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IFRS Viewpoint

Potential accounting consequences of the US tax reform for IFRS preparers

Our 'IFRS Viewpoint' series provides insights from our global IFRS Team on applying IFRSs in challenging situations. Each edition will focus on an area where the Standards have proved difficult to apply or lack guidance. This edition provides guidance on the potential accounting consequences arising from the recent reform of the United States' tax system.

What's the issue?

On 22 December 2017, the President of the United States (US) signed into law the 'Tax Cuts and Jobs Act' (Act). The Act is a sweeping reform of US taxation which is likely to have a significant impact on financial statements prepared under IFRS for entities with US operations.

Furthermore, because the Act became law on 22 December its effects must be included in interim and annual reporting periods that include that date. The range and complexity of the Act means that companies with US operations need to analyse the impact of the Act in detail. This IFRS Viewpoint addresses some of the issues that entities will face when doing so.

Relevant IFRS

IAS 1 Presentation of Financial Statements

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

IAS 12 Income Taxes

IFRIC 23 Uncertainty over Income Tax Treatments

Background

On 22 December 2017, the President of the United States signed into law what is commonly known as the 'Tax Cuts and Jobs Act'. The Act is the most comprehensive reform of US taxation since 1986 and makes sweeping changes to both individual and corporate taxation.

Foremost among the changes is the reduction in the US corporate tax rate from 35% to 21%. There are however a number of other changes which are aimed at encouraging economic growth and reducing the incentives for US companies to shift their tax base to low- or no-tax jurisdictions.

We discuss a number of these areas in our publication and set out our views on the financial reporting issues arising from them.

The Act is a complex piece of legislation and IFRS preparers with operations in the US will need to spend a considerable amount of time analysing it in order to understand how it may impact accounting for income taxes in their financial statements.

Furthermore, because the Act became law on 22 December its effects must be included in interim and annual reporting periods that include that date. With many companies preparing financial statements for annual reporting periods ended 31 December 2017, this could have a potentially material impact due to both the complexity of the Act and the difficulty of gathering information in relation to some aspects of it.

IAS 12's requirements

IAS 12 'Income Taxes' contains the following accounting requirements for current tax and deferred tax.

Current tax

Current tax is measured at the amount expected to be paid to (or recovered from) the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

Deferred tax

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the period in which the asset is realised or the liability is settled, based on tax rates that have been enacted or substantively enacted by the end of the reporting period.

Our view

In the case of the 'Tax Cuts and Jobs Act' it is clear that the law was enacted on 22 December 2017. We expand on the effects of this in the table on the following pages.

Backwards tracing

Under IAS 12, current tax and deferred tax must be recognised outside profit or loss if the tax relates to items that are recognised outside profit or loss (a process known as 'backwards tracing'). Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:

a in other comprehensive income, shall be recognised in other comprehensive income
b directly in equity, shall be recognised directly in equity.

Key provisions of the Act for corporate entities

Topic	Summary	Potential financial statement impact
Drop in corporate tax rate	Perhaps the biggest impact to companies is the reduction in the US corporate tax rate from 35% to 21%. This is effective from 1 January 2018 regardless of the reporting entity's reporting period.	The reduced tax rate will have an impact on current tax from 1 January 2018. Entities that do not have a 31 December reporting date will be subject initially to a pro-rated or 'blended' tax rate, based on the ratio of days in the tax year that occur before and after the effective date. As discussed above, IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. The change will therefore impact the measurement of deferred tax in reporting periods ended 31 December 2017. Entities with a non-calendar reporting period will need to consider whether temporary differences reverse during a period when a pro-rated tax rate applies.
100% capital allowances	The Act creates 100% first year relief for capital expenditure for all expenditure on assets acquired and placed into service after 27 September 2017 up to the end of 2022. The relief will then be phased out over a period of five years.	Companies will need to determine whether capital expenditures made after 27 September 2017, qualify for immediate expensing and consider the effect of the relief on any current and deferred tax balances as a result of this accelerated depreciation. Companies should consider the implications that the increased bonus depreciation will have on the realisability of any resulting deferred tax assets. Accelerated depreciation may create or increase NOL carryforwards and may also create taxable temporary differences that may be considered a source of income for purposes of assessing the realisability of deferred tax assets.
Repeal of Alternative Minimum Tax (AMT)	AMT has been repealed for years beginning on or after 1 January 2018. AMT carryforwards can be offset against regular tax through 2020, while entities may claim a refund for any remaining balances in 2021, regardless of whether an income tax liability exists.	Deferred tax assets that previously went unrecognised should now be reassessed given the carryforwards are expected to be fully refunded.
Net Operating Losses (NOL)	NOL created before 1 January 2018, typically have a carryback period of two years and a carryforward period of twenty years. Now, NOL created after 2017 can be carried forward indefinitely but cannot generally be carried back. NOL are also limited to 80% of taxable income for losses arising in tax years beginning after 2017.	Companies will need to reassess the recoverability of deferred tax assets arising from NOL and make adjustments if it is more likely than not that all or a portion of their deferred tax assets will not be realised. Significant changes to the NOL carryforward that may impact a company's reassessment would include (1) elimination of the carrybackperiod and (2) the indefinite carryforward period.
Limitation on interest deductions for tax purposes	The Act limits the deduction for net interest to 30% of adjusted taxable income for tax years beginning after 31 December 2017. Interest not recovered in the year in which it is incurred can be carried forward indefinitely.	Companies would include the tax effect of disallowed current-year interest, as a result of the limitations on net interest deductibility, in their estimated annual effective tax rate. The ability to carry forward interest not recovered could potentially create additional deferred tax assets which will in turn need to be assessed for recoverability.

