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Technical Line

Accounting for the income tax effects of the CARES Act and the COVID-19 pandemic

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What you need to know

- Companies need to consider how the CARES Act and current market conditions resulting from the coronavirus pandemic affect their accounting for income taxes and their disclosures.
- Companies need to account for the income tax effects of the CARES Act in the period that includes the 27 March 2020 enactment date.
- The CARES Act allows companies with net operating losses (NOLs) originating in 2018, 2019 or 2020 to carry back those losses for five years and temporarily eliminates the tax law provision that limits the use of NOLs to 80% of taxable income.
- The CARES Act increases the Internal Revenue Code Section 163(j) interest deduction limit and allows for the acceleration of refunds of alternative minimum tax credits.
- Companies may need to remeasure and reassess the realizability of their deferred tax assets. Companies affected by current market conditions may also need to reconsider their ability to indefinitely reinvest foreign earnings.
- Affected companies may face challenges in estimating all or parts of ordinary income when calculating their estimated annual effective tax rate for interim reporting purposes.

Overview

Companies need to consider the income tax accounting and disclosure implications of the relief provided by the Coronavirus Aid, Relief, and Economic Security (CARES) Act enacted on 27 March 2020 and the market conditions related to the coronavirus (COVID-19) pandemic.

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The income tax accounting and disclosure implications may range from narrow to extensive, depending on a company's facts and circumstances.

In addition, governments around the world are considering various forms of assistance or grants that eligible companies will also need to consider.

This publication supplements our Technical Line, ***Accounting and reporting considerations for the effects of the coronavirus outbreak***, which provides a broader discussion of the accounting and disclosure implications of the COVID-19 pandemic.

Key income tax provisions of the CARES Act

The CARES Act includes many measures to assist companies, including temporary changes to income and non-income-based tax laws, some of which were enacted under the Tax Cuts and Jobs Act (TCJA) in 2017.

Some of the key income tax-related provisions of the CARES Act include:

- Eliminating the 80% of taxable income limitation by allowing corporate entities to fully utilize NOLs to offset taxable income in 2018, 2019 or 2020
- Allowing NOLs originating in 2018, 2019 or 2020 to be carried back five years[1]
- Increasing the net interest expense deduction limit 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 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 the immediate recovery of qualified improvement property costs rather than over a 39-year recovery period

A careful analysis of the temporary relief provided by the CARES Act is necessary to determine whether a company is eligible to use the relief and, if so, how the provisions should be applied. Affected taxpayers will also need to carefully consider the sequencing and interaction of the amended provisions as well as their interaction with various other federal tax provisions, many of which were enacted with the TCJA (e.g., global intangible low-taxed income (GILTI), base erosion and anti-abuse tax (BEAT), foreign-derived intangible income (FDII), 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.

In addition to the income tax provisions noted above, the CARES Act includes non-income tax relief measures, such as allowing payments of the employer share of Social Security payroll taxes that would otherwise be due from the date of enactment through 31 December 2020 to be paid over the following two years. Other provisions will allow eligible employers subject to closure due to the COVID-19 pandemic to receive a 50% credit on qualified wages against their employment taxes each quarter with any excess credits eligible for refunds. Refer to our To the Point, ***Relief provided by the CARES Act will affect accounting and financial reporting***, for more information about the effects of other provisions of the CARES Act.

Accounting for tax law changes in the appropriate period

Accounting Standards Codification (ASC) 740, *Income Taxes*, requires the effect of changes in tax rates and laws on deferred tax balances to be recognized in the period in which new legislation is enacted. In the case of US federal income taxes, the enactment date is the date the bill becomes law, which generally is upon presidential signature. For the CARES Act, that is 27 March 2020.

The tax effect of a change in tax laws or rates on taxes payable or refundable for a prior year is recognized as of the enactment date as tax expense (benefit) for the current year. The effect of a change in tax laws or rates on taxes currently payable or refundable for the current year is recorded after the effective date and reflected in the computation of the annual effective tax rate beginning no earlier than the first interim period that includes the enactment date.[2]

For interim reporting, the effect of new legislation is recognized in the interim period in which the legislation is enacted even if the change in the tax rates is retroactive. Companies cannot allocate the effects of retroactive rate changes to prior interim periods. Furthermore, ASC 740-270-30-11 prohibits including the effect of tax law changes in the computation of the estimated effective tax rate for the year, effectively prohibiting spreading the effects of the change over interim periods following enactment.

Determining when to account for the effects of tax law changes in other countries that provide relief related to COIVD-19 requires an understanding of the legislative process in the specific jurisdiction. Under ASC 740, the enactment date is when all steps in the process for legislation to become law have been completed. In Australia, the United Kingdom and Canada, for example, the enactment date would be when Royal Assent is given to legislation, not when it is passed by Parliament. Refer to chapter 8 of our Financial reporting developments (FRD) publication, ***Income taxes***, for additional considerations on the accounting for tax law changes.

