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IFRS Alert

Brexit – Accounting for the impact on current and deferred tax

February 2021 – IFRS Alert 2021-02

Executive Summary

For entities with operations in the United Kingdom (UK) and the EU, the determination of the income tax impact on Brexit will require some significant judgements to be made. These judgements should be based on the facts and circumstances of the reporting entity after considering the tax laws and regulations substantively enacted at 31 December 2020 because any future changes to tax laws requiring legislative activity cannot be taken into account. The change in the UK's tax status (because it is not longer a member of the EU) could also trigger the application of a different set of existing tax laws, which means changes to existing current and deferred tax balances may result.

Background

Following a General Election held in 2019, the UK left the EU on 31 January 2020. However, a transition period was put in place and that expired on 31 December 2020. During this transition period all EU rules and laws continued to apply to the UK. Towards the end of the transition period widespread media attention was given to the negotiations setting out the new arrangements that would come into effect after 31 December 2020. As noted in the press, the negotiations during the transition period focussed primarily on trading arrangements; they did not focus on the wording of the laws impacting income taxes.

Some commentators drew attention to the exact timing on when the transition period ended for UK reporting entities – ie 23.00 GMT 31 December 2020. The consequence of this is that UK entities would in some instances be accounting for certain tax related events in 2020 rather than 2021. Given this, we believe tax specialists should be called upon to help identify the areas where the tax rules might change as a result of Brexit.

Current tax

For reporting periods that ended on 31 December 2020, the current tax amount reflected in financial statements will need to be determined in accordance with the tax legislation enacted or substantively enacted at that date. Given this, when determining the current tax impact of Brexit we encourage entities to consider:

- If the existing tax legislation still applies or whether new legislation relating to income tax, that is already enacted or substantively enacted by the reporting entity, applies. Preparers of financial statements may have to consult with tax experts to ensure they are applying the correct legislation at 31 December 2020, in light of any bilateral tax arrangements that might also be applicable.
- Whether or not Brexit changes the tax status of any past transactions that may have previously been exempted. If situations like this exist, retrospective tax implications will need to be assessed to determine whether they arose before or after the end of the transition period (ie 31 December 2020). If the retrospective impact arises before the transition period ended, then a current tax liability will need to be recognised at 31 December 2020. However, if the retrospective impact arises after the transition period ends (ie 1 January 2021) then the impact will need to be reflected in 2021.
- Whether the income tax liability is appropriately classified as current or non-current when the transition period ends in light of the requirements set out in paragraph 69 of IAS 12 'Income Taxes'.

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Deferred tax

IAS 12 requires an entity to reflect the estimated future tax effects of temporary differences that exist at the end of each reporting period. This requires entities to determine how and when their temporary differences will reverse in future periods and at what tax rate. As is the case for calculating current tax, deferred tax should be determined on the basis of the law enacted or quasi-enacted at the reporting date. For some entities a considerable amount of professional judgement will need to be applied.

More specifically, as a result of Brexit, entities will need to consider:

- What tax legislation has been enacted or substantively enacted at 31 December 2020 that will be applicable in future reporting periods. This might be difficult to ascertain given many EU countries have not yet made any changes in their local tax laws to address the potential impact of Brexit.
- The lack of precedents on which to base any tax assessments given the UK is the first country to exit the EU. For example, what Brexit has done is introduce uncertainty, when currently there is none, as to whether future dividends from foreign subsidiaries will be subject to withholding tax, and also what future tax rates should be applied. A 'one size fits all' approach will not be appropriate to resolve all EU related tax matters because of bi-lateral tax agreements and double taxation frameworks that exist between member countries.

Next steps

The guidance in IAS 12 is clear; future changes to tax laws requiring legislative activity cannot be taken into account. That said, changes in the UK's tax status may trigger the application of a different set of existing laws, and there are many to consider. Assessments made at 31 December 2020 may need to be adjusted in later reporting periods in light of legislation that is subsequently enacted. Preparers will then need to determine whether any changes made in 2021 and in future accounting periods should be accounted for as a change in accounting estimate or as a prior period adjustment.

Our thoughts

Entities currently subject to UK income tax will need to carefully assess their current and deferred income tax positions at 31 December 2020 in light of Brexit given many countries in the EU have still to pass changes to their current income tax legislation to reflect the fact that the UK is no longer part of the EU. Given this state of flux, we encourage reporting entities to seek guidance from tax specialists before finalising their current and deferred tax positions for the year ended 31 December 2020.

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