BUREAU OF
REVENUE &
TAXATION

Tax 502:

2023 Business Profits Tax (BPT) Return Guide

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Gross Revenue

Indicates revenue that is assessed Business Profits Tax

- ✓ Gross revenue from the sale of goods or services including service charges and labor fee charged.
- ✓ Interest earned from business savings accounts in 2023 shown on the periodic bank statements.
    - Note: Interest for time deposit or certificate of deposit accounts is declared on the date of maturity.
- ✓ Gross revenue from rent or lease includes payment received for rental or lease of an asset.
- ✓ Gross Foreign Revenue includes revenue from business conducted outside of Palau without a permanent establishment to tie the revenue too.
- ✓ Gain on the disposal of asset occurs when an asset is sold for an amount greater than the book value of the asset, it realizes a gain on the disposal of asset in simpler terms, the company made a profit from selling the asset.
- ✓ Carry over 1/3 of all trade receivables balance at the end of 12/31/2022 as gross revenue for 2023.
- ✓ Following accrual basis of accounting gross revenue includes amounts recorded as trade receivables. Trade receivables are amount owed to a business by its customers following the sale of products or services on credit.
- ✓ Gross revenue for long-term contracts will be based on the "percentage of completion method.
    - A long-term contract is a construction or engineering contract lasting over 12 months.
    - Percentage of calculation method:
      The cost incurred in period /Total estimated costs X Contract Revenue

Non-Gross Revenue

Indicates revenue that is not to be assessed Business Profits Tax

- ✓ Non-trade receivables. Nontrade receivables are amounts owed to the company unrelated to providing service or selling a product. For example, cash advances for employees or employee loans.
- ✓ Revenue is subject to International Transportation Tax and/or Non-Resident Withholding Tax.
- ✓ Distributions received from resident entities. (e.g., the dividend paid by the resident company).
- ✓ Amounts to the extent exempt from taxation under Chapter 8 of Title 28 or an international agreement.

Accounting Method

The required accounting method for Business Profits Tax is accrual basis of accounting however, you may seek approval to the Director of the Bureau of Revenue & Taxation to account for Business Profits Tax (BPT) following the cash basis of accounting.

Basics of Accrual Basis of Accounting

Revenue Recognition

- ☐ Ensure that revenue is recorded when it is earned, regardless of when the cash is received.
- ☐ Verify that revenue is recognized when goods are delivered or services are performed, and the customer is obligated to pay.

Expense Recognition

- ☐ Record expenses when they are incurred, not necessarily when the cash is paid.
- ☐ Check that expenses are matched with the revenues they help to generate, following the matching principle.

Accrued Revenues

- ☐ Identify any revenues earned but not yet received in cash.
- ☐ Accrue revenue if services are provided or goods delivered, but payment is expected in a later period.

Accrued Expenses

- ☐ Identify expenses incurred but not yet paid.
- ☐ Accrue expenses if services have been received or goods have been used, but payment is not yet made.

Prepaid Expenses

- ☐ Identify expenses paid in advance.
- ☐ Record prepaid expenses as assets initially and recognize them as expenses over the period they benefit the company.

Unearned Revenues

- ☐ Identify cash received in advance of providing goods or services.
- ☐ Record unearned revenues as liabilities initially and recognize them as revenue once the goods are delivered or services are performed.

Depreciation

- ☐ Record depreciation expense for fixed assets to allocate their cost over their useful lives.
- ☐ Ensure that depreciation is recorded as an expense to match the cost of assets with the revenues they help to generate.

Cash Basis vs. Accrual Basis of Accounting

Cash Basis

- ✓ In cash-basis accounting, revenue and expenses are recorded only when cash is received or paid out.
- ✓ This method does not recognize accounts receivable or accounts payable, which means income is recognized when the cash is received, and expenses are recognized when the cash is paid.

Accrual Basis

- ✓ Accrual basis accounting records revenue and expenses when earned or incurred, regardless of when the cash is received or paid.
- ✓ Expenses are recorded when incurred, regardless of when the cash transactions occur.

Principles of Allowable Deductions

- A deduction is allowed for expenditures or losses to the extent incurred by a person in deriving amounts included in gross revenue.
- To claim a deduction, there needs to be a clear connection or link between the expense and revenue earned so that it is evident that deductions occurred as a part of generating revenue.
- An expenditure or loss incurred for a purpose other than deriving gross revenue is not allowed as a deduction.
- Expenditures or losses related to earning exempt income, income subject to non-resident tax, or for purposes unrelated to generating gross revenue (such as personal expenses) are not eligible for deduction.
- Capital expenditure is generally not deductible in one year. Rather, the deduction is allocated for the asset's life (see Depreciation)

Allowable Deductions

The following expenses may be allowable deductions, assuming they satisfy the abovementioned general principles.

