New Developments Summary

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COVID-19 and the CARES Act: income tax accounting and reporting considerations

Contents

In response to the market volatility and economic instability prompted by COVID-19, President Trump signed into law on March 27 the CARES Act (the Act), a $2 trillion relief package comprising a combination of tax provisions and other stimulus measures. The Act also makes certain technical corrections to the 2017 Tax Cuts and Jobs Act.

This publication provides a summary of the provisions of the CARES Act and discusses many income tax accounting and financial reporting considerations triggered by the Act and COVID-19. Entities are required to record the tax effects of the Act in the interim and annual periods that include March 27, 2020, which is the date when the new law was enacted.

Given the rapidly evolving nature of the global economic impact of COVID-19, entities should maintain close communication with their board of directors, legal advisers, external auditors, and other service providers. Stay informed at Grant Thornton's COVID-19 Resource Center.

A. Summary of key provisions

A number of provisions in the Coronavirus Aid, Relief, and Economic Security Act (CARES Act or Act) could have significant income tax accounting implications for entities, including changes to how deferred tax assets and liabilities are measured, whether deferred tax assets are realizable, or in an entity's tax positions. Entities should not evaluate the impact of these changes in isolation, as there may be interplay between various provisions.

The key changes to corporate taxation under the CARES Act include

- Revisions to net operating loss rules, including a technical correction to the 2017 Tax Cuts and Jobs Act (TCJA)
- Temporary changes to the business interest expense disallowance rules
- Acceleration of corporate alternative minimum credit refunds
- A technical correction to allow accelerated deductions for qualified improvement property
- Modification of charitable contribution limits
- Payroll tax relief

B. Recognition of changes in tax laws and rates

An entity records the effects of an enacted change in a tax law or tax rate in the period that includes the enactment date—that is, the date when a tax bill becomes law—in accordance with both the general income tax recognition guidance in ASC 740-10-45-15 and the interim reporting guidance for income tax recognition in ASC 740-270-25-5. For example, U.S. federal tax law and rate changes are enacted when the legislation is signed by the President. The effects of a change in tax law or tax rate cannot be anticipated in the financial statements, so the effect of these changes should be recognized in the period when the change is enacted, which is the period that includes March 27, 2020 for the CARES Act.

The enactment date of a tax law or tax rate change is often different from the effective date. In some instances, a tax law change may include retroactive provisions whose impact is reflected in the period of enactment. In other words, the tax effects of retroactive changes in tax laws or rates on income taxes receivable (payable) for a prior year are recognized in income tax expense (benefit) from continuing operations as of the date of enactment. If the retroactive changes impact income taxes receivable (payable) for the current year, the impact is considered in determining the estimated annual effective tax rate beginning in the interim period that includes the enactment date.

The guidance in ASC 740-10-45-15 requires entities to include the effect of adjusting deferred tax assets and liabilities related to an enacted tax law or rate change as a discrete component of tax expense (or benefit) in income from continuing operations in the period that includes the enactment date. A discrete component of tax expense (or benefit) is individually computed and recognized in the period the item occurs. The effect of a change in tax law or rate on the deferred tax liability or asset should not be apportioned among interim periods by adjusting the annual effective tax rate. The effects are generally based on the deferred tax balances as of the enactment date; however, balances as of the beginning of the year may be used as a proxy.

The tax effect related to a change in tax law or rate is reflected in continuing operations, regardless of where the related tax provision or benefit was initially recorded. Accordingly, entities should remeasure temporary differences arising either from prior-year transactions related to discontinued operations or from items that were not originally included in income from continuing operations (such as adjustments for a change in accounting principle, a business combination, gains or losses on available-for-sale securities included in other comprehensive income, and differences for share-based compensation that were recorded directly to equity), and reflect the change in current-period income tax expense (or benefit). Consequently, an entity is prohibited from “backward tracing” the income tax effects of tax provisions or benefits related to the CARES Act that were originally recorded in other comprehensive income.

Certain provisions of the Act may require additional guidance from the Treasury, so entities should closely monitor proposed and final tax regulations issued after the enactment date. Subsequent tax regulations may result in an interpretation of a provision under the Act that differs from an interpretation made on the enactment date.

Grant Thornton insights: Disclosure of significant components

One of the items that an entity is required to disclose in the notes to financial statements under ASC 740-10-50-9 is the significant components of income tax expense (or benefit) attributable to continuing operations for each year presented. These significant components may include income tax expense (or benefit) related to adjusting a deferred tax liability or asset for enacted changes in tax laws or rates. Under ASC 740-10-50-9(g), this component should be reported as a separate component of income tax expense (or benefit) attributable to continuing operations.