How we see it

Because governments around the world are considering various forms of relief measures in response to the economic conditions of COVID-19, companies will need to monitor developments in the jurisdictions where they have significant operations for tax law changes that could have income tax accounting and disclosure implications.

Income tax accounting considerations related to the CARES Act

Companies will need to account for the income tax provisions of the CARES Act in the period that includes 27 March 2020 (i.e., the first quarter for calendar year-end companies). Certain income tax provisions of the CARES Act are retroactive to earlier years and may, therefore, require companies to amend previously filed tax returns or file Change in Accounting Method applications.

For example, the law allows companies 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 companies 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.

How we see it

Many corporate taxpayers will benefit from the income tax relief provided by the CARES Act. However, the complexity of the tax law requires careful consideration of the overall effect, including the sequencing of and interaction between its provisions and other federal tax laws.

Changes to the NOL carryback and carryforward rules

The CARES Act allows corporate taxpayers to carry back NOLs arising in tax years beginning after 31 December 2017 and before 1 January 2021 (e.g., calendar-year companies can carry back NOLs arising in 2018, 2019 and 2020) and use them to offset taxable income in each of the five years preceding the tax year the loss was generated. For example, 2018 losses can be carried back to offset taxable income from 2013 through 2017.

This change provides temporary relief from the provisions of the TCJA that had generally repealed all carrybacks of losses generated in taxable years ending after 31 December 2017. The CARES Act also provides special carryback rules for certain taxpayers, such as real estate investment trusts and life insurance companies, and provides a technical correction to the TCJA, allowing a fiscal year company to carry back an NOL arising in its 2018 tax year under the prior NOL carryback regime (allowing for a two-year carryback).

Companies that carry back NOLs to years subject to the transition tax under TCJA (i.e., Internal Revenue Code (IRC) Section 965) will need to perform additional analysis to understand how the changes to the NOL carryback rules in the CARES Act affect them. In addition, companies may need to adjust amounts previously recorded for uncertainty in tax positions affected by the interactions of the provisions in the CARES Act.

The changes to NOL carryback and carryforward rules may require companies to schedule the reversals of their temporary differences.

The CARES Act also temporarily eliminates the provision of the TCJA that limits the amount corporate taxpayers are able to deduct for NOLs generated in tax years beginning after 31 December 2017 to 80% of their taxable income. That is, the CARES Act allows corporate taxpayers to fully use NOLs to offset taxable income in 2018, 2019 or 2020. For tax years beginning after 2020, the 80% limit will be reinstated.

Accounting considerations related to the changes to the NOL carryback and carryforward rules

Adjustments to existing DTAs and DTLs

ASC 740-10-30-8 states that the objective of the measurement guidance for deferred tax assets (DTAs) and deferred tax liabilities (DTLs) is "to measure a deferred tax liability or asset using the enacted tax rate(s) expected to apply to taxable income in the periods in which the deferred tax liability or asset is expected to be settled or realized." Therefore, companies with federal NOLs originating in 2018 and 2019 that expect to carry them back to earlier years will need to remeasure the DTAs related to their NOLs. This is because the NOLs originating in 2018 and 2019 were initially measured at the current US corporate tax rate of 21%; however, these NOLs may now be carried back to offset taxable income that was taxed at a 35% tax rate.

In addition, a company may need to schedule its temporary differences to determine whether any of its DTAs and DTLs, upon reversal in 2020, will give rise to an NOL that will be recovered by a carryback to a prior year. A company with beginning-of-the-year DTAs for deductible temporary differences in excess of DTLs for taxable temporary differences that will reverse in the 2020 taxable year into an NOL that is expected to be realized by carryback should remeasure those DTAs and DTLs using the tax law and rates for the year the refund is expected to be realized (i.e., the year to which the loss is expected to be carried back) as a discrete item in the interim period including 27 March 2020. However, if net DTLs are expected to reverse in 2020, this would not result in an NOL being generated upon their reversal. In the situation where an overall loss is expected for the year, a company should measure the beginning-of-the-year net DTLs using the tax law and rates for the year the refund is expected to be realized (i.e., the year to which the loss is expected to be carried back) as part of the estimated annual effective tax rate.

Companies that have DTAs for disallowed interest deductions originating in 2019 may need to consider whether the temporary increase in the interest deduction limitation changes either the amount of NOLs originating or utilized in 2019 that can now be carried back. See the *Temporary changes to the business interest deduction limitation rules* section below for further discussion of the temporary changes to the interest deduction limitation rules.

Companies that carry back losses to offset taxable income in prior years under the CARES Act will also need to consider how other tax attributes that were used in a prior year may now be recalculated as a result of the carryback (e.g., previously used foreign tax credits may be recalculated after carrying back a loss). In addition, GILTI, BEAT, FDII and Section 199 amounts may be affected. Other considerations relating to the interaction of the NOL carryback with other provisions include the effect on the taxpayer's AMT liability or credits, if any, in the carryback year. Refer to the *Valuation allowance considerations* section below for additional discussion.

