

AN ALERT FROM THE BDO NATIONAL ASSURANCE PRACTICE

BDO FLASH REPORT

FASB



SUBJECT

A FOCUS ON INCOME TAX IMPLICATIONS: UNITED KINGDOM BEGINNING THE FORMAL PROCESS OF EXITING EUROPEAN UNION

SUMMARY

The UK's first step in withdrawing from the European Union may trigger certain disclosure requirements for SEC registrants with international operations. This memorandum addresses income tax considerations under ASC 740 (US GAAP) and IAS 12 (IFRS).

DETAILS

Background

In late March 2017, the United Kingdom (UK) prime minister delivered a formal document to the European Union (EU) initiating the UK's withdrawal from the EU. The move follows from the outcome of the June 2016 referendum in which a plurality of UK citizens voted to leave the EU. The letter submission initiated a formal process whereby the UK has two years (through March 2019) to negotiate its formal withdrawal with all member states (e.g., certain provisions in UK income tax treaties with member states). The UK will have until March 2019 to finalize its exit, unless all remaining 27 EU member states agree to extend the negotiation period. If negotiations are not finalized by March 2019, nor extended, EU treaties would cease to apply to the UK. In addition to initiating its withdrawal, the UK government published details of what is called the "Great Repeal Bill" which is necessary to ensure future EU laws would no longer apply in the UK.¹

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¹ The Bill will repeal the 1972 European Communities Act, which took Britain into the EU and meant that European law took precedence over laws passed in the British parliament. It will also end the jurisdiction of the European Court of Justice. All existing EU legislation will be copied across into domestic UK law to ensure a smooth transition on the day after Brexit.

In the meantime, EU law still stands in the UK until it ceases being a member (i.e., UK will continue to abide by EU laws and treaties).

Brexit, a term coined with the UK's decision to leave the EU, will impact UK trade, taxation of UK persons, business tax laws, and many more aspects of the broader UK economy. This alert focuses on the income tax accounting implications from the March 2017 letter submission under Topic 740 *Income Taxes* and the International Accounting Standard (IAS) 12, which is the IFRS equivalent standard.

Income Tax Considerations

Under ASC 740 and IAS 12, deferred tax accounting is required when changes are formally enacted (US GAAP) or "substantively" enacted (IFRS).

With respect to Brexit, the main income tax accounting issue is whether the letter submission in March 2017 had an income tax accounting impact under Topic 740 or IAS 12. On this point, we understand the SEC staff has concluded that the letter submission did not trigger the need for an entity to adjust its deferred income taxes. Specifically, the letter submission is not considered a tax law enactment (under Topic 740) or "substantive" enactment (under IAS 12). The SEC staff expects that income tax accounting will occur when law changes are enacted or substantively enacted, or/and when the UK ceases to be a member of the EU.

However, the SEC staff has indicated that disclosures about the nature of the event and its potential implications might be necessary, depending on a registrant's facts and circumstances. Accordingly, disclosure might be appropriate in MD&A, as well as the footnotes related to risks and uncertainties under Topic 275 and income taxes under Topic 740. Registrants may consider consulting with their advisors when determining the nature and extent of such disclosures.

BDO Observation: We believe this conclusion is consistent with the legal status of the letter submission, which is an administrative step necessary to begin negotiating income tax treaties between the UK and other member states. The UK has extensive bilateral tax agreements and the outcome of any negotiation is uncertain (e.g., a particular country might agree to retain specific benefits that are currently only afforded EU member states).

Other uncertainties exist, including whether the withdrawal process will trigger the recognition of deferred intercompany profits on a retroactive or prospective basis. Registrants potentially impacted by Brexit should monitor UK-EU negotiations leading to enactments (or substantive enactments) of tax law changes to reflect their financial statement impact in the appropriate period.

Sample Disclosure

Included below is a sample disclosure; it should be modified for a company's specific facts & circumstances related to UK operations. The information in [] pertains to the relevant IFRS standard for companies reporting under IFRS.

"We [Company XYZ] have operations in the UK and several European countries where we historically had material current and deferred income tax balances related to those activities. As such, the UK's 2016 decision to withdraw from the European Union or EU could have a material effect on our current and deferred income taxes. In March 2017, the UK initiated, through letter submission to EU, a formal two-year process to officially withdraw its membership. During this two-year period, the UK and EU member states are expected to negotiate many provisions in the UK bilateral agreements and tax treaties with EU member states as well as EU rules governing the income tax treatment of deferred intercompany profits. The final outcome of these negotiations will not be known until both the EU and the UK approve them and the UK enacts the related changes in its tax laws. EU law will cease to apply in the UK at the end of the two-year process in March 2019, unless the negotiations are extended. The letter submission in March 2017 is an administrative step required to begin the formal withdrawal process and is **not** considered a tax law enactment under ASC 740 [or substantive enactment under IAS 12]. Consequently, we plan to adjust our current and deferred taxes when tax law changes related to UK's withdrawal from EU are actually enacted [or substantively enacted] and/or when EU law ceases to apply in the UK."

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