

# *The use of debt as a tax avoidance form in Albania*

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## **ABSTRACT**

*Under the Albanian law, the entrepreneurship may be organized in any of the following forms: the sole entrepreneur, general partnerships, Limited Liability Companies (Shpk), Joint Stock Companies (SHA).*

*Limited Liability Companies, otherwise known in Albanian law as "sh.p.k", are companies founded by natural or legal persons whose liability for obligations undertaken by company are limited to their contribution and the share is divided in proportion of the contribution. The basic capital of a "sh.p.k" (or LLC) is fixed to ALL 100 and cannot offer its shares in public. Our research interest will be focused on Limited Liability Companies and their financing activities. These activities include financing in forms of debts or loans and owner's contribution.*

*Otherwise, the owner may grant funds to the business, the loan is formal with a contract including interest; interest on the loan is taxable to the owner personally when it is repaid. The repayment of the principal is not taxable, since one has already paid the taxes on it and this is the first reason why we often find "Owners Liabilities/loans" in the liability section of the balance sheet. As this item, found in the balance sheet can be included, funds are withdrawn by the owner for "an illegal" purpose, such as bribery.*

*Many companies face bribery and other non-declared transactions. There appears to be no unified definitions of bribery that specifically states what is considered bribery. However, it is globally recognized as giving a reward or 'knockback' to a person, in an attempt to sway opinions or behaviors for personal advantages.*

*In this paper, we look through a descriptive and comparative analysis at how companies use debt to avoid tax, actions and policies government is expected to take and what is the current approach to combating this form of tax avoidance, and what more needs to be done.*

*The focus of this paper is to consider debt as a deductible cost, but many of the same issues arise for other deductible costs, such as management fees, insurance contracts or intellectual property fees. The aim will be to have a look at how companies account for bribes paid to third parties in their financial statements and what should be done to detect and prevent this phenomenon?*

**Keywords:** *Loan, tax evasion, IFRS, Fiscal policies.*

## **Introduction**

Financial statements are used by entities to accumulate and report financial information about the performance, financial position and cash flows of a business. Entities need information to manage the business, to invest or to lend money to it. They are aimed to systematically record transactions, sort and analyze them. Nevertheless, financial statements compiled under the full set of characteristics of qualitative information fall under the whirlpool of financial information manipulation. What is accounting manipulation in itself? What are the main traits and techniques? What is the niche allowed by the standards and what is the tendency of auditors to profit from it?

Accounting, in itself, is a subject based on social ethic much more than it is usually considered. The history of financial manipulation is older than it might be considered. Most of the auditors refer to the well-known examples of last World Crisis, such as: Enron, Lehman Brothers, but indeed accounting manipulation dates from area of Luca Pacioli. Almost 500 years ago he shaped the practices of creative accounting in his book "De Arithmetica".

Other authors, such as Copeland, invented the term to be referred to as "some ability to increase or decrease reported net income, at will".

The history of accounting in Albania is relatively young. The first plan of accounts was presented by Mr. Jani Vreto. After the declaration and establishment of Albania's independent state there was emerged the need to have and establish an accounting organization and regulation for registering the incomes. The next phase that marked a positive transition was the period where Albania started the implementation and convergence of International Accounting Standards, in 2008. After this period, financial statements had a better information quality and equal chances to be presented in broader markets, outside Albania.

However, despite all the measures taken, Albania faces a constant challenge in information asymmetry between all parties involved in economic relations.

In this paper, we look through a descriptive and comparative analysis at what practices are mostly used by companies to use debt to avoid tax, what actions and government policies are expected to take and what is the current approach to combating this form of tax avoidance, and what it needs to be done in this regard. We take into focus some of the motives for creative accounting. We look for the development presented in scientific databases in evaluations of debt as a deductible cost, as we face that the same issue arise for other deductible costs, such as: management fees, insurance contracts or intellectual property fees.

There appears to be no unified definitions of bribery that specifically states what is considered bribery. However, it is globally recognized as giving a reward or "kickback" to a person, in an attempt to sway opinions or behaviors for personal advantages.

## Literature Review

Previous publications are giving us an insight on the development of relation between tax and debt. These two factors cannot be studied as separate element, but they will be studied in samples with more variables, as it happens in the dynamic of the business.

Numerous studies from researchers such as (Desai. M.A ., Dharmapala .DH, 2006) , (2009); Ge.W (2006); They concluded in their research that there does exist a relationship that approves the agency perspective that emphasizes the relationship between corporate governance and proves that management tries to profit from tax shields in creating a diversion of rents when applied the tax avoidance activities.

Other researchers conducted studies where finding stated that the cost of debt of a firm is determined by the characteristics of the firm. These characteristics affect

default risk, agency cost and the information asymmetry problem as presented by (Centindamar and Husoy ,2007)

The average effect of tax avoidance on firm value was with little significance on cost of debt. It is stated that in firms that are well governed entities have a positive effect on the cost of debt caused by the tax avoidance practices.

