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Possible impact of the effects of COVID-19 on annual accounts and Corporate Income Tax

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On 14 March, the government declared a state of alarm, imposing several extraordinary measures with immediate effect on companies' business activity and on the economy in general, which may have an impact on companies' accounting profits or losses and, therefore, on Corporate Income Tax and the first instalment thereof, the filing deadline for which is 20 April.

The recently approved measures to contain the spread of contagion and the health crisis caused by COVID-19, particularly those adopted by way of Royal Decree 463/2020 of 14 March and Royal Decree-law 8/2020 of 17 March, require companies to take into account the possible effects of this situation on the annual accounts prepared pursuant to the provisions of the Spanish Accounting Plan. [1] In relation to the 2019 financial year, in the case of companies with a financial year coinciding with the calendar year, although the applicability of accounting adjustments cannot be completely ruled out, the accounting effects will generally be limited to describing in the annual report the post-closing events derived from this health crisis and the measures applied in response to the same.

Companies may see their accounting figures affected in the 2020 financial year, however, without prejudice to the provision of relevant information in the annual report that complements the financial statements. Furthermore, taking into account that the starting point for the Corporate Income Tax base is the accounting profit or loss, there is no doubt that many companies will be affected in the 2020 financial year. In fact, the first effects of this situation will be revealed in the first Corporate Income Tax instalment, for which the filing deadline, which has not been suspended, is 20 April 20 (forms 202/222, depending on whether the company files individual or consolidated taxes).

We therefore describe below some of the main ways in which the current crisis may impact companies' accounting profit or loss and, consequently, affect its tax base and instalment

[1] This paper does not, therefore, take into account accounting legislation applicable to listed groups, which apply the European Union Regulations that adopt international financial reporting standards issued by the IASB.

payments. We want to emphasise that, even in those cases where, under the applicable accounting standards, certain expenses should be recorded that would not be tax deductible (certain provisions or impairments, for example), companies' instalment payments may be reduced if the minimum payment based on the accounting result for the period is applied (companies with significant tax loss carryforwards, or significant negative adjustments to be applied to the tax base, for example).

Below is a brief analysis of certain aspects that could be considered:

-Revenue/Net turnover (R/NT)

The health crisis has had an immediate impact on certain sectors whose business has been reduced or discontinued, with direct effects on their revenue and, therefore, on turnover, negatively affecting the income statement for 2020 or the period until 31 March, if we are talking about the first payment on account.

The following aspects, among others, could be considered in this situation:

- A possible increase in sales returns, discounts or others.

- Contract clauses related to delays in the delivery of products by suppliers or even the cancellation of the contract, for example, in relation to possible compensation (receipt of the compensation having to be verified in order to record, where appropriate, the appropriate revenue, which would have tax effects).

From a specific Corporate Income Tax point of view, we must consider:

- Certain tax incentives and/or limitations that depend on the company's R/NT (consideration as a small company, limits on the offsetting of negative taxable income, deductible expenses in the form of hospitality to clients and suppliers, instalments and minimum payments, etc.), so their applicability must be reviewed, both in companies whose sales have decreased and those whose business has increased (private health centres, medical device factories, etc.). However, we should point out that, in relation to the next instalment payment, any possible change in the R/NT for the first quarter of 2020 would only affect deductible expenses in the form of hospitality to clients and suppliers, since for the rest of the incentives/limitations described above, the amount of R/NT from the previous year (2019) would apply.

- We should bear in mind that a decrease in R/NT, and therefore in the company's operating profit, may in turn lead to direct effects on certain tax restrictions such as:

    - the limitation on the deductibility of financial expenses (the general rule states that net financial expenses are deductible up to a limit of 30% of operating profit - assimilable to EBITDA - for the year).

- **Renegotiation of contracts. Special reference to leases.**

It seems that the economic effects of any possible contract renegotiation should have accounting effects and also, therefore, Corporate Income Tax effects. In other words, as a result of the above, there may be a reduction in rents, which may have an impact on the income statement to the extent that this is in line with the exceptional circumstance caused by the present crisis, meaning that the novation of the contract is not merely an incentive granted by one of the parties.