- ✓ Bad debts: amounts owed to a company by customers or other parties that can no longer be collected or recovered. These expenses must have been included in net income and now be written off in your accounts.
    - Non-deductible expense: bad debts before 2023
- ✓ Expenses payable or paid for equipment rental expense, i.e., payments to an independently contracted boar operator.
- ✓ Expenses payable or paid to another individual (employer) for services a contracted laborer (subcontracted employee) provides.
    - Non-Deductible: If payments were made directly to the subcontracted employee and not the employee's employer.
- ✓ Fuel expense paid for fuel, i.e., gasoline, diesel, and jet fuel, does not include LPG gas in this line item.
- ✓ Expenses payable or paid for government licenses, permits, and charges such as Custom's entry fee, Koror State wharfage fee, and national and state business licenses.
    - Non-deductible: A fine or penalty imposed for violating any law or regulation, such as penalties and interest for late tax filing or ticket citations.
    - Non-deductible: Business Profits Tax installment payments, Gross Revenue Tax payments, and PGST paid (where you get a credit for that PGST).
- ✓ Inventory Expenses: These are tangible goods held by a company for sale in the ordinary course of the business or for use in producing goods or services to be sold i.e., good. (Details on inventory in pp.8)
- ✓ Loan loss reserve (banks only) provisional amounts covering potential losses from loans and leases that may be repaid in full.
- ✓ Life Policy Reserves (insurance companies only) are funds set aside by insurance companies to cover future obligations to policyholders, primarily related to payment of future policy benefits and claims.
- ✓ Legal, Advertising, and Auditing Expenses

  - Legal expenses include litigation costs, contract drafting and review, regulatory compliance, general legal advice, and consultation. However, legal fees incurred for acquiring, improving, or protecting a capital asset are considered capital expenditure, therefore, part of depreciation.
  - Advertising expenses are costs incurred by a business or organization to promote its products, services, or brand. These expenses include media purchases, creative production, ad placement and distribution, market research and analysis, promotional events and sponsorships, advertising technology, and tools.
  - Auditing expense is the cost incurred by a company for auditing services provided by an external auditor, i.e., external audit fees.
- ✓ Losses on the sale disposal of business capital assets occurs when a capital asset was sold or disposed for less than its net book value in other words, the proceeds from the sale are lower than the asset's recorded value.
- ✓ Non-Wages and Salary Training Expenditure
  - Training Development refers to expenses incurred by businesses for employee training and development programs, including preparation costs to attend training, such as airfare, accommodation, cost of training materials, instructor fees, and course fees.
- ✓ Training expenses incurred by businesses associated with providing training programs to employees. Including costs of designing, developing, and delivering training programs and certification costs.
- ✓ Provision of unexpired risks (insurance companies only) portion of premiums received for insurance policies that have not yet expired.
- ✓ Rent expense is the cost incurred by a business to utilize property or location for an office, retail space, factory, or storage space.
- ✓ Repairs and maintenance expenses incurred for maintaining and repairing assets, however, do not prolong the asset's life more than its determined useful life, i.e.., periodic oil changes for a company vehicle.
- ✓ Royalties are expenses incurred by a company to a third party for using intellectual property, such as patents, trademarks, or other proprietary rights.
- ✓ Utilities expenses are expenses made for electricity and water.
- ✓ Other allowable deductions may include bank charges i.e., LPG gas, merchant fees, office supplies and all other allowable business expense that are not included in line items 11 – 34.

Employee Expenses

- ✓ 200% gross wages and salary deduction for Palauan employees possessing the Skilled Labor Certificate issued by the Palau Community College, i.e., an employee possessing a skilled labor certificate and paid a gross salary of $25,000, an employer is entitled to a deduction of $50,000.
- ✓ Gross wages and salary paid to a Palauan employee while attending a training that is to be considered an eligible training expenditure is allowed an additional 20% deduction for wages paid during their training.
- ✓ All other gross wages and salary payable to employees that are not included in deductions for gross wages and salary for employees possessing a skilled labor certificate and eligible training expenditure.
  - Non-deductible: "Gross wages and salary" payable to a sole proprietor by a business belonging to the sole proprietor. Sole traders cannot pay themselves wages and salary.

- ✓ Non-cash employee benefits include employee housing, transportation, and other fringe benefits.
- ✓ Other employee expenses include the cost of labor permit renewals, cost of airfare, cost of recruitment and health certificates.
- ✓ The employer's share of social security contributions to the employer's employees is deductible.
- ✓ Employer's share of retirement and/or healthcare contributions to the employer's employees.

