10 July 2020

Global Tax Alert

COVID-19 and US CARES Act implications on interim filings under IFRS

EY Tax News Update: Global Edition

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This Alert highlights certain global tax accounting considerations for interim reporting resulting from the current economic environment, as well as tax accounting considerations of tax law changes, including, specific discussion on the United States (US) CARES Act which entities filing under the guidelines of International Financial Reporting Standards (IFRS) may need to consider as part of their interim financial reporting for income taxes.

EY previously published Alert 2020-0696 *COVID-19 could have implications on income tax accounting* discussing certain US GAAP tax accounting guidance related to COVID-19.

EY also maintains a global tax and policy response tracker to summarize government responses to COVID-19 and related economic effects, in over 130 countries. The tracker is updated routinely for recent developments. The latest version of the tracker may be accessed via the following link: *EY Tax COVID-19 Response Tracker*.

Tax accounting for an interim period – general rules under IFRS

International Accounting Standards (IAS) 34, Interim Financial Reporting, states that income tax expense should be accrued using the "best estimate of the weighted average annual income tax rate expected for the full financial year" and applying that rate to actual pre-tax income for the interim period.

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[IAS 34.30(c), B12]. While the standard also describes this rate as "the tax rate that would be applicable to expected total annual earnings," [IAS 34.B12], this is not the same as estimating the total tax expense for the year and allocating a proportion of that to the interim period even though it might sometimes appear that way.

Because taxes are assessed on an annual basis, using the weighted average annual income tax approach to determine the annual effective income tax rate and applying it to year-to-date actual earnings is consistent with the basic concept in IAS 34, that the same recognition and measurement principles apply in interim financial reports as in annual financial statements. [IAS 34.B13]. In estimating the weighted-average annual income tax rate, an entity should reflect a blend of any progressive tax rate structure expected to be applicable to the full year's earnings, including changes in income tax rates scheduled to take effect later in the year that are enacted or substantively enacted as at the end of the interim period. [IAS 34.B13].

If an entity operates in a number of tax jurisdictions, or where different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), the standard requires that to the extent practicable, an entity: [IAS 34.B14]

- Estimates the average annual effective income tax rate for each taxing jurisdiction separately and applies it individually to the interim period pre-tax income of each jurisdiction; and
- Applies different income tax rates to each individual category of interim period pre-tax income.

This means that the entity should analyze each tax jurisdiction and arrive at an interim tax charge by applying the tax rate for each jurisdiction to actual earnings from that jurisdiction in the interim period. However, the standard recognizes that, while desirable, such a degree of precision may not be achievable in all cases and allows using a weighted-average rate across jurisdictions or across categories of income, if such rate approximates the effect of using rates that are more specific. [IAS 34.B14]. The format of the interim period calculation may be particularly relevant in light of the uncertainties brought on by COVID-19 and the impacts of tax law changes.

Implications

Quarterly and mid-year interim reporting for many entities is likely to present increased challenges in the accounting and reporting for income taxes. Entities may need additional time to collect and discuss the inputs needed to project the weighted-average annual income tax rate and overall income tax provision for the interim period. Information on forecasts of income or losses may be updated frequently. Entities should review the forecast used for tax provision purposes for consistency with other financial accounting estimates. It will be important for tax calculations to be based on the same estimates and forecasts used for other non-tax areas of financial reporting (e.g., projections used for impairment testing). Entities should also consider whether recent changes in supply chains or operations are reflected in the projected forecast of pre-tax earnings by jurisdiction and that such revisions align with internal corporate transfer pricing policies. In addition, entities that have significant variations in the customary relationship between income tax expense and pre-tax accounting income in the interim period financial statements should disclose the reasons if they are not otherwise apparent from the financial statements or from the nature of the entity's business.

Repatriation of foreign earnings, realization of deferred tax assets, and changes in tax laws and rates

IFRS provides guidance on tax accounting for changes in circumstances such as: changes in plans for remittance of foreign earnings of a subsidiary, changes in realization of deferred tax assets, and changes in tax laws and tax rates. These circumstances may involve complex calculations and significant judgment. For example, a parent company entity may require foreign subsidiary earnings to be distributed to provide liquidity for working capital or to service debt obligations. The calculation of the tax impact of an anticipated remittance of a foreign subsidiary's earnings may be complex and involve a combination of multiple tax effects, including, for example, domestic taxes, foreign withholding taxes, and foreign tax credits through a chain of entities.