- **Grants and aid**

In relation to any aid that companies may receive from third parties or from the public administration as a result of the current situation, it would be advisable to analyse whether aid received from third parties other than shareholders or owners is considered a gift (Accounting and Valuation Standard 18 – Legacies, gifts and grants received), as such must be booked to profits (for example, the lower interest rates on government-backed loans).

Corporate Income Tax follows the accounting criterion for grants, although when it comes to third-party aid, it is booked under taxable income in the year in which such aid is granted.

- **Asset depreciation**

As a result of the period of inactivity or lower activity caused by COVID-19 in certain sectors (real estate, hospitality, etc.), the pattern of asset consumption may vary or, as the case may be, as indicated below, there could be an indication of asset impairment.

In certain sectors, however (private hospitals, manufacturers of medical devices, etc.), a higher rate of depreciation of their depreciable non-current assets may occur, due to, for example, the use of fixed assets in different shifts. . These events should be valued, in case they affect the depreciation to be recorded.

For the purposes of Corporate Income Tax, it should be verified if the requirements provided in the tax regulations for the deductibility of this possible increase in depreciation (tax tables, if this method is chosen) are met, or, in the event there is a decrease in depreciation, the fact that depreciation below the minimum provided for in such tax tables may have been recorded.

- **Impairment of fixed assets**

The risk derived from COVID-19 may affect the organisation of future cash flows or the discount rate to be used to identify the utilisation value or recoverable amount of an asset. For this reason, it is necessary, where appropriate, to analyse whether there are any impaired assets in the fixed assets, real estate investments and intangible assets, including goodwill. For these purposes, in relation to these and other assets, as described in the sections below (financial, inventories, etc.), it is essential to evaluate the impacts of the fall in levels of business, solvency or market values, in order to decide on their valuation and impairment.

Fiscally, impairments in fixed assets, real estate investments and intangible assets, including goodwill, are not deductible under Art. 13(2) of the Corporate Income Tax Act, but could have effects on the amount of the minimum instalment payment, as they affect the profit or loss for the period.

- **Impairment of inventory**

It would only be possible to account for impairment for this type of asset if the net realizable value of the inventory is lower than its acquisition price or production cost. That is why, a priori, an impairment of inventory cannot be caused by a mere decrease in a company's sales volume or by an increase in stock turnover, when these events are not accompanied by the corresponding decrease in the net realizable value of such inventory.

Fiscally, the impairment of inventory is deductible if it complies with the accounting standard.

- **Default**

As a consequence of this crisis, the status of loans (commercial or financial transactions) held by the company will have to be analysed in detail.

In general (for the credit institution sector there are specific rules based on the expected loss model), an impairment will apply for to the difference between the book value of a loan and the current value of estimated future cash flows (which may be influenced by the insolvency of the debtor, but in which a possible enforcement of the loan's security must also be considered).

They will be deductible if they meet the requirements of Art. 13(1) of the Corporate Income Tax Act are met (six months after maturity of the obligation, debtor declared insolvent, etc.).

- **Changes in the fair value of financial assets and liabilities**

The effect of changes in fair values of financial assets and liabilities should also be taken into account, especially those that have a direct impact on the income statement (derivative instruments and trading portfolios and other assets at fair value on the income statement), which, as a general rule, have a direct impact on the tax base of Corporate Income Tax (Art. 17(1) of the Corporate Income Tax Act).

In relation to equity instruments, note that:

- The possible modifications to the Spanish Accounting Plan, which were expected to be incorporated in 2020, have not yet been approved, so the criteria relating to the portfolio of financial assets available for sale continue to apply. For these purposes, it would be necessary to assess whether these equity instruments have suffered significant or prolonged losses leading to their being recorded as impaired assets in the year's profit or loss.

- In the case of shares in group companies, multi-group companies and subsidiaries, although the valuation rules of the Spanish Accounting Plan allow the value of the investee's equity, corrected for tacit capital gains, to be established as the recoverable value, if there is evidence that the recoverable amount of the investment has fallen below its stated value, it could be used.

However, the aforementioned impairment of these shares are not deductible items, taking into account the limitations set out in the Corporate Income Tax Act.