Balance sheet classification

Companies that plan to carry back losses from 2018 or 2019 should reclassify the amount of tax-effected NOLs they expect to offset against a prior year's taxable income from deferred taxes to an income tax receivable (or a reduction in income taxes payable) if they expect a refund within the next 12 months. Refer to Illustration 2 below for an example of the adjustments to existing DTAs related to NOLs.

NOL carryforward considerations

Companies that utilized NOL carryforwards from post-tax-reform years to offset taxable income in 2019 will need to consider whether they can further offset additional taxable income in those years, due to the elimination of the 80% limitation on the usage of NOLs. In this case, a company may need to reclassify a portion of the existing NOL carryforwards to an income tax receivable (or a reduction in income taxes payable) if the company expects a refund as a result of the limitation being eliminated for those tax years.

Illustration 1 — Effects of modifications to the limitation on usage of NOLs

Facts

- A company generated $1,500 in NOL carryforwards in 2018 that were previously subject to the 80% limit under the TCJA. The company does not have taxable income in any of the carryback years.
- The company's taxable income during 2019 was $1,000.
- The company has not recorded a valuation allowance.

Analysis

The following table illustrates the company's 2019 income tax provision before the CARES Act, when the NOLs were subject to the 80% limit under the TCJA, and after the CARES Act, when the temporary relief allowing the full use of NOLs is in effect:

	Pre-CARES Act	**Post-CARES Act**
Taxable income before utilization of NOLs	$ 1,000	$ 1,000
NOLs used (subject to 80% limit pre-CARES Act and no limit post-CARES Act)	(800)	(1,000)
Taxable income	200	-
Remaining NOL carryforward before and after CARES Act	$ 700	$ 500

As the table shows, the company can now use an additional $200 of its NOL carryforward ($1,000 rather than $800) because of the temporary elimination of the 80% limit. The company should reclassify the tax-effected amounts of the NOLs ($200*21% or $42) from DTAs to an income tax receivable (or a reduction in income taxes payable). In addition, if the company had previously recorded a valuation allowance against these DTAs, it would need to reverse its valuation allowance related to this portion of the DTA because the $42 in DTAs would become realizable when the 80% limit on the use of NOLs was eliminated.

Valuation allowance considerations

Companies may also need to reevaluate previous valuation allowance conclusions in the period that includes the enactment date because of the CARES Act's changes to the NOL carryback and NOL limitation rules.

Under the TCJA, companies were not permitted to carry back losses generated in taxable years ending after 31 December 2017. After the enactment of the CARES Act, companies are allowed to carry back NOLs arising in 2018, 2019 and 2020 and use them to offset taxable income in each of the preceding five years. As a result, companies that were not previously able to consider taxable income in carryback periods as a source of taxable income when evaluating the realizability of their NOLs are now able to do so. Refer to Illustration 2 below for an example of the effect of this provision in a company's valuation allowance assessment.

Companies may need to reevaluate their previous valuation allowance conclusions.

In addition, when evaluating other sources of future taxable income prior to the CARES Act, companies would need to carefully consider the limitation on the use of their NOLs to 80% of their taxable income. After the enactment of the CARES Act, the usage of NOLs to offset taxable income is limited to 80% of taxable income only in years after 2020.

Because of the temporary measures in the CARES Act, companies may reach different conclusions regarding the realizability of their DTAs in the period of enactment. Refer to sections 6.3, *Source one — taxable income in prior carryback years*, and 6.4, *Source two — future reversal of existing temporary differences*, of our FRD, ***Income taxes***, for additional discussion on using carrybacks and carryforwards when evaluating the realizability of DTAs.

Illustration 2 — Effects of modifications to NOL carryback rules

Facts

Company A, a calendar-year company has the following at 31 December 2019:

- Deductible temporary differences of $1,000, expected to reverse entirely in 2021
- NOL carryforwards of $300 originating in 2018 and $300 originating in 2019
- Taxable temporary differences of $700, expected to reverse entirely in 2022 (i.e., a period the 80% limitation is in effect)
- A valuation allowance as it has no projected future taxable income beyond the reversal of its taxable temporary differences and no tax planning strategies available

Additionally, the company had taxable income of $250 in both 2016 and 2017.

The tax rate was 21% in 2019 and 2018 and 35% in 2017 and 2016.

Pre-CARES Act analysis

Under the TCJA, carrybacks for the losses generated in 2018 and 2019 were not available. Therefore, the company would have performed its valuation allowance assessment without considering taxable income in prior carryback years, as follows:

	Gross	Tax-effected (at 21%)
Deductible temporary differences	$ 1,000	$ 210
NOL carryforwards	600	126
Total temporary differences and carryforwards to be assessed	1,600	336
Source one: carryback — repealed under the TCJA	N/A	N/A
Source two: reversals of existing taxable temporary differences (limited to 80% based on the taxable income limitation in effect for 2022 (700*80%))	(560)	(118)
Sources three and four: tax planning strategies and projections		-
Total DTAs realizable based on sources of taxable income		(118)
Net DTAs requiring a valuation allowance		218
Valuation allowance		(218)
Net DTAs after valuation allowance		$ -

Because Company A does not have any taxable income from sources three and four to support the realizability of its existing DTAs, its assessment was limited to the future reversals of existing taxable temporary differences. Based on its analysis, Company A recorded a valuation allowance for $218.