C. Implications of key provisions of the CARES Act

This section provides a summary of the key provisions of the CARES Act, along with a discussion of the accounting and financial reporting implications of each provision.

Net operating losses

Under the TCJA, net operating loss (NOL) deductions arising in tax years beginning after December 31, 2017 may offset only up to 80 percent of future taxable income. The TCJA also prohibited carrybacks for NOLs arising in tax years ending after December 31 2017, but allowed indefinite carryforwards.

Under the CARES Act, NOLs arising in tax years beginning after December 31, 2017 and ending before January 1, 2021 may be carried back for five years for all entities, excluding those qualifying as a real estate investment trust (REIT). A REIT may not carry back NOLs to any tax year, regardless of whether the entity was a REIT in the prior tax year. Special rules also apply to certain industries, such as insurance and farming. Generally, an NOL must be carried back to the earliest applicable tax year. Any NOL carried back under the Act may not offset the Internal Revenue Code (IRC) Section 965 inclusion for the one-time repatriation tax, which was a major provision of the TCJA. Under the CARES Act, entities may now elect to forego carrying back NOLs to the year that includes the one-time repatriation tax, so that an overpayment created in that carryback year is not applied to the one-time tax. Entities may also elect to forego the carryback of NOLs arising in any of these tax years and may carry these losses forward indefinitely.

Further, the 80 percent limitation enacted under the TCJA is temporarily suspended for tax years beginning before 2021 and will be reinstated beginning in 2021.

As a result of the CARES Act and in conjunction with the TCJA, there are now generally three “baskets” of NOLs, each with different carryback and carryforward eligibility based on the tax year in which the NOL was generated. The attributes of each of these baskets is shown in the following table.

Figure 1: Net operating loss categories

Tax year when NOL is generated	Taxable income offset	Carryback eligibility	Carryforward eligibility
Beginning on or before Dec. 31, 2017	100% of taxable income	Two years	Twenty years
Beginning after Dec. 31, 2017 and before Jan. 1, 2021	100% of taxable income prior to 2021; 80% of taxable income after 2020	Five years	Indefinite
Beginning on or after Jan. 1, 2021	80% of taxable income	No carryback	Indefinite

The CARES Act codifies a less favorable application of the rules for ordering pre-TCJA and post-TCJA NOLs, requiring the entity to first consider pre-2018 NOLs and then to apply the 80 percent limitation on taxable income to determine how post-TCJA NOLs are used. The Act also provides guidance when dealing with circular taxable income limitations by clarifying that taxable income for purposes of determining the 80 percent limitation is calculated without considering deductions for qualified business income, foreign-derived intangible income, and global intangible low-taxed income (GILTI).

NOLs arising in 2018, 2019, or 2020 are generated in a year that has a 21 percent federal income tax rate. If these NOLs are carried back to years before 2018, the resulting refund would be recorded in a 35 percent tax year, resulting in potential permanent cash tax savings for entities. As a result, entities may seek to increase NOLs created in tax years 2018 through 2020 in order to maximize the potential cash refund associated with carryback claims. Careful evaluation may be needed to determine how the benefit affects the current-period provision for any carryback claims, since other tax positions may be affected. For example, a carryback claim may impact the amount of deductible interest, GILTI, base erosion and profit shifting (BEAT), credits and incentives, or other items on the prior years’ amended tax returns.

Entities may need to update their analysis of whether and how much of the deferred tax assets may be realized, including the scheduling of temporary difference reversals. An entity may have reduced deferred tax assets related to NOLs because, as a result of carrying back NOLs, it has fewer NOLs to carry forward into future periods. Similarly, an entity may be required to compute an alternative minimum tax NOL for purposes of determining the amount of alternative minimum tax due and any corresponding changes to alternative minimum tax credit carryforwards. When assessing NOL-related deferred tax assets to be realized in future periods, entities may need to consider whether those NOLs are expected to reverse in a period where they are 100 percent deductible or in a period subject to the 80 percent limit.

