). Furthermore, research reveals that the comparison between costs and income as costs should be directly linked to income gained in an exact tax period is not absolute in tax law. Formal contravention of the matching principle (requirement) could be acceptable if tax abuse or distortion of corporate income tax base are not identified. Inter alia, analysis of the matching principle (requirement) shows that identification of taxpayer‘s dishonesty automatically does not lead to the forfeit of costs related to income deduction. These thoughts are based on the scientific research of tax disputes cases about the connection between financial accounting standards and legal entities' taxation (on corporate income tax).

In addition to this, it should be mentioned that since the beginning of the year 2015, the following institutions have launched their activity intensively: the State Tax Inspectorate under the Ministry of Finance of the Republic of Lithuania (hereinafter – the STI under FM) and a permanent working group of AAA specialists, which analyses causes and cases of differences and similarities between provisions of the LoCIT and financial accounting managed in accordance with the BAS, and classifies in respect to various topics (for instance, long-term tangible asset depreciation/amortisation, income recognition etc.), thus seeking both to facilitate corporate income tax administration and assure the quality of financial statements. The results of analyses being conducted by the permanent working group (cases of differences between the LoCIT and BAS met, their practical examples, identification methods) will be summarised and publicised on the websites of the STI under FM and the AAA. This will assist taxpayers in identifying such differences and facilitate fulfilment of proper tax obligations[8] (*STI under FM...*, 2020). Thus, the existing practical problems and collaboration that starts between institutions 'are sending a clear signal' that at present there is a proper time instance to conduct also scientific research in the specific field of legal regulation being analysed, which could both assist such institutions to achieve constructive results and initiate potential changes in the LoCIT, coordinating with financial accounting legal regulations.

Before presenting conclusions and suggestions at the end of the article, it is important to justify the basis on which these conclusions and suggestions are put forward. There is presented the theoretical problem of the subject matter of this publication in the first part of the article. What is more, there

[8] It should be noted that the STI under FM and AAA, some decade ago, also conducted similar collaboration in order to analyse and show differences between rates of the LoCIT and financial accounting, still, this collaboration was interrupted, while the material prepared at that time is not relevant at present.

is presented practical cases research of the relation between financial accounting standards and taxation on corporate income in the second part of the article. It is important to explain that the article does not aim to quote and analyse the LoCIT and court practice in detail, but the following conclusions and suggestions are presented based on the LoCIT provisions and court practice mentioned in the article above, as well as a systematic summary of the analysis performed in both parts. In addition, it should be mentioned that these suggestions and conclusions are not presented as concrete summaries of the analysis, but as independent result based on the sources analysed in the article, also developed by analysis by independent national research of the author about the connection between financial accounting and corporate income tax.

Conclusion

The findings of the analyses indictate that proposals and conclusions shall be divided into four separate parts, which shall be described as research result core-matter of the article:

1. The differences between provisions of the LoCIT and financial accounting must not be absolutely abolished; still, they should be minimised, matching the LoCIT to the BAS provisions. Such an equalisation of legal regulations can be justified by optimising the costs of the tax administrator and taxpayers to administer/compute their corporate income tax, simpler declaration of corporate income tax and clearer application of the LoCIT provisions.

2. Separation of the financial accounting from corporate income tax accounting (tax accounting) determines a clearer system of precise tax assessments of business facts that should be referred to by both taxpayers who want to fulfil their tax obligations properly and the tax administrator who controls the process of fulfilling these obligations. A legal concept of corporate income tax accounting (tax accounting) is to be proposed, which is possible in the tax law theory: a field of financial accounting being regulated by the LoCIT in which the system of registration, classification and generalisation of business operations and business events, expressed in money and intended for fulfilment of an entity's tax obligation, is managed.

3. When imposing the tax on corporate profit (systematically referring to the LoCIT, practice of institutions dealing with tax disputes), in reality the principles of accumulation (including the requirement of income and expense comparison), the enterprise, periodicity, currency unit and substance over form principles are applicable. Such financial accounting principles as the following: continuity of enterprise activity, stability, caution and neutrality are not relevant (not applicable) when imposing tax on profit. Article 7 of the LoCIT should be complemented (one part each, adding one more part to this Article). It should regulate that sales income and expense are recognised on the basis of conditions prescribed in the BAS, except for the cases when this contradicts with specific provisions of the LoCIT or the purpose of the LoCIT. A 'mixed combination of money and accumulation principles' entrenched in Article 8 of the LoCIT and its application intended in Article 9 of the LoCIT should be abolished, foreseeing that instead of it the accumulation principle would be applicable, as in financial accounting.

4. Prior to adopting amendments to the LoCIT, also when the tax administrator is preparing the comment on the LoCIT, and corporate income taxpayers and the tax administrator are assessing specific practical situations, it is purposeful at all times to assess possibilities of the application of financial accounting provisions when imposing tax on profits.

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