Note, in this illustration, the taxable temporary difference reverses in a period when there are no reversing deductible temporary differences. Therefore, based on the expected reversal pattern, the company would only be able to utilize NOLs of up to 80% of the expected taxable income or $560.

Post-CARES Act analysis

Company A will carry back $500 of the $600 of NOLs to offset taxable income in 2016 and 2017, based on the temporary relief provided by the CARES Act. There is no available taxable income in any other carryback period and, therefore, the remaining $100 loss is carried forward.

Because the deferred taxes for NOLs were measured using the tax rate at which they were expected to be recovered (i.e., 21%), the $500 of NOLs being carried back need to be remeasured based on the tax rate enacted in the carryback period (i.e., 35%). The adjusted amount is reclassified from deferred taxes to income tax receivable (or reduction in income taxes payable) because Company A will file a refund claim and expects a refund within the next 12 months. The remaining $100 of NOLs that will be carried forward would be still tax-effected at 21%.

The updated valuation allowance assessment would be as follows:

	Gross	Tax-effected
Deductible temporary differences (at 21%)	$ 1,000	$ 210
NOLs — carried back (at 35%)	500	175
NOLs — carried forward (at 21%)	100	21
Total temporary differences and carryforwards to be assessed	1,600	406
Source one: NOLs carried back to 2016 and 2017 under the CARES Act	(500)	(175)
Source two: reversal of existing taxable temporary differences (limited to 80% based on taxable income limitation in effect for 2022 (700*80%))	(560)	(118)
Sources three and four: tax planning strategies and projections		-
Total DTAs realizable based on sources of taxable income		(293)
Net DTAs requiring a valuation allowance		113
Valuation allowance		(113)
Net DTAs after valuation allowance		$ - [(a)]

[(a)] In this example, the net DTA after valuation allowance is zero because the company expects the $175 to be refunded within the next 12 months and reclassified that amount to income tax receivable or a reduction in income taxes payable.

Because of the changes to the NOL carryback rules under the CARES Act, the company can now realize $175 of its DTAs for NOLs ($500*35%). The company will recognize the change in the valuation allowance, along with the increase in the carrying value of its NOLs in the period of enactment. For interim periods, this amount would be recognized discretely with any other income tax effects of applying the CARES Act.

Note, in this illustration, the taxable temporary difference reverses in a period when there are no reversing deductible temporary differences. Therefore, based on the expected reversal pattern, the company would only be able to utilize NOLs of up to 80% of the expected taxable income or $560. This example demonstrates the need for careful scheduling to determine the entire effects of the CARES Act changes related to NOL rules.

Other considerations, including recalculated tax credits

Companies that carry back losses to offset taxable income in prior years under the CARES Act also need to consider that other tax positions and attributes that were used in a prior year may now be adjusted as a result of the carryback. The carryback of NOLs can affect other tax calculations, including foreign tax credits (FTCs), FDII, GILTI, Section 199, R&D tax credits, BEAT and Section 965 transition tax calculations, among others.

For example, a company may have used FTCs to offset taxable income in 2016. If the company now carries back NOLs originating in 2019 to offset 2016 taxable income, the FTCs previously used in 2016 will be recalculated and may be available to be carried back or forward. If those recalculated tax credits would expire unused after a company applies the loss carryback, a valuation allowance may be necessary for the related DTAs equal to the amount of recalculated tax credits. In other words, although the carryback of the current period deductible temporary difference would result in the realization of those DTAs, the previously realized tax credits may no longer be realizable. This situation results in the same tax position as deeming it to be more likely than not that all or a portion of the current period deductible temporary differences will not be realized and recognizing a valuation allowance in the current period on those DTAs.

How we see it

Companies should consider the effects of temporary changes to NOL carryback and carryforward rules on the resulting taxable income or loss in carryback years as well as the realizability of their DTAs (including NOL-related DTAs) and tax credit carryforwards. This likely will require companies to schedule the reversal of their temporary differences.

Interim reporting considerations

For interim reporting, the effects from adjusting DTAs or changes to valuation allowances as a result of the CARES Act should be recognized as a component of income tax expense or benefit from continuing operations in the interim period that includes 27 March 2020 and should not be allocated to subsequent interim periods by an adjustment of the estimated annual effective tax rate (EAETR). Companies that expect to have taxable losses for 2020, and have taxable income in periods earlier than 2018, may be able to benefit from those losses at a 35% tax rate rather than the current US corporate tax rate of 21%.