Similarly, business disruption resulting from COVID-19 may result in an entity recognizing asset impairments or forecasting losses. These circumstances may introduce new uncertainties that an entity must consider in its analysis of realization and recognition of deferred tax assets. Entities should update their projections of income for recent events. Tax attribute carryforwards that were otherwise expected to be utilized in the near term should be reviewed to determine if the attributes might expire unutilized. In addition, entities should assess whether changes in expiration periods or limitations on the use of tax attributes have been enacted

in jurisdictions in which the attributes reside that would impact management's judgments on the amount of deferred tax asset to be recognized in the balance sheet. Entities also should consider whether they need to provide additional financial statement disclosures to more fully explain the use of estimates or management's judgments in reaching its conclusions on the amount of unrecognized deferred tax assets.

Further, in responding to the COVID-19 crisis, many countries have enacted new tax laws and provided a variety of government assistance. Determining whether government assistance should be subject to income tax accounting or another accounting model requires the use of significant judgment. If an entity determines that the governmental assistance does not fall within the scope of IAS 12, then the entity should consider whether the governmental assistance is a governmental grant, (i.e., a benefit received from a government entity without regard to taxable income). The accounting for government grants received has been addressed in IAS No. 20, Accounting for Government Grants and Disclosure of Government Assistance (IAS 20).

Finally, the estimated income tax rate applied in the interim financial report should reflect changes that are enacted or substantively enacted as at the end of the interim reporting period but scheduled to take effect later in the year. [IAS 34. B13]. IAS 12 acknowledges that in some jurisdictions, announcements by government have substantively the same effect as enactment. [IAS 12.48]. Accordingly, an entity should determine the date on which a change in tax rate or tax law is substantively enacted based on the specific constitutional arrangements of the jurisdiction. While not specifically addressed in the standard, we believe an entity should recognize the effect on deferred tax measurement of a change in tax law applying to future periods if substantively enacted by the end of the interim reporting period. Therefore, an entity should recognize a substantively enacted change applying to future years in measuring deferred tax assets and liabilities as at the end of the interim reporting period. One way to treat the cumulative effect to date of this remeasurement is to recognize it in full, by a credit to profit or loss or to other comprehensive income, depending on the nature of the temporary difference being remeasured, in the period during which the tax legislation is enacted. Alternatively, if the effective current tax rate is not distinguished from the measurement of deferred tax, it could be contended that IAS 34 allows the change in the deferred tax asset/liability to be included in the estimate of the effective income tax rate for the year.

If legislation is (substantively) enacted only after the end of the interim reporting period but before the date of authorization for issue of the interim financial report, its effect is disclosed as an event after the interim period that has not been reflected in the financial statements for the interim period. [IAS 34.16A(h)]. This is consistent with the requirement under IAS 10, Events after the Reporting Period, where estimates of tax rates and related assets or liabilities are not revised in these circumstances. [IAS 10.22(h)].

Implications

Tax accounting for changes in circumstances requires careful evaluation to calculate the impact and determine the appropriate reporting period(s) in which to include the impact. Entities may require additional time to collect inputs needed to analyze and calculate the tax accounting impact of such changes. Entities should closely monitor tax law changes and stimulus packages that could result in immediate and future tax effects to the financial statements in the period of enactment. Determining whether a benefit is an income tax or above-the-line benefit should be considered based on the facts and circumstances of each jurisdiction's benefit. A tax classified as an income tax is accounted for under IAS 12. Taxes other than income taxes are accounted for under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and, in particular, International Financial Reporting Interpretations Committee (IFRIC) 21, Levies, or by reference to the accounting standard most closely related to the item subject to such a non-income tax (such as IAS 20, noted above, or IAS 19, *Employee Benefits*, in the case of payroll taxes). Disclosures may be required for the interim reporting that addresses tax law changes substantively enacted both before and after the balance sheet date.

US CARES Act

Among the many stimulus packages implemented or enacted worldwide, on 27 March 2020 the *Coronavirus Aid, Relief, and Economic Security (CARES) Act* (the Act) was enacted in the US. Entities will need to consider the income tax accounting implications of it, as well as others, under IFRS. Key provisions in the Act include:

- Eliminating an 80% of taxable income limitation by allowing corporate entities to fully utilize net operating losses (NOLs) to offset taxable income in 2018, 2019 or 2020
- Allowing NOLs originating in 2018, 2019 or 2020 to be carried back five years