(continued)

Key provisions of the Act for corporate entities (continued)

Topic	Summary	Potential financial statement impact
Base Erosion Anti-Abuse Tax (BEAT)	The Act discourages base erosion and profit shifting (BEPS) behaviour by imposing a tax based on deductible payments to foreign related parties. An entity must pay a base erosion minimum tax amount in addition to its regular tax liability after credits. This generally equates to the excess of a fixed percentage of a company's modified taxable income over its regular tax liability.	US entities making base erosion payments that will be subject to the BEAT should consider the impact on their effective tax rate. BEAT is intended to be an incremental tax, meaning that an entity can never pay less than the statutory tax rate of 21%. Futhermore, an entity may not know whether it will always be subject to BEAT or not. We therefore believe that in many circumstances, entities will measure deferred taxes at the 21% rate, with any incremental BEAT payments being reflected as income tax expenses in the period in which they are incurred.
Global Intangible Low-Taxed Income (GILTI)	The Act includes provisions under which, in some conditions, income of foreign subsidiaries is included in the taxable income of its US parent. Essentially, GILTI assigns a routine percentage return to a company's foreign tangible assets with income above that return being attributed to intangibles and taxed in the US.	We believe that IFRS preparers affected by GILTI will be able to recognise the charge for GILTI in the year in which it is payable. In some circumstances, it could also be appropriate to include the impact on the rate used to measure deferred taxes for temporary differences that are expected to reverse as GILTI. However, the calculation of GILTI is subject to future and contingent payments that may make estimating whether and to what extent an entity will have a charge in relation to GILTI in a specific future year difficult. Significant judgement would need to be applied in determining the appropriateness of such an approach.
Foreign-derived intangible income (FDII)	The Act allows US corporations a deduction for a portion of foreign derived intangible income. This is to incentivise US companies that produce in the US and sell overseas.	As with GILTI, we believe that IFRS preparers affected by FDII will be able to recognise the deduction in the year in which it is payable. In some circumstances, it could also be appropriate to include the impact on the rate used to measure deferred taxes, however we expect that such an approach will be difficult to reliably model and that it will be simpler to recognise the deduction as a current income tax item in the period in which it is received.
Replacement of a worldwide system of taxing US corporations with a territorial system	The current worldwide system of taxing US corporations on the foreign earnings of their foreign subsidiaries is being replaced with a partial territorial system. This will provide a 100% dividends received deduction (DRD) to domestic corporations for foreign source dividends received from 10% or more owned foreign corporations.	Entities may need to consider the accounting for 'outside basis' differences (the difference between the carrying amount of the investment in the corporate entity and its tax base in situations where for instance undistributed profits in the investee increase the parent's investment in the investee to above its tax cost). Entities may need to assess whether such differences will reverse in the foreseeable future and could affect the measurement of any deferred tax liability arising on investments in subsidiaries.
Repatriation transition tax	The Act subjects unrepatriated foreign earnings to a one-time transition tax.	A liability for current income tax will need to be recognised for the effect of the transition tax. This may be challenging from a practical perspective of collecting the information within a group where the parent company is preparing financial statements for the year ended 31 December 2017. Nevertheless, we expect entities to make their best estimates and give appropriate disclosures to support their accounting (see page 7).

Regulators' reactions to the Act

Entities with US operations should look out for any advice that may be issued by their regulator.