For changes in valuation allowances that are not related to the CARES Act, a company will apply the guidance in ASC 740-270 to determine whether those changes should be reflected in the EAETR. The tax effect of a valuation allowance expected to be necessary for DTAs and carryforwards originating during the year should be included in the EAETR. Changes to the beginning-of-the-year valuation allowance as a result of a change in expectations of future years' income (i.e., subsequent to the current year) are not reflected in the EAETR but recorded discretely in the period.

Temporary changes to the business interest deduction limitation rules

The TCJA modified IRC Section 163(j) to limit a company's interest deduction to 30% of the taxpayer's adjusted taxable income (ATI).[3] ATI is currently computed as taxable income excluding depreciation, amortization or depletion (approximating earnings before interest, taxes, depreciation and amortization) and will include these items beginning in 2022 (approximating earnings before interest and taxes). The CARES Act temporarily changes this interest deduction limit to 50% of a taxpayers' ATI for tax years that began in 2019 or 2020. Therefore, companies may be able to deduct more interest expense during those fiscal years.

For 2020, the CARES Act provides taxpayers with the option to use their 2019 ATI to calculate their interest deduction limitation instead of their 2020 ATI. Given the current economic conditions, many taxpayers may have greater ATI in 2019 than 2020. In those cases, electing to use 2019's ATI in lieu of 2020's ATI will generally result in a higher interest deduction in 2020 than otherwise would be permitted. The additional interest expense deducted may give rise to (or increase) an NOL originating in 2020, which, as previously discussed, may now be carried back to offset taxable income in five prior tax years. Companies that prepare interim financial statements should consider whether they will elect to use their 2019 ATI when estimating the amount of deductible interest in determining their EAETR for 2020.

Because of the relief measures, companies might see their interest deduction carryforwards reduced because they can now deduct more of their 2019 interest. Companies may need to reassess the realizability of any DTAs for interest carried forward due to the temporary increase in the amount of interest eligible to be deducted in 2019 and 2020. Refer to section 6.4.3, *Consideration of the limits of interest expense deduction*, of our FRD, ***Income taxes***, for additional discussion of considerations relating to the limits on the interest expense deduction.

If a company is relying on projections of future taxable income, it will also need to consider the effects of the limitations in those projections, including any projections of future interest expense.

Illustration 3 — Effects of modification to the interest deduction limitation

Facts

- During 2019, a company had ATI of $1,000 and interest expense of $600.
- At 31 December 2019, the company had an interest deduction carryforward from disallowed business interest of $300.
- As of 31 December 2019, the company had no NOL carryforwards or any other temporary differences.

Analysis

The following table illustrates the company's 2019 ending net temporary differences and carryforwards before the CARES Act, when the interest deduction was subject to the limit of 30% of ATI under the TCJA, and after the CARES Act, when the limit on interest deductions temporarily increased to 50%:

	2019 Pre-CARES Act	2019 Post-CARES Act
ATI income	$ 1,000	$ 1,000
Allowed interest expense deduction (30% and 50% of ATI, respectively)	(300)	(500)
Temporary differences and carryforwards:	**Balance at 12/31/2019**	**Balance at 12/31/2019**
Interest deduction carryforward generated (total interest expense of $600 — interest expense deducted)	300	100

Under the CARES Act, the company can deduct an additional $200 of interest expense in 2019. As a result, its interest deduction carryforwards are reduced by that amount. In addition, if the company had recorded a valuation allowance on 31 December 2019, it would need to assess whether to adjust the amount. For interim reporting, any adjustments to deferred tax amounts or valuation allowances resulting from the CARES Act should be recorded discretely in the period of enactment.

Additionally, increased interest deductions may affect the calculation of other income and expense items during the affected years, which will need to be carefully considered and factored into a company's scheduling of the reversal of its temporary differences when assessing the effect of the CARES Act. Potential interactions include the Section 250 deduction, NOL utilization, BEAT, and FTCs in tax years beginning in 2019 and 2020 as follows:

- Section 250 deduction — Because the Section 250 deduction is limited based on taxable income, an increase to the business interest deduction may reduce a company's Section 250 deduction, affecting amounts of GILTI and FDII.
- Section 59A (BEAT) — An increased business interest deduction may create or increase BEAT liability by reducing a company's regular tax liability.
- FTCs — Increased business interest deductions may reduce a company's allowable FTCs due to adjustments to the FTC limitation.

Acceleration of refundable AMT credits

The CARES Act provides companies with potential additional liquidity by accelerating AMT credit refunds, allowing them to claim the refund in full in either 2018 or 2019 for any remaining credits instead of recovering the credit through refunds over a period of years, as it was established by the TCJA.

Companies that presented their remaining AMT credits as a noncurrent income tax receivable should reclassify them as current income tax receivable if they expect the amounts to be refunded in the next 12 months.

Changes to charitable contribution limits

The CARES Act allows companies to deduct more of their 2020 charitable contributions by temporarily increasing the limit on cash contributions to 25% of taxable income from 10%. The higher limit applies only to contributions made in 2020.