- **Provisions**

These are liabilities of undetermined amounts or cancellation dates linked to legal, contractual, implicit or tacit obligations. Under accounting regulations, it is not possible to record future losses, so a provision can only be recorded for situations derived from past events. Therefore, it is not possible to record, for example, provisions for an estimated decrease in sales or similar reasons, since these would not be liabilities.

We should also point out that if, after registering a provision, the company expects to receive compensation from a third party (insurance), the collection right derived from such income to be received must also be recorded, provided there are no doubts that the income will be received. The only circumstance where there is no need to record the provision is when there is a legal or contractual link through which the risk has been externalized and by virtue of which the company is not liable.

In the context of the current crisis, the following provisions should be borne in mind:

- **Provisions for liabilities**: compensation, expenses to be paid for ongoing litigation and other contractual obligations that may have arisen due to the present crisis and that are likely to entail an outlay for the company (breach of contracts by the company itself; contracts in which it acts as guarantor for a third party, in the event of actual or possible breach by the guaranteed party, etc.).

  Provisions for legal or contractual obligations, but not implicit or tacit obligations, will be tax deductible; however, they will be included in the tax base for the year in which the expense is applied or allocated to its purpose.[2]

- **Provision for restructuring**. These provisions must correspond to a planned action programme that produces a significant change in the scope of the company's business activity or in the management thereof, not the costs associated with the company's continuing business activity. For example, those related to personnel would only generate a provision when there is a valid expectation.

  Only provisions for legal or contractual obligations, but not tacit obligations, will be tax deductible.

- **Provision for onerous contracts**. These provisions are for losses in contracts that become "onerous", because the cost cannot be recovered, for example, or because delivery cannot be made. It may occur in cases where a supplier, due to the coronavirus crisis, has to assume an unexpected volume of work in relation to the work that was estimated when setting the contract price.

[2] In the particular case of the Collective Redundancy Schemes (abbrev. EREs), the Directorate-General for Taxation (inter alia, formal binding answer to taxpayer's query V2883-14), has confirmed that at the time that the labor authority approves the scheme, the provision for the pay that will be derived from said EREs would become deductible, and this will be the case, even if the notification by the labor authority of said approval, or the payment itself, takes place in a subsequent fiscal year. However, it should be borne in mind that in the Temporary Collective Redundancy Schemes (abbrev. ERTEs) no pay is due to the workers, so the fact that an ERTE is approved should not imply the accounting of any provision, at least in relation to the labour cost.

These are not tax deductible until the year in which they are used for their purpose.

- **Provision for other commercial transactions**

This concept includes incidental costs that the company expects to incur due to the existence of sales returns.

They are tax deductible pursuant to Art. 14(9) of the Corporate Income Tax Act.

- **Fair or market value in related-party transactions**

Without prejudice to verification of the reliability of fair or market values at such a volatile time, as required by accounting regulations and must be understood under these exceptional circumstances, it is true that the values that must be taken into account have to be adapted to the current circumstances.

In other words, during the period in which the health crisis has effects, it is possible to see a change in the normal parameters to be taken into account in deciding the market prices to be applied in related-party transactions.

- **Exceptional expenses**

Any exceptional expenses that may arise from the current crisis (exceptional losses, etc.) must be properly recorded in the company's accounting records.

These will be deductible for tax purposes, unless they are items that the law deems non-deductible (fines and penalties).

Furthermore, we should bear in mind that any donations made by companies as a consequence of the state of alarm must be recorded as an expense that, although it is not considered a tax deductible expense for the purposes of the Corporate Income Tax Act, the deduction could possibly be applied to the tax base if the requirements set out in the Tax Regime for Not-For-Profit Organisations and Tax Incentives for Patronage Act 49/2002 of 23 December are met.

- **Deferred tax assets**

Deferred tax assets shown on the balance sheet are subject to probable reversal based on future earnings. It will be necessary to check whether the forecast on which the recording of these assets was based is still valid.

The effect has no impact on the tax base (Art. 15 of the Corporate Income Tax Act), but it does have an impact on the profit/loss for the year.