Practices, such as: tax avoidance, may cause agency conflicts between management and debtholders. Despite the efforts to create tools that can monitor managerial performance, still there can be created managerial rent diversions that induce information asymmetry.

Other studies conducted by Fernandez (2004) and Massari et al. (2008) give recommendations that tax shelters and tax avoidance are a substitute for the use of debt.

Fernandez (2004) states that it is important to give recommendations to managers, treasurers and CFOs to re-valuate their companies' debt policies. Firms should made careful calculations on the benefits obtained by increasing leverage. If the entity is in the position on using debt and the profits of its usage will be larger than not using it then it is recommended to increase leverage. If not, the firm should not consider at using debt.

Massari et al. (2008) examines whether participating in tax avoidance activities is negatively associated with the cost of debt (COD), and whether institutional investors, as shareholder activists, intensify the effect of tax avoidance on the COD. They have found a negative relationship between tax avoidance and the COD for a large sample of Korean firms, supporting the trade-off theory. Further tests reveal that the negative relationship becomes stronger when institutional investor ownership is high.

The above results of the searches indicate that firms use less debt when they engage in tax sheltering. Using the tax avoidance measure modified from Desai and Dharmapala (2006), Fernandez (2004) determines the existence of a substitution effect of tax avoidance for the use of debt for a large sample of Korean firms. These results were consistent with the results of Inselberg and Kaauford (2004). If tax avoidance is a substitute for the use of debt (Cooper and Nyborg (2008), Hoti (2014)), it could increase financial slack, reduce expected bankruptcy costs, enhance credit quality, lower default risk, and therefore reduce the cost of debt

## **Method**

### **Evaluation of interest and debt from National Accounting Standards and Law on Tax Procedure**

There is a divergence between the Albanian Tax legislation and the part of recognition of the real costs and expenses valued under IAS. Albanian tax legislation does not recognize as tax deductible a large part of costs. For example, there is a fixed rate of depreciation recognized as a deductible expense by tax authorities. In case when entities for different causes or circumstances have passed that rate they might evaluate the depreciation according to IAS for their internal managerial process in decision making, but never the less when compiling financial statements for tax purposes they need to make corrections on expenses recognition only at the approved level of tax authorities. They need to make it accordingly and correctly after their guidance to calculate the tax profit otherwise fiscal penalties get applied upon them.

Often the divergence encourages the entrepreneurs to make changes for decision making purposes, but sometimes they find the niche to use for incorrect behaviors. In cases when there is a need to take a loan entities are encouraged to submit a position/ financial performance financial statement to financial institutions to obtain the LOAN. As banks make the risk evaluation on financial statements information. Tax law makes even some more drastic open niches where bigger abuse finds place. Tax law predicts that when an entity is submitting no profit for three consecutive years, the entity might not be subject of control.

According to international accounting standards, loan interests are evaluated according to the specific of the case they are being treated as part of the performance financial statement or as part of the cost and exposed at the position financial statement. In Albania, all financial statements should be in full accordance with fiscal law nr 129/2016 "Income Tax", as changed. Specifically, the article 21: "Unrecognized Expenses"

For the purpose of determining taxable profit, expenses listed below are not recognized:

- Paid interest that exceeds the average 12-month interest rate on the banking market, according to the official publication of the Bank of Albania.
- Also, according to the normative act No. 5 dated 30.11.2019 it is determined that if during the tax period, the loan and the prepayment exceed on average four times the amount of its own capital, the interest paid for the exceeded amount is not recognized as a deductible expense.
- Except as provided in paragraphs 2 and 3 of the Article, in cases of loans, borrowings of financing by related parties, the excess of the net interest expense exceeding 30 percent of the profit of the tax is not recognized as deductible expenses of the tax period.
- Property, plant and equipment IFRSs: Must be estimated by reporting entity: Revaluation; Amortization, depreciation and depletion;

- Useful life. Albanian tax rules: The rate of amortization, depreciation is determined by tax law. Assets
- Intangible assets. IFRSs: Must be estimated by reporting entity; Useful life; Amortization; Revaluation. According to Albanian tax rules: The rate of amortization is 15 %, based on straight- line method. Revaluation not permitted for tax.

## **Ratio on liabilities/capital**

Most of entities have a tendency to use a higher level of loan and debt, compared to the owner's equity. This derives only due to the favoring of the bankruptcy law in liquidation of the company. The debt-to-equity ratio, also known as risk or gearing ratio, is a solvency ratio that shows the relation between the portion of assets financed by creditors and shareholders. Using figures obtained through financial statements, the ratio is used to evaluate a company's financial leverage i.e. the percentage of financing that comes from creditors and investors. This report shows the extent to which the company is being financed with debt with its own capital. It serves to measure the firm's viability and ability and ability to pay its obligations.

The increase in this ratio is a signal that the company is being financed by creditors, rather than its own resources, which could be a risk signal. Lenders and investors usually prefer these debt-to-equity ratios, because their interests are more protected, their interests are more protected in the event of a potential in the event of a potential business failure. However, leverage is not always a "bad" indicator, as it can lead to an increased return on investment of shareholders. Also, very often there are benefits from taxes, associated with borrowing. In general, a high level of debt to equity indicates that a company may not be able to generate enough money to pay its debts. However, the low level of debt/equity may indicate that a company is not taking advantage of the increased profits that may come from using leverage.