In the United States, the Securities and Exchange Commission (SEC) staff issued Staff Accounting Bulletin (SAB) 118 shortly after the publication of the Act. It addresses the application of US GAAP in situations where a US registered entity does not have the necessary information in reasonable detail to complete the accounting for certain income tax effects of the Act.

Although the guidance is primarily aimed at providing clarity on the application of US GAAP to the accounting for the tax reforms made by the Act, the SEC staff also indicated it would not object to SAB 118 being applied by Foreign Private Issuers reporting under IFRS in accounting for the impact of the Act under IAS 12.

Our view

Our view is that entities with operations in the US that are affected by the Act may look to SAB 118 for guidance in so far as it does not conflict with the requirements of IFRS. For example, in a situation where a US company concludes that it cannot determine a reasonable estimate of the Act, SAB 118 states that an entity should continue recognising and measuring current and deferred taxes based on the provisions of the tax laws that were in effect immediately prior to the Act being enacted. Such an approach would not be possible under IFRS as it contradicts the specific requirements of IAS 12.

In Europe, the European Securities and Markets Authority (ESMA) issued a statement on 26 January 2018 (https://www.esma.europa.eu/sites/default/files/library/public_statement_on_accounting_for_income_tax_consequences_of_the_us_tax_reform_under_ifrs_2.pdf) in response to concerns over entities' ability to fully complete the required accounting under IAS 12 in their 2017 financial statements due to the short time available to assess the accounting consequences of the Act and the lack of information on their tax position.

In the statement, ESMA acknowledges that a complete understanding of the implications of the Act may take some time. Nevertheless, ESMA expects EU entities to be able to make a reasonable estimate of the impact of the material aspects of the Act on their current and deferred tax assets and/or liabilities in their 2017 annual financial statements.

Our view

We believe entities should be able to make a reasonable estimate of the impact of the material aspects of the Act in all cases by breaking the effects of the Act down into separate units of account. In applying such an approach, an entity may view the individual aspects of the Act as separate units of account. Judgement may need to be exercised over the extent to which it is appropriate to aggregate the effects of particular aspects of the Act when adopting such an approach.

ESMA acknowledges that these reported amounts may be subject to a higher degree of estimation uncertainty than is usually the case and that measurement adjustments may need to be made in subsequent reporting periods as issuers obtain more accurate information on the impact of the Act and the modalities of its application. Consequently, ESMA highlights the need for transparent and informative disclosure both in relation to the amounts reported in the 2017 annual financial statements and on their subsequent re-measurement.

Our view

Given that reported amounts may (as ESMA has noted) be subject to a higher degree of estimation uncertainty than is usually the case in the first accounting period affected by the Act, it is likely that adjustments will be needed in subsequent reporting periods. Our view is that these will generally be accounted for under IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors' as revisions of estimates (accounted for prospectively) rather than accounting errors (accounted for retrospectively). Corrections of errors are likely to be limited to the discovery of mathematical mistakes and situations such as fraud or misinterpretation of facts that were reasonably available.

Affected entities both inside and outside Europe would be wise to consider ESMA's advice. In the meantime, they should start analysing the impact of the Act in order to estimate its financial reporting effects.

Disclosure

As with any area of the financial statements that is subject to estimation uncertainty and management judgement, clear disclosure is vital. IAS 1 'Presentation of Financial Statements' requires entities to disclose:

- the judgements management has made that have the most significant effect on the amounts recognised in the financial statements
- assumptions made about the future, and other major sources of estimation uncertainty, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next reporting period.

As with any disclosures, the information given should be clear and tailored to the reporting entity's individual circumstances. In the last couple of years, information on tax disclosures has been an increased area of focus for regulators with particular attention being given to the nature of the evidence supporting the recognition of deferred tax assets.

Against this background, regulators can be expected to scrutinise disclosures relating to the impact of the US tax reforms, paying particular attention to matters such as:

- identification of the significant aspects of the reforms and the impact they are expected to have on the entity
- factors affecting the effective tax rate including an explanation of changes compared to the previous reporting period
- consistency with the entity's approach to uncertain tax positions under IFRIC 23 'Uncertainty over Income Tax Treatments'.

Contact

Stephen Murray
Partner, Audit and Assurance
E stephen.murray@ie.gt.com
D +353 (0)1 680 5689

Fergus Condon
Partner, Financial Accounting and Advisory Services
E fergus.condon@ie.gt.com
D +353 (0)1 680 5610

Louise Kelly
Partner, Audit and Assurance
E louise.kelly@ie.gt.com
D +44 (0)28 9587 1100

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