A company that is computing its interim income tax provision should consider the new limit when determining its EAETR for the quarter that includes the enactment date.

Accounting considerations relating to current market conditions

Indefinite reinvestment assertion

Companies that historically asserted their intent and ability to indefinitely reinvest foreign earnings should challenge whether they can continue to do so if their operations have been affected by the COVID-19 pandemic or current market conditions.

The assertion that earnings from foreign operations will be indefinitely reinvested should be supported by projected working capital and long-term capital needs in the locations in which those earnings are generated (or other foreign locations) and an analysis of why those funds are not needed upstream. Although companies may have historically been able to demonstrate their ability to indefinitely reinvest foreign earnings, current market conditions may call into question a company's ability to continue to indefinitely reinvest foreign earnings, particularly if a company is shifting the location of operations.

If a company changes its reinvestment assertion during an interim period, the deferred income tax effects of undistributed earnings related to prior years, including any deferred income tax effects of the beginning-of-the-year cumulative translation adjustment related to the investment (i.e., the outside basis difference on the company's investment in a foreign subsidiary as of the beginning of the year) should be reported in continuing operations as a discrete charge to income tax expense in the period in which the change in assertion occurs. The backward tracing of the tax effects of the beginning-of-the-year cumulative translation adjustment to accumulated other comprehensive income would not be appropriate.

The tax effects of undistributed earnings, including translation adjustments related to the current year (i.e., the outside basis difference related to the current reporting year), would be recognized as an adjustment to the EAETR in the period in which the change in assertion occurs. The deferred tax effects of the translation adjustment related to the current period should be reported in other comprehensive income in accordance with ASC 740-20-45-11.

Realizability of DTAs and carryforwards

Companies affected by current market conditions related to the COVID-19 pandemic may be incurring unexpected losses and may need to reevaluate and change their conclusions about the realizability of their DTAs. Future realization of DTAs ultimately depends on the existence of sufficient taxable income of the appropriate character in either the carryback (if permitted under the tax law) or carryforward period under the tax law. Determining whether a valuation allowance for DTAs is necessary often requires an extensive analysis of positive and negative evidence regarding the realization of the DTAs, including an assessment of the likelihood of sufficient future taxable income.

ASC 740 lists the following four possible sources of taxable income that should be considered in determining whether a valuation allowance is required:

- Taxable income in prior carryback year(s), if carryback is permitted under the tax law
- Future reversals of existing taxable temporary differences
- Tax-planning strategies
- Future taxable income exclusive of reversing temporary differences and carryforwards

Companies that expect to be in a cumulative loss position based on revised forecasts that reflect the effects of the pandemic should consider this negative evidence about the realizability of DTAs.

ASC 740 states that recent cumulative losses or the expectation that a company will have cumulative losses constitutes significant negative evidence about the realizability of DTAs that is difficult to overcome. We do not believe that, for the purpose of this assessment, there is a significant difference between being in a cumulative loss position and expecting to be in one. Therefore, a company that currently is not in a cumulative loss position but expects to be in such a position based on a revised forecast that reflects current market conditions should consider the negative evidence of the expected cumulative losses in the same manner as a company that is already in a cumulative loss position.

For companies that prepare interim financial statements, ASC 740 requires that the effect of a change in the beginning-of-the-year balance of a valuation allowance as a result of a change in judgment about the realizability of the related DTA in future years be recognized as a discrete event in the interim period that the change in judgement is made and not apportioned to other interim periods. The tax effect of a valuation allowance expected to be necessary for DTAs and carryforwards originating during the year should be included in the EAETR.

Management should also consider whether the disclosures made in the notes to the financial statements and management's discussion and analysis (MD&A) regarding the realizability of the company's DTAs are sufficient, especially if the company changes its assessment of the realizability of its DTAs from the prior reporting period because of significant losses in the year-to-date period and/or changes to its expectations about taxable income in the future.

Accounting for income taxes in an interim period

A company is required at the end of each interim reporting period to make its best estimate of the annual effective tax rate for the full fiscal year and use that rate to provide for income taxes on a current year-to-date basis. The EAETR is applied to ordinary income. Ordinary income (or loss) refers to income (or loss) from continuing operations before income taxes (or benefits), excluding significant unusual or infrequently occurring items (as these terms are defined in ASC 220-20, *Income Statement — Reporting Comprehensive Income — Unusual or Infrequently Occurring Items*). Discontinued operations and the cumulative effects of changes in accounting principles are also excluded from ordinary income (or loss).

Significant unusual or infrequently occurring items are reported as discrete events (i.e., not included in the annual effective tax rate) if they reflect transactions that are separately reported or reported net of the related tax effects (e.g., discontinued operations). In addition to being unusual or infrequently occurring, a transaction also must be significant to be excluded from ordinary income (and, therefore, excluded from the effective tax rate calculation). Significance generally does not, in and of itself, allow for a transaction to be recognized discretely.