- Increasing net interest expense deduction limitations to 50% of adjusted taxable income from 30% for tax years beginning 1 January 2019 and 2020
- Allowing taxpayers with alternative minimum tax (AMT) credits to claim a refund in 2020 for the entire amount of the credit instead of recovering the credit through refunds over a period of years, as originally enacted by the 2017 *Tax Cuts and Jobs Act* (TCJA)
- Allowing companies to deduct more of their cash charitable contributions paid during calendar year 2020 by increasing the taxable income limitation from 10% to 25%
- Retroactively clarifying an omission in the TCJA by allowing the immediate recovery of qualified improvement property costs rather than over a 39-year recovery period

Both IAS 12 and IAS 34 require that, for carryforwards of unused tax losses and tax credits, a deferred tax asset should be recognized to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits may be utilized. In assessing whether future taxable profit is available, the criteria in IAS 12 are applied at the interim date, including sufficient taxable temporary differences relating to the same taxation authority and the same taxation entity which are expected to reverse in the same period as the deferred tax asset, or in a period into which a loss arising from the deferred tax asset may be carried back or forward. [IAS 12.28]. If these criteria are met as at the end of the interim period, the effect of the tax loss carryforwards is included in the estimated average annual effective income tax rate. [IAS 34.B21].

In contrast, the year-to-date approach of IAS 34 means that the benefits of a tax loss carryback are recognized in the interim period in which the related tax loss occurs [IAS 34.B20] and are not included in the assessment of the estimated average annual tax rate. This approach is consistent with IAS 12, which requires the benefit of a tax loss that can be carried back to recover current tax incurred in a previous period to be recognized as an asset. [IAS 12.13]. Therefore, a corresponding reduction of tax expense or increase of tax income is also recognized. [IAS 34.B20].

Where previously unrecognized tax losses are expected to be utilized in full in the current year, it seems intuitive to recognize the recovery of those carried forward losses in the estimate of the average annual tax rate. Where the level of previously unrecognized tax losses exceeds expected taxable profits for the current year, a deferred tax asset should be recognized for the carried forward losses that are now expected to be utilized, albeit in future years.

IAS 34 does not show how such a deferred tax asset is created in the interim financial report. We believe there are two acceptable methods:

1. The estimate of the average annual effective tax rate includes only those carried forward losses expected to be utilized in the current financial year and a separate deferred tax asset is recognized for those carried forward losses now expected to be utilized in future annual reporting periods.
2. The estimate of the average annual effective tax rate reflects the expected recovery of all the previously unutilized tax losses from the beginning of the period in which the assessment of recoverability changed.

Implications

A careful analysis of the temporary relief provided by the CARES Act is necessary to determine whether an entity is eligible to use the relief and, if so, how the provisions should be applied. Affected entities will also need to consider carefully the sequencing and interaction of the CARES Act provisions with various other US federal tax provisions, many of which were enacted with the TCJA including, for example, global intangible low-taxed income (GILTI), base erosion and anti-abuse tax (BEAT), foreign-derived intangible income (FDII), Internal Revenue Code Section 199 domestic production deduction (Section 199). Detailed calculations may be necessary to determine the best use of available deductions and tax attributes during the potential carryback periods.

Entities will need to account for the income tax provisions of the CARES Act in the period that includes 27 March 2020. Certain income tax provisions of the CARES Act are retroactive to earlier years and may, therefore, require entities to amend previously filed tax returns or file Change in Accounting Method applications in the US.

For example, the law allows entities to carry back losses from 2018 or 2019 for a period of five years and increases interest deduction limitations in 2019. Likewise, the retroactive clarification for the immediate recovery of qualified improvement property costs, rather than over a 39-year recovery period, for assets placed in service after 27 November 2017 will require entities to either file amended returns or file for a Change in Accounting Method. The effect of these changes on existing deferred taxes or current income taxes payable or refundable should be recorded in the reporting period that includes the enactment date.

Other considerations

In addition to the items outlined above, entities may need to consider special interim reporting tax accounting rules regarding loss entities and other impacts, such as transfer pricing arrangements and reasonableness of historical assumptions and estimates included in interim tax accounting calculations. Also, first-time application of new, complex tax legislation may result in uncertain tax treatments. For example, tax relief provided by local governments may give rise to uncertainty and the need for entities to make judgments and estimates when assessing their income tax treatment. Entities will need to determine whether it is probable that the taxation authority will accept their income tax treatment, and if not, IFRIC 23 requires entities to assess whether to recognize any additional liability for uncertain tax treatments.

This Alert is not an all-inclusive list of the topics to consider, but rather provides some guidance on areas that may require additional time to consider. Additional topics to consider, including accounting for government grants under IAS 20 is available in EY's July 2020 publication, Applying IFRS – IFRS accounting considerations of the Coronavirus pandemic.

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EYG no. 004749-20Gbl

1508-1600216 NY
ED None

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