Entities should consider when to recognize the effects of refund claims in the income tax provision, as well as the classification of anticipated refunds as current or noncurrent receivables. Entities that expect to carry back losses that originated in 2018 or 2019 should adjust the carrying amount of the NOL deferred tax asset if the loss will be used to offset taxable income that was taxed at a 35 percent rate. NOL deferred tax assets that are expected to be carried back are generally reclassified as income taxes receivable or as a reduction of income taxes payable. The balance-sheet presentation of anticipated refunds of income taxes paid in prior periods should reflect when the NOLs are expected to be monetized. If the NOL is expected to generate a cash refund in the current year, a current receivable would be recorded. Alternatively, if an NOL is carried back to a year with a one-time transition tax payment and will be used to offset future installment payments, the impact is recorded as a reduction to the outstanding one-time transition tax liability.

Interest deduction

The TCJA limited the deduction for interest expense to 30 percent of adjusted taxable income for tax years beginning after December 31, 2017. Adjusted taxable income is defined similarly to earnings before interest, taxes, depreciation, and amortization (EBITDA). For periods beginning on or after January 1, 2022, adjusted taxable income is generally equivalent to earnings before interest and taxes. Any disallowed interest expense can be carried forward indefinitely.

The CARES Act allows an entity to make an election to limit its deduction for net business interest expense to 50 percent of adjusted taxable income instead of 30 percent for tax years beginning in 2019 and 2020. For 2019, this provision does not apply to partnerships. Partners may instead deduct 50 percent of their distributive share of the partnership's excess business interest expense in 2020, without regard to the limitation. Further, the Act allows an entity to use taxable income from tax years beginning in 2019 in calculating its 2020 limitation—a potential benefit if the entity has significantly reduced taxable income in 2020 compared to 2019. The IRS recently released guidance for making and revoking certain elections under Section 163(j) due to these developments, including electing to use 2019 adjusted taxable income for the 2020 calculation, electing out of the new 50 percent adjusted taxable income limit, and revoking or making a late election under Section 163(j)(7) to be exempt from Section 163(j) in exchange for foregoing bonus depreciation.

These elections can offer significant benefits to entities, particularly the ability to reassess their circumstances and to make a late election or revoke a previously made election for exemption from Section 163(j). However, all the elections may affect other aspects of a tax return, sometimes negatively.

Entities should evaluate the impact of the increased interest deductibility for 2019 and 2020 on the income tax provision, including any changes affecting the realizability of deferred tax assets. An increased interest deduction may result in an increase to an NOL carryforward as well as a decreased carryforward for disallowed interest deductions. Taxpayers with an NOL may be able to recognize a benefit from the additional interest expense by carrying the NOL back to a pre-TCJA tax year, resulting in a reduction to income taxes at a higher tax rate. Extensive modeling may be necessary to determine the changes to the income tax provision given the interrelationships between various tax provisions, such as GILTI, BEAT, interest expense deductibility, and NOLs. Entities should consider the current and deferred tax effects of the potential increased business interest deductions for 2019 and 2020, including valuation allowance considerations.

AMT credit

The TCJA repealed the corporate alternative minimum tax credit (AMT) and allowed entities to claim any unused AMT credit as a refundable credit over four tax years beginning in 2018, with remaining AMT credit carryforward refunded in 2019, 2020, and 2021. The CARES Act allows entities to claim any remaining AMT credits in full in tax years beginning in 2018 and 2019. Under the mechanics of the Act, an entity is allowed to claim the remaining AMT credit in full on its 2019 tax return, to amend its 2018 tax return to claim any remaining credit in full, or to claim any remaining credit on Form 1139, Corporation Application for Tentative Refund.

Entities should determine whether AMT credits reflected as deferred tax assets should be reclassified as current receivables if a refund is expected in the next 12 months.

Depreciation of qualified improvement property

The provisions of the TCJA originally provided for 100 percent expensing, or bonus depreciation, of qualified assets placed in service after September 27, 2017 and before January 1, 2023. A drafting error in the legislative language removed qualified improvement property (QIP) placed in service after December 31, 2017 from the list of properties that qualify for bonus depreciation, and also failed to include QIP in the list of 15-year property. As a result, the TCJA required entities to depreciate QIP over 39 years without bonus depreciation. The CARES Act includes a technical correction to the TCJA that provides QIP with a 15-year life under the general depreciation system and makes it eligible for bonus depreciation retroactively. QIP includes almost any improvement to the interior of leased or owned space. As a result of the technical correction, depreciation of QIP over 39 years on a 2018 or 2019 federal tax return is no longer a permissible depreciation method. Taxpayers will generally be able to use Form 3115, Application for Change in Accounting Method, to change the method of accounting on their next return, and may also have the option of amending previous returns.