The optimal debt-to-equity ratio is considered to be 1, but this ratio depends on the specific industry, in which an entity operates, because it depends on the composition of current and non-current assets. The more non-current assets, such as capital-intensive industries, the more the capital is required to finance these long-term investments.

To test these theoretical and fiscal restrictions we have worked on the ratios of debt to equity on a group of the most influential of private entities on the sectors with the highest economic growth in Albanian economy. The variables taken into in consideration when choosing the sample are the activity, liability and owner equity.

There are fourteen entities under the study. We have worked on the financial statements submitted to the Business National Database of Albania. Each one of the statements has been double checked by authors whether there are corrections, accounts arrangements, consolidated accounts or other corrections indicated according to fiscal law.

To test this correlation and behavior of entities in Albania we have worked on the reports as presented below on the table.

**TABLE 1.** Table of ratios of liability/owner equity

	ACTIVITY	LIABILITIES	OWNER EQUITY	RATIO LIABILITY/ OWNER EQUITY IN %	RAPORT TOTAL DET/KAP NE HERE
Gener 2	construction	4,005,192,386	3,885,759,963	103%	1.03
Alb-Building	construction	2,158,675,974	4,132,217,263	52%	0.52
Gjoka Construction	construction	6,471,361,229	5,967,527,576	108%	1.08
Fratari Construction 1990	construction	2,441,678,116	1,242,600,243	196%	1.96
Gjikuria	construction	2,611,309,518	542,776,198	481%	4.81
Gega Center GKG	Fuel	317,456,869	711,342,266	45%	0.45
Skenderi G	Fuel	1,088,217,734	294,504,933	370%	3.70
Adriatik Pertolum Albania	Fuel	411,406,724	- 270,279	-152216%	-1522.16
Eroil	Fuel	5,143,912,914	177,484,186	2898%	28.98
Europetrol Durres Albania	Fuel	4,735,605,231	1,924,224,463	246%	2.46
ADD	Distribution	1,282,202,181	2,534,855,992	51%	0.51

Interbrands	Distribution	144,305,232	242,135,999	60%	0.60
Agna	Distribution	5,724,187,306	8,672,065,870	66%	0.66
Marketing & Distribution SHpk	Distribution	2,403,838,162	3,564,358,851	67%	0.67

## Results

As stated by the table we have focused our study in three different fields in our industries.

Construction industry has had the biggest growth during these last 30 years in Albanian economy. Entities operating in this market have been numerous and few of them have stand the challenge of the market dynamics. Here we could state that there are entities that, even though are operating from the beginning, are taking part in biggest projects accomplished still they have a very high rate of liabilities compared to their equity. Interesting, is the fact that companies mostly present a very high level of liabilities compared to their equity. Surprising, to the fact that prices of residential and commercial dwellings is continuously increasing much more that the prices of raw materials and cost of labor has increased during the years.

Another question rises naturally.....how is it possible in these circumstances there is no sufficient self liquidity...where is the profit going to???

The next is fuel. Fuel has another characteristic compared to construction. Fuel industry is naturally characterized by a high level of liquidity. Also, the market of fuel is mainly centralized on the hands of few companies. Even these facts still companies operating in the market are submitting Financial Statements that show a high level of liability compared to their equity. Companies are having a rate higher than 1. Sometimes an absurd one such as a negative one, or higher than 1,2 or even 3.

Distribution is the last sector of economy taken into consideration In our study. As expected distribution sector Is characterized by a normal level of liability over owner equity. Distribution such as fuel industry is characterized by a high level of liquidity, a high turnover rate and is giving satisfactory ratios of profit. Here entities are showing that one of the forms of using the profit is reinvesting it on the company in the operational and managerial transactions. The ratios of liability/ on owner equity are lower than 1.



## Conclusions

It would be unrealistic to think that it is possible to eliminate creative accounting or earnings management practices at all. However, it would be possible to minimize at least the negative effects of them by adopting the accounting standards, giving more importance to ethical considerations and decreasing the flexibility of the managers in deciding among different accounting methods.

Tax is a significant motivator. Imposition of tax levies are based on the income. Tax authorities should find ways to control fiscal evasion and corruption. The motivation for creative accounting is the gap between the actual performance and the firm expectation when there is a significant capital market transaction anticipated.

As previously stated, expenses according to international accounting standard will be recognized as deductible expenses and therefore will be a reduction in profit. As we have stated from our search in databases most of the entities have low capital investment which makes the interest of loan to be a deductible expense.

By placing online cash registers, with a stronger organization and control of the customs system, with new guidelines for controlled payments through banks and especially through the operation of the online declaration system of businesses, we can say that we have a reduction of this asymmetry of information. But a reduction not enough! This is because the administrators' economic units are always prone to corruption and tax evasion and seek to present financial situation totally different to tax authorities in comparison the real financial situation.

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