Companies affected by the COVID-19 pandemic and current market conditions may be recognizing goodwill or long-lived asset impairment charges or entering (or expecting to enter into) transactions to modify leases, loans or other contracts. Deciding whether significant events should be considered unusual or infrequently occurring items can be challenging and requires careful consideration of the facts and circumstances as well as expectations about the future.

In some instances, an event may not be infrequent or unusual but may change the ordinary income projections so significantly that it calls into question a company's ability to estimate its ordinary income. See the following section for discussion when a company does not have the ability to estimate its ordinary income.

Ability to estimate the annual effective tax rate

Under ASC 740, each interim period is considered an integral part of the annual period, and the tax expense is measured using an EAETR. A company is required, at the end of each interim reporting period, to make its best estimate of the annual effective tax rate for the full fiscal year and use that rate to provide for income taxes on a current year-to-date basis. The estimated effective tax rate should reflect enacted federal, state and local income tax rates; foreign tax rates and credits; percentage depletion; capital gains rates; other taxes and credits; and available tax-planning alternatives. The rate should be revised, if necessary, as of the end of each successive interim period during the fiscal year to the company's best current estimate of its annual effective tax rate.

Companies affected by the COVID-19 pandemic may experience a reduction in demand, temporary closures of their operations or supply chain interruptions that may create challenges in preparing reliable estimates. Estimates of the annual effective tax rate are, of necessity, based on evaluations of possible future events and transactions and may be subject to refinement or revision.

ASC 740 addresses the consequences of a company's inability to reliably estimate some or all the information that is ordinarily required to determine the annual effective tax rate in an interim period financial statement. When a company is unable to estimate a part of its ordinary income (loss) or the related tax expense (benefit) but is able to make a reliable estimate of its EAETR, the tax expense (benefit) applicable to the item that cannot be estimated should be reported in the interim period in which the item is reported.

In some cases, a company may not be able to make a reliable estimate of its EAETR (e.g., when minor changes in estimated ordinary income could have a significant effect on the estimated effective tax rate). This could occur when a company's operating results will be at or near breakeven or when permanent differences are significant compared to estimated income. If a reliable estimate of the EAETR cannot be made, the actual effective tax rate for the year to date may be the best estimate of the annual effective tax rate.

In addition, when there is a significant variation in the customary relationship between income tax expense and pretax income in the interim period financial statements, a company should disclose the reasons in its interim financial statements if they are not otherwise apparent from the financial statements or from the nature of the company's business.

How we see it

We generally expect a company to be able to make a reliable estimate of ordinary income and an EAETR. However, due to challenges relating to current market conditions, a company may not have the ability to make a reliable estimate of all or part of its ordinary income. We believe that a company's conclusion that it cannot make a reliable estimate of all or parts of its ordinary income or its EAETR should be consistent with conclusions reached about similar projections used by management in the financial statements and disclosures made to users of the financial statements.

Companies with operations in multiple jurisdictions

A company that has operations in multiple jurisdictions may be experiencing losses in certain jurisdictions due to the current market conditions. Generally, ASC 740 requires a company that is subject to tax in multiple jurisdictions to determine one overall EAETR to calculate the interim period tax expense (benefit). However, there are two exceptions to this requirement:

- If, in a separate jurisdiction, the company anticipates an ordinary loss for the fiscal year or incurs an ordinary loss for the year-to-date period for which a tax benefit cannot be realized, the company should exclude the ordinary income (loss) in that jurisdiction and the related tax (benefit) from the overall computations of the EAETR and interim period tax (benefit). The company must compute a separate EAETR for this jurisdiction, which would be applied to the ordinary income (loss) in that jurisdiction.
- If a company is unable to estimate the annual effective tax rate in a foreign jurisdiction in dollars or is otherwise unable to make a reliable estimate of the ordinary income (loss) or the related tax (benefit) in a foreign jurisdiction for the fiscal year, the company should exclude the ordinary income (loss) in that jurisdiction and the related tax (benefit) from the overall computations of the EAETR and interim period tax (benefit). The company must compute separately the interim tax (benefit) in this jurisdiction as the jurisdiction reports ordinary income (loss) in an interim period.

Companies with year-to-date ordinary losses in an interim period

Affected companies may have unexpected ordinary losses and will need to determine whether they will be able to benefit from those losses when computing their EAETR. In addition, when a company has a year-to-date ordinary loss that exceeds the anticipated ordinary loss for the fiscal year, ASC 740 limits the income tax benefit recognized for the year-to-date interim period to the amount that would be recognized if the year-to-date ordinary loss were the anticipated ordinary loss for the fiscal year.

This limitation does not apply to companies that have early adopted Accounting Standards Update (ASU) 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*, which eliminates this exception in ASC 740. Under the new guidance, a company would no longer limit the tax benefit recognized in an interim period if it expects to realize a tax benefit.