The IRS released Revenue Procedure 2020-25 providing guidance to taxpayers for correcting the recovery period for QIP and for making or revoking certain bonus depreciation elections. The Revenue Procedure also includes guidance for either making a late election or revoking certain bonus depreciation elections previously made for tax years ending in 2018, 2019, or 2020. This guidance specifies that depreciating QIP as nonresidential real property over 39 years is not permissible and provides the corrective actions for entities to fix the impermissible method. Under the Revenue Procedure, the entity may generally correct QIP depreciation by either (1) filing an amended federal income tax return or filing an administrative adjustment request (AAR), as applicable, for the tax year in which the property was originally placed in service, or (2) attaching Form 3115 to a timely filed federal income tax return. The guidance overrides the normal rule that prohibits changing an established tax accounting method via an amended return.

Figure2: Options to correct QIP

<table>
<tr><th></th><th>FY2018 return</th><th>FY2019 return</th><th>Option 1</th><th>Option 2</th></tr>
<tr><td rowspan="2">2018 QIP</td><td rowspan="2">Filed</td><td>Filed</td><td>Form 3115 FY20</td><td>Amend FY18 and FY19</td></tr>
<tr><td>Not filed</td><td>Form 3115 FY19</td><td>Amend FY18 BEFORE filing FY19</td></tr>
<tr><td rowspan="2">2019 QIP</td><td rowspan="2">N/A</td><td>Filed</td><td>Form 3115 FY20</td><td>Amend FY19</td></tr>
<tr><td>Not filed</td><td>Use correct method for QIP</td><td>N/A</td></tr>
</table>

When an entity files for a change from an improper to a proper tax method of accounting, the entity generally receives audit protection for those prior periods with respect to that position. The tax effects of making a voluntary change from an impermissible method to a permissible method are generally recognized in the financial statements in the period the method change has been filed with the IRS.

Entities will need to evaluate the impact on the overall income tax provision of creating (1) an additional deferred tax liability for depreciation, or (2) an additional deferred tax asset related to the NOL. The determination of how these changes affect the provision may be impacted by whether the entity intends to amend its 2018 income tax return or include the additional deduction in its 2019 return.

Charitable contributions

The Act increases the limit on charitable contribution deductions for corporations making cash contributions in 2020 from 10 percent to 25 percent of taxable income, as well as deductions for contributions of certain food inventory from 15 percent to 25 percent. Entities should consider the current tax effects of the increase in 2020 charitable contribution deductions.

Deferral of employer payroll taxes

Under the Act, employers are allowed to defer deposits of the 6.2 percent employer portion of the Social Security tax from March 27, 2020 through the end of 2020. Half of the deferred payment amount is due by December 31, 2021, with the remainder due by December 31, 2022. Eligible entities may opt to defer payment of these amounts to improve cash flow, or they may choose to pay the employer portion of the Social Security tax in 2020 in order to maximize the NOL that may be carried back five years, since amounts are generally not deductible for income tax purposes until paid, unless the entity has adopted the recurring item exception to deduct amounts paid within 8½ months after the close of the year. Deferring the employer portion of the Social Security tax will result in a deductible temporary difference, or deferred tax asset, that may need to be evaluated for realizability in conjunction with the overall valuation allowance assessment.

D. Evaluating the realizability of certain deferred tax assets

A valuation allowance is used to reduce the deferred tax asset to the amount that is more likely than not to be realized. Evidence of future taxable income under the initial measurement guidance in ASC 740-10-30-18 includes

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

Under the guidance in ASC 740-20-45-8, entities are required to recognize a change in the valuation allowance in an interim period through the estimated annual effective tax rate when the change relates to either (1) the origination of the related deferred tax assets during the current year, or (2) deferred tax assets that exist as of the beginning of the year that are expected to be realized as a result of current-year ordinary income. If, on the other hand, an entity recognizes a change in the valuation allowance for deferred tax assets existing at the beginning of the year that are expected to be realized in future years, the change should be recognized in full in the interim period of the change.

In the reporting period that includes March 27, 2020, entities need to determine whether there is a change in the estimated realizability of deferred tax assets under the various provisions of the Act. Expiration periods and the limitations on the use of tax attributes should be reviewed to determine if the impact under the Act might cause them to expire unutilized. These determinations may require extensive scheduling and modeling to determine how each provision under the Act impacts the entity's tax provision, whether to change existing tax accounting methods, and whether to amend previously filed tax returns.

