Grant Thornton

2020 deferred tax provision

The COVID-19 pandemic is having a tremendous impact on the world's economy. Many businesses are struggling to stay afloat and doing whatever they can right now to rationalise costs and preserve any cash surpluses they have in order to bridge future cash flow needs. Around the world, governments are stepping in to try and limit the impact of the pandemic by providing financial support in numerous ways from direct cash payments through to the deferral of tax payments.

This article sets out four key areas of your tax provision that could be affected by the impacts of COVID-19. More specifically we focus on how government support in the form of tax incentives and tax relief might change previous assessments that were made applying IAS 12 'Income Taxes' (IAS 12). A key point to be mindful of is that any one of the following may be applicable if interim financial statements under IAS 34 'Interim Financial Reporting' (IAS 34) are being prepared.

Recognition of deferred tax assets

For an established business with a long history of profitability, deferred tax assets are often recognised without debate for deductible temporary differences that exist at each reporting date. For many entities, deferred tax assets can be recognised for non-capital losses, but only when supported by convincing evidence that future taxable profit exists. This requirement is set out more fully in IAS 12.35-36. Under this standard, when it is no longer probable that future taxable profit will be available, any previously recognised deferred tax assets recognised on that basis may need to be reversed.

Entities that have been considerably impacted by COVID-19 should reassess any deferred tax assets previously recognised. No matter whether it is interim or annual financial statements being prepared, one of the greatest challenges for reporting entities will be providing compelling evidence to support the profitability assumptions that have been made into the future. A key point to note is that while entities can carry net operating losses forward for long periods (depending on the jurisdiction), financial statement preparers may be challenged by regulators, auditors and others when developing projections of future profitability that exceed five years.

In July 2019, the European Securities and Markets Authority (ESMA) clarified that DTAs should be recognised to the extent that it is 'more likely than not' that they will be realised, ie a greater than 50% probability of utilisation exists for those DTAs recognised – and provided specific guidance on what this means in practice. ESMA also clarified its definition of 'convincing other evidence' to support the expectation of future taxable profits. While ESMA is a European authority, the guidance issued may be helpful to users of IFRS in other jurisdictions.

Deferred tax liabilities associated with investment in subsidiaries

For many entities with foreign subsidiaries, accumulated foreign profit is usually re-invested in overseas operations or used to finance further global expansion. As a result of COVID-19, many entities are assessing whether these earnings should now be repatriated to the parent entity's jurisdiction through dividends. Dividends received by the taxpayer may have to have a full dividend deduction attached to them provided they are paid out of active business earnings of the foreign subsidiary.

There are other instances when these dividends are subject to corporate level tax. IAS 12.39 does not require the recognition of deferred tax liabilities associated with these, 'outside basis differences', so long as management has control over the disbursement of funds, and it is probable that these funds will not be repaid within the foreseeable future. With the COVID-19 pandemic, preparers of financial statements should be modelling possible contingency plans that include needing to fund future deficits associated with any resulting economic downturn the entity might encounter.

Any company that has plans to incorporate cash repatriation to the entity's jurisdiction might discover that a tax liability needs to be recognised. Management should, therefore, assess carefully whether or not a deferred tax liability associated with these, 'outside basis differences', has to be recognised in the entity's financial statements if the cumulative conditions of IAS 12.39 are no longer expected to be met.

Expected manner of reversal

Under IAS 12.51, taxable and deductible temporary differences are required to be measured using the rates at which these differences are expected to reverse. Often, the relevant rate is the general corporate income tax rate applicable to the profit of the entity.

In some jurisdictions, however, the tax rates which apply to gains and losses on the disposition of property or intangible assets are different from these general rates. Business rationalisation may be an inevitable consequence of COVID-19, which could alter the composition of existing temporary differences as well as the way those temporary differences reverse. This could result in a change in the appropriate tax rate used to measure certain components of deferred tax.

Interim reporting – effective tax rate

IAS 34.30(a), requires the use of the so called, effective tax rate (ETR) method, as the most appropriate depiction of a reporting issuer's tax provision on a quarterly basis. The ETR method uses the weighted average annual ETR and applies this to the pre-tax income of the interim period. The ETR should be computed on the basis of the tax rates that have been enacted or substantively enacted at the end of the interim reporting period and that will apply at the end of the annual reporting period. In other words, expected changes in tax rates or tax laws, as a result of government measures to support entities affected by COVID-19 should not be anticipated when computing the ETR.

The logic being that in the normal course of business, entities are taxed based on their annual income, which encompasses the activity of an annual reporting period (all quarters of a year) and not the activity of one specific quarter. Absent significant uncertainty, a projected effective tax rate should be a reasonable approximation of an annual tax rate.

With COVID-19 and the existing uncertainty as to when global economies will begin to recover, coupled with various government support and incentives that are being announced daily with the administration of the programs not yet finalised, it may be difficult to demonstrate that a reliable estimate of the annual tax rate can be made using the ETR. Furthermore, the composition of taxable income could be highly uncertain as a result of government programs.

As reporting entities look to record their interim income tax accruals, be it quarterly or half yearly during the 2020 reporting period, consideration should be given to whether the continued use of the ETR method is a reasonable approach to reporting income taxes on an interim basis. If a reasonable estimate of the ETR cannot be made, reporting issuers may wish to consider a year-to-date actual tax calculation as the best estimate of the ETR. IAS 34 in general, requires anticipated tax credits and benefits, relating to a one-off event be recognised in the interim period in which they are anticipated to be received. This requirement may further complicate the ability to derive a reasonable ETR.

Additional considerations

Some additional areas that entities should consider are:

- Receipt of Government Assistance: whether any government assistance received is within the scope of IAS 12 or IAS 20 'Accounting for Government Grants and Disclosure of Government Assistance'

- Changes to tax law: certain governments have adopted tax reforms as a means of supporting business in 2020 potentially affecting substantially enacted tax rates and/or realisation of deductible temporary differences

- Global tax planning arrangements: entities may be engaging in global tax planning arrangements to take advantage of the various government tax reforms and incentives related to COVID-19. Those tax planning strategies may need to be considered when preparing the 2020 quarterly tax provisions.

The items covered in this article are potential impacts that the COVID-19 crisis might have on your income tax provision. This list is not exhaustive. The situation is fluid and government responses around the globe are continuously changing.

We are here to help

Preparers of financial statements will need to be agile and responsive as the situation unfolds. Having access to experts, insights and accurate information as quickly as possible is critical – but your resources may be stretched at this time.

We can support you as you navigate through accounting for the impacts of COVID-19 on your business. Now more than ever the need for reporting entities and their auditor or accounting advisor to work closely together is essential, so if you would like to discuss any of the points raised, please contact Dr. Shqiponja Isufi.

Contact

Dr. Shqiponja Isufi
Partner - Audit
Grant Thornton AG
T +41 43 960 71 53
E shqiponja.isufi@ch.gt.com

Grant Thornton AG
Claridenstrasse 35
P.O. Box
CH-8027 Zurich

Grant Thornton

©2020 Grant Thornton Switzerland/Liechtenstein - All rights reserved. Grant Thornton Switzerland/Liechtenstein belongs to Grant Thornton International Ltd (referred to as “Grant Thornton International” below). “Grant Thornton” refers to the brand under which each individual Grant Thornton firm operates. Grant Thornton International (GTIL) and each member firm of GTIL is a separate legal entity. Services are provided by the individual companies separately from another, i.e. no individual company is liable for the services or activities provided by another individual company. This overview serves the sole and exclusive purpose of providing initial information. It contains neither advice nor any recommendation, nor does it claim to be complete. No liability whatsoever is assumed for the content.