Special Deduction:

- ✓ Cash donations paid to non-profit organizations not exceeding 5% of annual gross revenue.
    - Non-Deductible: Cash donations beyond 5% of gross revenue limit donated to non-profit corporations.
        - Non-deductible: In-kind donations to non-profit corporations.
    - Non-Deductible: Cash or in-kind donations made to any government agency and/or state government without a state of emergency declaration.

How to Calculate Inventory Expenses?

To calculate inventory expense, you must consider several factors, such as purchases, beginning inventory, ending inventory, and any additional expenses related to maintaining or storing the inventory. The deduction for Inventory expense is also referred to as your cost of goods sold.

Inventory Expense Formula

Inventory Expense = Opening Inventory + Purchases - Closing Inventory

Where:

- Beginning Inventory: The inventory value at the beginning of the accounting period.
  - It is either the previous year's closing inventory value or,
  - For new businesses, the cost of inventory is acquired before business commencement.
- Purchases: The cost of goods purchased during the accounting period.
- Ending Inventory: The value of inventory at the end of the accounting period
  - This is the lower of the inventory's cost or its net realizable value at the year's end.

Allowable costing methods

- Cash Basis Taxpayers:
  - Can calculate manufactured or produced inventory cost using either direct-cost or absorption-cost method.
- Accrual Basis Taxpayers:
  - The absorption-cost method must be used to calculate the cost of manufactured or produced inventory.
- Inventory Identification:
  - The first-in-first-out or weighted average method may be used if specific inventory items can't be readily identified.
- Method Definitions:
  - Definitions for absorption-cost, direct-cost, first-in-first-out, net realizable value, and weighted average methods adhere to Generally Accepted Accounting Principles (GAAP).

The following is a summary of how each of the abovementioned accounting methods for inventory works:

1. Direct-Cost Method

This method includes only those costs directly tied to the production or purchase of inventory. Manufacturing inventory typically involves raw materials and labor used directly in manufacturing. Overheads or indirect costs are not included in the inventory valuation using this method. It's simpler and may be preferred by businesses focusing on direct cost tracking.

2. Absorption-Cost Method

Under the absorption-cost method, inventory costs include all direct costs and an allocated portion of indirect costs (overheads), such as factory rent, utilities, and other manufacturing-related expenses. This method ensures that all costs associated with production are absorbed by the inventory, providing a more comprehensive inventory valuation. It is required for external reporting under Generally Accepted Accounting Principles (GAAP).

3. First-In-First-Out (FIFO) Method

The FIFO method assumes that the first items added to inventory are the first sold. This means that the inventory's cost is based on the oldest prices, which can be beneficial in times of rising prices as it results in lower COGS and higher profits. However, it may also result in higher tax liabilities.

4. Weighted Average Method

This method calculates the cost of inventory based on the average cost of all items available for sale during the period. It's determined by dividing the total cost of goods available for sale by the total number of units available. This method smooths out price fluctuations over the accounting period, providing a middle ground in terms of cost of goods sold and profits reported.

Closing Value Determination

The regulation also mentions that the closing value of inventory must be the lower of the cost or net realizable value (NRV). This principle, known as the "lower of cost or market rule," ensures that inventory is not overstated on the balance sheet. If the market value (NRV) of the inventory falls below its cost, the inventory is written down to reflect this loss in value.

Application in Tax Accounting

For tax purposes, the choice of inventory accounting method can significantly affect the taxable income. Businesses must adhere to the consistent use of the method chosen and comply with the tax regulations specific to their jurisdiction. The methods outlined adhere to GAAP, providing a framework for transparent and accurate financial reporting

Example 1: A construction company is building a house and purchases materials such as lumber, nails, paint, and electrical wiring. Initially the company purchases 1,000 pieces of lumber at $5 each and later, it purchases an additional 800 pieces at $6 each. Let's say 1,200 pieces of lumber were used during the financial year, Individual lumber cannot be identified when used.