Given the evolving economic conditions, entities may determine that historical transfer-pricing policies and methodology may no longer apply and that changes to intra-entity pricing and other transfer-pricing arrangements are warranted. These changes impact the expected future taxable income used for purposes of evaluating the realizability of deferred tax assets.

Entities may also need to reevaluate the recorded amounts of goodwill and other assets and to determine whether impairments need to be recorded. Impairment adjustments may give rise to changes in deferred tax liabilities or deferred tax assets that in turn might impact management's judgments around the amount of valuation allowances to record against deferred tax assets.

Grant Thornton insights: Realizability of deferred tax assets

Entities should update their projections of future income to account for both the impact of the Act and recent events. This should also be done for any material foreign jurisdictions that have been similarly affected or that have enacted similar legislation. In addition, management should consider whether more robust financial statement disclosures are needed to explain management's judgments around changes in valuation allowances recorded against deferred tax assets. When considering revised projections, entities may need to further evaluate whether changing economic conditions impact transfer-pricing assumptions inherent in their projections.

E. Indefinite reinvestment assertion

Under U.S. GAAP, entities with investments in foreign subsidiaries and joint ventures may have historically asserted under the exception in ASC 740-30-25-18 that they have the ability and intent to indefinitely reinvest their foreign earnings. This assertion typically has a significant impact on how an entity accounts for the income taxes related to these investments and is supported by specific plans of reinvestment in each jurisdiction, including projected working capital and long-term capital needs, as well as an analysis of why those funds are not needed elsewhere. Rapidly evolving market conditions triggered by COVID-19 might cause an entity to reevaluate its ability to continue to indefinitely reinvest foreign earnings. Reasons for changing this assertion may include shifts in the location (or extent) of planned operations, extended closings of facilities or locations, immediate capital needs to fund operations in another jurisdiction or failed transactions, bank requirements or restrictions, and other considerations. It is important for entities to evaluate the reinvestment assertion to determine whether they anticipate changing their position.

Entities that continue to assert that foreign earnings will be indefinitely reinvested, resulting in no deferred tax liability for accumulated earnings or other taxable outside basis differences, should consider whether there have been changes in the working capital needs of, or operating plans for, the entity's various locations that could give rise to potential negative evidence of the entity's ability to continue to indefinitely reinvest foreign earnings.

Entities that no longer intend to assert indefinite reinvestment should consider whether the deferred tax liability recognized during the period is appropriate and represents the tax effects of repatriation at each tier of the organization.

Entities that assert a one-time repatriation from accumulated earnings and profits is needed, but that they will continue to indefinitely reinvest the remainder, should consider whether there is sufficient information supporting a partial reinvestment assertion.

The tax effects of undistributed earnings, including translation adjustments related to the current year (that is, the outside basis difference for the current reporting year) should be recognized as an adjustment to the estimated annual effective tax rate in the period the change in assertion occurs. The deferred tax effects of the translation gains or losses related to the current period should be reported in other comprehensive income in accordance with ASC 740-20-45-11.

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 (that is, the outside basis difference on the entity's investment in a foreign subsidiary as of the beginning of the year), should be reported in continuing operations as a discrete adjustment to income tax expense in the period the change in assertion occurs. The guidance in ASC 740-20-45-3 prohibits an entity from backward tracing the source of a deferred tax liability, so that in most cases, an entity should reflect the initial recognition of a deferred tax liability due to a change in the indefinite reinvestment assertion in continuing operations. Backward tracing the tax effects of the beginning-of-the-year cumulative translation adjustment to other comprehensive income would not be appropriate.

Grant Thornton insights: Changes in indefinite reinvestment assertion

Entities that are no longer asserting indefinite reinvestment in foreign jurisdictions may be subject to additional tax, including withholding tax, foreign country taxes, and state or local taxes, on these earnings if repatriated. An entity that can no longer make an indefinite reinvestment assertion should provide for these additional taxes when it makes the change in assertion. In determining the deferred tax liability for accumulated foreign earnings, entities should consider all outside basis differences, including those related to business combinations and cumulative translation adjustments, as well as the ability to utilize or realize a future benefit for foreign tax credits that will be generated on repatriation.

