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IFRS Alert

Uncertainty over tax issues resulting from the UK's decision to leave the European Union

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Executive Summary

The UK has formally begun the process of negotiating its withdrawal from the European Union. The outcome of these negotiations will determine whether various exemptions and reliefs existing under EU tax legislation will continue to be available to entities in the UK and EU.

Our view is that where an entity identifies potentially negative tax exposures from the UK's withdrawal, it will not be appropriate to provide for them in the immediate future due to the uncertainty that currently exists. Entities should give comprehensive disclosures instead.

Introduction

On 29 March 2017, the UK gave notice of its intention to withdraw from the European Union (EU) in accordance with Article 50 of the Treaty on European Union. The UK will now begin negotiations with the remaining 27 members of the EU over the terms of its withdrawal. There is a two-year time limit by which these negotiations have to be completed. The UK's decision to leave the EU raises a number of tax implications, which may also affect financial reporting. We outline some of the potential issues below.

Our view is that the giving of notice under Article 50 represents the commencement of the legal process to leave the EU and that the tax implications arising from it will only become clear as the withdrawal negotiations progress and tax treaties are revised. IAS 12 'Income Taxes' does not specifically address such uncertainties, however tax liabilities are generally recognised at the amount that is expected to be paid. Given existing legislation is unlikely to explicitly address the withdrawal of a member state from the EU, our view is that a considerable level of uncertainty exists and it is not currently possible to determine whether it is probable that there will be an outflow of resources in respect of possible tax issues arising from the UK's decision to withdraw from the EU, or to reliably measure them. We therefore believe that, in the immediate future, comprehensive disclosure is the most appropriate solution where entities identify such potential tax issues. This approach will need to be refined or revised over time as the negotiations over the UK's exit become clearer.

This Alert draws your attention to some of the potential tax issues that entities may encounter and factors for them to consider when drafting their financial statement disclosures. As well as being of direct relevance to entities within the EU, the matters discussed may also affect non-EU groups with UK subsidiaries or operations in the UK/EU.

Examples of tax issues arising

We outline below a couple of tax issues arising from EU directives that may potentially have an effect on UK entities' financial reporting or groups with operations in the UK/EU. There are likely to be many other issues besides these, and entities should give due consideration to identifying any issues that may be relevant to them.

Previous reorganisations

The EU Merger Directive allows certain gains to be transferred on cross-border transactions in the EU, in particular when a business is transferred from a company resident in one EU member country to a company resident in another EU member country in exchange for shares.

A potential issue then is that a tax charge in respect of previously deferred gains on such historic transfers may crystallise at the time the UK leaves the EU, depending on exactly how that Directive has been implemented into domestic law and the negotiations that may take place between now and the date that the UK actually leaves the EU.

Withholding tax on undistributed earnings

The EU Parent-Subsidiary Directive provides that Member States are not permitted to charge withholding tax on dividend payments from a subsidiary in one Member State to a parent company in another member State where the parent company holds at least 10% of the capital of the subsidiary.

Once the UK leaves the EU then, for example, dividends paid to a UK parent company from its EU subsidiaries will no longer benefit from this Directive. This may have implications in terms of the requirements in IAS 12 to provide for tax due on undistributed earnings of subsidiaries or make appropriate disclosures where distribution is not probable in the foreseeable future and the parent company is able to control the timing of payment.

Interest and royalties

The EU Interest and Royalties Directive deals with the elimination of certain withholding taxes on interest and royalties. Potential changes arising from the UK's withdrawal from the EU may mean that such relief is not available in the future.

Guidance

Given the considerable uncertainty which remains over the precise form of the UK's departure from the EU and the effect it may have in terms of taxation, we believe that comprehensive disclosure is the most appropriate solution in the immediate future where entities identify potential tax issues relating to the UK's withdrawal from the EU.

This is consistent with the requirement in IAS 1.125 for a reporting entity to "disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year". Management should also consider the disclosure requirements contained in IAS 37, as required by IAS 12.88.

When making disclosure, entities should be aware that regulators are increasingly challenging companies that make vague statements or ones which are not tailored to their individual circumstances. From a different viewpoint, investors will wish to gain an understanding of judgements and estimations made by management, including where particular decisions rank within a range of possible alternative outcomes.

As time progresses and the exact form of the UK's departure from the EU becomes clearer, it will be necessary to review the approach taken. This will mean providing more specific information as that information becomes available. At some point, liabilities will need to be provided for but we do not think this moment has arrived as yet.