FIFO:

-The cost of the first 1,000 pieces of lumber used in construction will be $5 each and the next 800 pieces will be priced at $6 each. *Individual lumber cannot be identified when used.*

(1,000 lumber X $5) + (200 lumber X $6) = $6, 200 is your cost of goods sold

Weighted Average:

1. Calculate the total cost of each purchase:
    - First purchase: 1,000 pieces of lumber at $5 each.
    - {Total cost of first purchase} = 1,000 X $5 = $5,000
    - Second purchase: 800 pieces of lumber at $6 each. Total cost of second purchase = 800 X $6 = $4,800
2. Calculate the total number of pieces of lumber purchased:

    Total pieces of lumber =1,000+800=1,800
3. Calculate the total cost of all lumber purchased: Total cost of all lumber = $5,000 + $4,800 = $9,800
4. Calculate the weighted average cost per piece of lumber:

    Total pieces of Total pieces of lumber/Total cost of all lumber = weighted average cost price

    $9,800 / 1,800} = approx. $5.44
5. Finally, to determine the cost of goods sold for the lumber used in building the house, you would multiply the weighted average cost per piece by the number of pieces used. Let's say 1,200 pieces of lumber were used:

    Cost of goods sold for lumber = 1,200 x $5.44= $6,528

So, using the weighted average method, the cost of goods sold for the lumber used in building the house would be approximately $6,528.

Schedule 4: Depreciation

Principles of Depreciation

- ✓ Assets must be depreciated back to when the asset was first acquired.

- ✓ A taxpayer may use a lower depreciation rate than the rate specified in BPT Regulations § 202. However, elected rates shall not be higher than such rates.
  - The election would be irrevocable, and
  - Therefore, taxpayers cannot elect a larger depreciation rate after making that election.
  - The rate must be in accordance with US GAAP.

- ✓ Assets that cost less than $300 will be depreciated once at 100%.

Depreciation Rates

Class	Depreciable Asset	Straight-Line Rate
1	Motor vehicles, buses and minibuses with a seating capacity of less than 30 passengers; goods vehicles with a load capacity of less than 7 tons; computers, computer equipment, data handling equipment and software, construction and earthmoving equipment.	25%
2	Buses with a seating capacity of 30 or more passengers, goods vehicles designed to carry or pull loads of 7 or more tons, specialized trucks, tractors, trailers and trailer-mounted containers, and plant and machinery used in manufacturing, mining, forestry, or farming operations.	20%
3	Vessels, barges, tugs, and similar water transportation equipment, aircraft, office furniture, fixtures, and equipment, and any depreciable asset not included in another class.	12.5%
4	Buildings and other structural improvements to land	5%
5	Intangible assets	See Below

Class 5: Intangible Assets

(1) For preliminary expenditure, 25%
(2) A land lease is 100% divided by the number of years in the asset's useful life.
(3) Intangible assets with more than 10 years of useful life, other than items 1 & 2, 10%.
(4) Any other intangible asset is 100% divided by the number of years in the useful life of the asset.

Depreciation

- ✓ Land lease-100% of value divided by the years in the asset's useful life.
    - Improvements to land, such as parking lots, fences, retaining walls, and access roads, may be included in the cost of the land lease asset.
- ✓ Building—any structure constructed or acquired by a business, such as office buildings, warehouses, factories, or retail stores.
- ✓ Motor vehicles
- ✓ Other transport equipment
    - Vessels, barges, tugs, aircraft
- ✓ Computer hardware equipment refers to physical devices such as computers, servers, networking equipment, printers, and other peripherals used to process, store, or transmit data. It includes purchase price, delivery installation, and any necessary modifications or enhancements to put the equipment into service.
- ✓ Furniture and fittings
    - Office furniture
    - Fixtures
- ✓ Other plant, machinery, and equipment
    - Plant and machinery used in manufacturing, mining, forestry, or farming operations.
- ✓ All other fixed assets
    - Buses and minibuses with a seating capacity of less than 30 passengers
    - Goods vehicles with a load capacity of less than 7 tons
    - Buses with a seating capacity of 30 or more passengers
    - Goods vehicles designed to carry or pull loads of 7 or more tons.
    - Specialized trucks, tractors, trailers, and trailer-mounted containers
- ✓ All other intangible assets are non-physical assets that hold value to a business due to legal or intellectual rights. They include:
    - Preliminary expenditures—expenses at the initial stage of a business
    - Patents, software, trademarks, brands, copyrights, contracts, and licenses.

Examples of Depreciation

Example 1: Assuming you are a calendar year taxpayer, your financial accounts close on December 31, and you purchase a company vehicle on June 15, 2020. Using the depreciation schedule above, what depreciation expense can you claim for each following year?

Year	Beginning Balance	Depreciation	Ending Balance (Beginning Bal. – Depreciation Exp.)
2020	$20,000	*Value of the asset X (Rate of depreciation x (day of the year/ total number of days in a year))* $20,000 x (25%x (199/365)) = $20,000 x 25% x 0.5452 = $20,000 x 13.63% = $2,726	$20,000 - $2,726 = $17,274
2021	$17,274	$5,000	$12,274
2022	$12,274	$5,000	$7,274
2023	$7,274	$5,000	$2,274
2024 -	$2,274	$2,274	$0