F. Planning ideas

Accounting method changes

As entities evaluate the impact of the Act, they may also consider changing to a more advantageous method of accounting and reporting for income tax purposes in order to change the timing of income items or deductions and to take advantage of the extended carryback period. For example, an entity may change its method of capitalizing costs to inventory under IRC Section 263A or the timing of deducting prepaid expenses to a more favorable method. Permanent cash tax savings may result from filing changes in accounting methods to accelerate deductions or defer revenue and increase NOLs for 2019 and 2020 if the NOLs can be carried back to offset taxable income in pre-2018 years, when the rates were as high as 35 percent. In addition, certain disaster-related losses sustained in 2020 may be reported on either 2019 or 2020 tax returns under IRC Section 165(i) and may contribute to NOLs reported in either of those years.

Changes from one proper tax method of accounting to another may be either automatic or non-automatic under tax authority procedures. The implementation guidance in ASC 740-10-55-59 through 55-61 addresses the temporary differences created when a taxpayer changes its method of accounting for an item on its tax return. Generally, the income tax accounting consequences of permissible to permissible automatic method changes are reflected in the financial statements in the period when management determines that the entity qualifies for a method change and management has the intent and ability to request the change. Non-automatic method changes require tax authority consent. As a result, entities should not reflect the impact of non-automatic method changes when accounting for income taxes in the financial statements until approval is granted. Additionally, an entity should not reflect automatic changes from an impermissible method to a permissible method in the financial statements until the entity files the method change request.

Amended return considerations and estimating refunds

The Act contains numerous provisions that can immediately help entities stimulate cash flow. Entities should disclose in the period that includes March 27, 2020 the amount of refund they expect to generate if they plan to carry back NOLs to prior periods and if the entity can make a reasonable estimate of the refund amount. For example, the change in the IRC Section 163(j) limitation from 30 percent to 50 percent might create or increase an NOL that the entity will carry back to offset income in prior years. However, at the balance-sheet date for the first quarter, the entity would probably not have finalized the 2019 computation of taxable income along with the amount of refund it expects to receive, but it should still disclose its best estimate of this refund amount if the amount can be reasonably estimated.

In many cases, the provisions under the Act may have multiple effects on an entity's 2019 taxable income that should be assessed before the entity can determine the amount of the 2019 NOL it expects to generate. Further, the entity may still be determining whether to carry back or carry forward the NOL. For example, the entity may be considering filing a number of method changes for which the analysis remains incomplete, and there may be numerous indirect effects that need to be considered if an NOL is carried back. Some of these indirect effects might generate or change items such as prior-year AMT credits, research and development credits, foreign tax credits (regular and AMT), IRC Section 163(j) limitations, GILTI and foreign-derived intangible income computations, inventory capitalization computations, and any BEAT liability, to name a few. The impact of IRC Section 382 and Section 383 limitations might also need to be considered. These changes might impact the tax attributes that are available in years for which returns were not amended to carry back the NOL. As a result, an entity might need to amend tax returns filed for those years within the five-year carryback period to reflect the adjusted tax attributes available in that year. With many scenarios to consider, entities may not yet have determined whether to carry the NOL back or forward and may be unable to provide a reasonable estimate of the impact of a potential refund by their next financial reporting deadline. If the entity is unable to provide a reasonable estimate of the amount of a refund, the entity should disclose its ongoing considerations and indicate that more information is needed before it can disclose a reasonable estimate.

Grant Thornton insights: Impact of NOL carryback on other previously reported items

Carrying back losses to prior years will require careful computations to understand the impact that the NOL has on other items previously reported. If carrying back the NOL affects prior-year income taxes receivable or payable balances or adjusts beginning-of-year deferred tax balances, an entity should reflect that impact discretely in the interim period for which a reasonable estimate of the NOL carryback refund can be made.

G. Financial statements not yet issued prior to March 2020

Subsequent event reporting

Entities with years ending before the enactment date of the CARES Act that have not issued their financial statements as of the enactment date should follow the guidance on reporting subsequent events in ASC 855, *Subsequent Events*. These entities should not reflect the effects of the Act in their annual financial statements because the enactment date is after their fiscal year-end, but they should consider disclosing the anticipated effects of the Act in the notes to the financial statements. The requirements in ASC 855-10-50-2 state that an entity should provide information about the nature of a nonrecognized subsequent event, as well as an estimate of its financial effect or a statement indicating that the effect cannot be estimated, to keep the financial statements from being misleading. Entities need to exercise judgment when determining the nature and extent of the estimated effects of the Act that should be disclosed.