Refer to our FRD, ***Income taxes***, for additional information.

Disclosures

ASC 740 requires companies to disclose the effects of adjustments to deferred tax amounts for enacted changes in tax laws or rates. Companies also need to carefully consider how other aspects of the CARES Act and the COVID-19 pandemic may affect each of the income tax disclosures required under ASC 740.

Additional SEC disclosure considerations

When the effects of tax law changes are or will be material to a registrant, the registrant should consider the disclosure implications in preparing its MD&A under Item 303 of Regulation S-K, including its discussion of results of operations and liquidity and capital resources.

The remeasurement of DTAs and DTLs and any reassessment of the realizability of DTAs may have a material effect on many registrants' tax provisions.

In addition, the CARES Act may result in changes to a registrant's effective tax rates in interim periods when the temporary provisions are in effect. When disclosing results of operations, registrants should disclose and explain the effect of the CARES Act on their tax provision as well as the expected effects on the effective tax rate in future periods.

The Securities and Exchange Commission (SEC) staff has historically requested that a registrant disclose the amount of cash held overseas that is unavailable for use domestically if the registrant has asserted that it will indefinitely reinvest foreign earnings. Registrants may need to revisit their assertions about permanently reinvesting foreign earnings in light of the COVID-19 pandemic and current market conditions, along with their disclosures about liquidity and capital resources in MD&A.

Government assistance

Measures considered by governments around the world to help companies deal with the economic fallout of the COVID-19 pandemic include providing loan guarantees or loans at below-market interest rates, grants, tax relief and paying for medical services (e.g., diagnostic testing for COVID-19). To receive the relief, companies may be required to agree to certain conditions.

Each government program likely has its own specific requirements, which require a careful assessment to determine both the eligibility and the proper accounting treatment of any government assistance a company receives. The accounting and disclosure implications (e.g., timing of recognition, financial statement presentation) would vary significantly, for example, depending on whether the assistance is considered a loan, a grant, a payment for goods or services, a contribution or an income tax credit.

Companies that receive government assistance need to carefully consider the type of assistance to determine the appropriate accounting treatment.

How we see it

Legislation providing assistance may use terms such as "grant" or "credit" to describe the form of the assistance, but companies will need to carefully evaluate the substance of the legislation to determine the appropriate accounting.

Determining whether government assistance relates to income taxes

We generally believe that a company that receives government assistance in the form of an income tax credit should account for the assistance in accordance with ASC 740.

ASC 740 applies to all federal, foreign, state and local (including franchise) taxes based on income. That is, any tax levied on (or credited to) a company based on the company's income (or income tax liability) is generally subject to the provisions of ASC 740. A credit from a government entity that isn't based on taxable income would generally be considered a government grant and would, therefore, be out of the scope of ASC 740. Refer to section 4.2.8, *Government assistance received,* of our FRD, ***Income taxes***, for additional information on the accounting for government assistance that is in the scope of ASC 740.

For more information about accounting considerations for government assistance not in scope of ASC 740, refer to our Technical Line, ***Accounting and reporting considerations for the effects of the coronavirus outbreak***.

Internal control considerations

Companies will also need to evaluate how the significant disruptions caused by the COVID-19 pandemic have affected their processes and key controls relevant to the accounting for income taxes on an interim basis. The business provisions of the CARES Act change US tax law and need to be accounted for during the interim period that includes the 27 March 2020 enactment date. This will require companies to execute key controls over non-routine aspects of the accounting for income taxes while likely facing significant operational challenges.

As indicated above, several provisions of the CARES Act can affect temporary differences between taxable income and book income and, therefore, may require revisions to the accounting for DTAs and associated valuation allowances. Given the decline in operating results many companies have experienced and the uncertainties about the economic outlook, companies may find it challenging to develop financial projections needed to establish the EAETR, evaluate the realizability of DTAs and support an indefinite reinvestment assertion for non-recognition of deferred income taxes.

Companies may also face challenges in aggregating adequate financial information at an interim date to execute key management review controls with a sufficient level of precision, particularly if their operations in one or more geographic locations are acutely affected by the pandemic.

Accordingly, it is critical for companies to evaluate whether their legacy processes and controls are adequate in the current operating environment or whether they need to modify their controls to address new risks of material misstatement that relate to the COVID-19 pandemic.

Endnotes:

[1] For fiscal year taxpayers, this includes the fiscal tax years beginning in 2018, 2019 and 2020.

[2] ASU 2019-12 requires a company to reflect the effect of an enacted change in tax laws or rates in the annual effective tax rate computation in the first interim period that includes the enactment date of the new legislation. For public business entities, the guidance is effective for fiscal years beginning after 15 December 2020 and interim periods within those fiscal years. For all other entities, the guidance is effective for fiscal years beginning after 15 December 2021 and interim periods within fiscal years beginning after 15 December 2022. Early adoption is permitted.

[3] Additional US federal regulations are expected that may change the definition of ATI. Companies should continue to monitor developments.