Grant Thornton

Snapshot

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Accounting for income taxes impacted by Brexit

The United Kingdom withdrew from the EU on January 31, 2020. However, a transition period was put in place that expired on December 31, 2020, during which EU rules and laws continued to apply in the United Kingdom. The transition period provided time for the United Kingdom and the EU to negotiate new arrangements that took effect on January 1, 2021, which focused primarily on trade agreements, security, and travel. The Trade and Cooperation Agreement did not address income tax laws and treaty provisions.

The transition period ended December 31, 2020 at 11 p.m. Greenwich Mean Time. As a result, U.K. entities need to account for certain tax-related events in 2020 rather than in 2021. Given this, we believe that entities may want to call in tax specialists to help identify areas where the tax rules might change as a result of Brexit. For example, treaties that were in force during 2020 may no longer apply as of midnight on December 31, 2020.

Calculating current tax

For reporting periods that ended on December 31, 2020, the current tax amount reflected in the financial statements must be determined in accordance with the tax legislation in force in that tax jurisdiction on that date. When determining the current tax impact of Brexit, entities are encouraged to consider the following factors:

- Whether the existing tax legislation still applies or whether new income tax legislation applies. Preparers of financial statements may want to consult with tax specialists to ensure they are applying the correct legislation at December 31, 2020 in light of any bilateral tax arrangements that might also apply.
- Whether or not Brexit changes the tax status of any past transactions that were previously exempted under treaties or other bilateral agreements. In these situations, entities need to assess retrospective tax implications to determine whether they arose before or after the end of the transition period (that is, December 31, 2020). If the retrospective impact arises before the transition period ended, then a current tax liability should be recognized at December 31, 2020. However, if the retrospective impact arises after the transition period ends (that is, January 1, 2021), then the impact must be reflected in 2021.
- Whether the income tax liability for any tax payable or for unrecognized tax benefits is appropriately classified as current or noncurrent when the transition period ends based on the expected timing of reversal.

Calculating deferred tax

The guidance in ASC 740 requires an entity to reflect the estimated future tax effects of temporary differences that exist at the end of each reporting period. This guidance requires entities to determine how and when their temporary differences will reverse in future periods and at what tax rate. Similar to calculating current tax, deferred tax should be determined on the basis of the law in force in that tax jurisdiction at the reporting date. Some entities will need to apply a considerable amount of professional judgment.

Specifically, entities will need to take into account the following considerations as a result of Brexit:

- Which tax legislation was enacted at December 31, 2020 that will apply in future reporting periods. This determination might be difficult for many entities given that many EU countries have not yet changed their local tax laws to address the potential impact of Brexit, even though the existing laws and treaties may no longer apply.
- The lack of precedents on which to base any tax assessments since the United Kingdom is the first country to exit the EU. For example, Brexit has introduced uncertainty as to whether future dividends from foreign subsidiaries will be subject to withholding tax and which 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 bilateral tax agreements and double taxation frameworks that exist between member countries.
- Any changes to management assertions or estimates related to indefinite reinvestment, valuation allowances, or uncertain tax positions.

Impact of future tax law changes

The guidance in ASC 740 states that future changes to tax laws cannot be accounted for until those tax laws are enacted. That said, changes in the United Kingdom's tax status could trigger the application of a different set of existing laws due to treaty provisions or a lack of clarity. Tax assessments made at December 31, 2020 may need to be adjusted in later reporting periods to reflect legislation that is subsequently enacted. Financial statement preparers will 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.

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