Estimated annual effective tax rate

As entities evaluate changes in operations in this unprecedented time, they may conclude under ASC 740-270-25-3 that they cannot reliably estimate one or more components of their overall estimated annual effective tax rate, which may lead them to separately compute the income tax expense or benefit for one or more individual tax jurisdictions.

In general, an entity recognizes income tax expense in interim periods based on the overarching view that each period is an integral part of the annual period. Under that rationale, the entity estimates its overall annual effective tax rate and applies that rate to its year-to-date ordinary income or loss. If an entity is unable to reliably estimate its annual effective tax rate, the actual year-to-date tax rate may be the best estimate of the annual effective tax rate. If an entity is unable to reliably estimate individual items within consolidated ordinary income, it should recognize the tax effect of those items in the period the item is reported, which may apply to a particular jurisdiction or to a particular component of ordinary income. Entities using a discrete approach to compute one or more components of the overall income tax expense or benefit generally need to disclose their inability to reliably project such income.

As a result of COVID-19, an entity may identify significant "unusual" or "infrequently occurring" items, such as goodwill or asset impairment, significant loan or lease modifications, debt restructuring, and other significant events. In determining the estimated annual effective tax rate under ASC 740-270-30-12 to 30-13, an entity excludes significant unusual or infrequently occurring items only when those items are separately presented either on the face of the financial statements or in the disclosures related to other comprehensive income. The tax effects of these unusual or infrequently occurring items are recognized in the interim period when the transaction arises. While it is clear that certain items that are presented net of tax in the financial statements, such as discontinued operations and the cumulative effects of changes in accounting principles, would be excluded when determining the estimated annual effective tax rate, entities are required to exercise a significant amount of judgment when determining whether an item is "unusual" or "infrequently occurring." The ASC Master Glossary definition of "ordinary income (or loss)" specifically excludes discontinued operations and the cumulative effects of changes in accounting principles, and goes on to state that the meaning of unusual or infrequently occurring items is consistent with how those terms are used in the Master Glossary definitions of "unusual nature" and "infrequency of occurrence." (See "Impairment of assets and other fair value determinations" below for more information.)

It is important to understand whether an impairment or related event is, in fact, unusual or infrequently occurring or whether such events should be considered in updating the estimated annual effective tax rate that is applied to year-to-date ordinary income. A corresponding change in the valuation allowance assessment as a result of an unusual or infrequently occurring transaction might impact either the estimated annual effective tax rate to the extent the change is a result of current-year activity, or tax expense in the period the event occurs if the change is the result of a change in judgment about the beginning-of-year valuation allowance.

Grant Thornton insights: Recognizing income tax benefit in interim periods

ASU 2019-12, *Simplifying the Accounting for Income Taxes*, removes the exception within ASC 740-270-30-28 that limits the income tax benefit recognized in interim periods when the year-to-date loss exceeds the anticipated pretax loss for the year. Entities that have early adopted the amendments in ASU 2019-12 should record the entire benefit determined under the model used to estimate the annual effective tax rate in ASC 740-270. Early adoption of ASU 2019-12 is permitted in any interim or annual period, with any adjustments reflected as of the beginning of the fiscal year of adoption. Note that if an entity chooses to early adopt the amendments, it must adopt all of the amendments in ASU 2019-12. For a summary of these amendments, see our NDS 2020-01, "FASB simplifies the accounting for income taxes."

Interim disclosure requirements

ASC 740-270-50-1 notes that the interim-period requirements for reporting income taxes may result in a large variation from expectations in the relationship between income tax expense and pretax accounting income. These variances can result from discrete items, such as adjusting deferred taxes during the period that includes the enactment date, and from other adjustments that are necessary to appropriately reflect the impact of the new tax legislation on the current period, such as the impact of a tax law change in calculating the estimated effective annual tax rate in the period that includes the enactment date. The guidance requires entities to disclose the reasons behind such variances in their interim-period financial statements if such differences are not readily apparent from the financial statements themselves or from the nature of the entity's business.

H. Other financial reporting implications

The impact of COVID-19 and the provisions of the CARES Act are likely to affect entities in areas other than accounting for current and deferred federal income tax expense. Presented below are additional accounting and other implications that entities should consider.

Impairment of assets and other fair value determinations

COVID-19 is having a significant impact on global markets driven by supply chain and production disruptions, workforce restrictions, unemployment, and shelter-in-place restrictions, among other factors, which are negatively affecting many entities' financial performance. As part of the overall analysis of the financial reporting impact of both COVID-19 and the Act, entities may need to evaluate whether these operational disruptions indicate a change in circumstances that might trigger impairments to goodwill; indefinite-lived intangible assets; property, plant and equipment; finite-lived intangible assets; and lease right-of-use (ROU) assets. See NDS 2020-04 for additional background and discussion.

When an entity is estimating the annual effective tax rate, it generally includes all events that are expected to affect income tax expense and ordinary income during the current fiscal year. The definition of "ordinary income (or loss)" referred to in ASC 740-270-20 differentiates ordinary income from items that are unusual in nature or that occur infrequently. Goodwill and asset impairments and their related tax effects should be included in the estimated annual effective tax rate for the interim period in which they occur.

The guidance in ASC 740-270-30-12 to 30-13 states that entities should exclude the tax effect of significant unusual or infrequently occurring items that are reported separately within income from continuing operations or in the notes under comprehensive income when calculating the estimated annual effective tax rate, and that they should instead record these items on a discrete basis for the period in which they occur.

Deciding whether an item is unusual or infrequent is an area that requires significant judgment. For example, catastrophe losses, such as losses resulting from natural disasters like a hurricane, are not unusual or infrequent for property and casualty insurance companies because these entities are in the business of insuring customers against such risks; however, hurricane losses may be unusual or infrequent for an entity with operations in an area that is generally not considered to be a hurricane zone.

Financial instruments

Impacted entities may experience cash flow challenges as a result of business disruptions from COVID-19 and may need to obtain additional financing or to amend the terms of existing debt agreements or obtain waivers if they can no longer satisfy debt covenants. Entities may need to consider the guidance in ASC 470-50, *Debt: Modifications and Extinguishments*, and in ASC 470-60, *Troubled Debt Restructuring by Debtors*, to determine whether any changes to existing debt arrangements represent a troubled debt restructuring, a debt modification, or potentially a debt extinguishment, which would have accounting implications in each case.

Complex tax issues may arise when an entity amends, modifies, restructures, or otherwise extinguishes its debt. The tax treatment of these transactions might be different than the treatment for financial accounting purposes and could impact an entity's income tax accounting. It is anticipated that there will be an increase of debt workout activity due to the business stoppages resulting from COVID-19.

For income tax purposes, debtors recognize the cancellation of debt income (COD income) when they retire debt for consideration that is less than its "adjusted issue price," as defined in the IRC. COD income may give rise to current taxable income or may be excluded under certain IRC provisions. If COD income is excluded from taxable income, an entity may be required to reduce tax attributes (for example, NOL) and property bases (for example, depreciable property basis), which would give rise to increased deferred tax liabilities.

COD income may arise in several types of debt workout transactions, including when debt is satisfied for cash or property, equity of the debtor, new debt, or any combination thereof. For U.S. federal income tax purposes, a modification of the terms of an existing debt instrument may be considered an exchange of the old debt for a new debt instrument.

If a debtor transfers its own equity (for instance, a debtor corporation transfers its own stock) to a creditor to satisfy its debt, the debtor is treated as having satisfied the debt with an amount equal to the fair market value of the equity. These transactions may require a valuation of the equity issued to satisfy the debt.

If a debtor issues a new debt instrument to satisfy its existing debt, the debtor is treated as having satisfied the existing debt for an amount of money equal to the issue price of the new debt instrument. The issue price of the new debt is generally equal to the stated principal amount if neither the existing debt nor the new debt is "traded on an established market" (meaning publicly traded) for U.S. federal income tax purposes and there is an adequate amount of stated interest. If either the existing debt or the new debt is publicly traded, the issue price of the new debt is based on the fair market value of whichever instrument is publicly traded. Debt is publicly traded under Treasury Regulation 1.1273-2(f) for this purpose if, at the appropriate time, one or more of the following exists: (i) a sales price appearing in a medium that is made available to issuers, persons that regularly purchase or sell debt, or persons that broker purchases or sales of debt; or (ii) a quote is available from at least one broker, dealer, or pricing service. Many debt instruments are considered publicly traded because prices or quotes are available either on FINRA's Trade Reporting and Compliance Engine (TRACE) or on a subscription service, such as Bloomberg or Markit. Generally, debt is not publicly traded under the IRC if it does not exceed $100 million.

A debt-for-debt exchange occurs under the IRC when a modification of an existing debt constitutes a "significant modification" pursuant to Treasury Regulation Section 1.1001-3. Specifically, a significant modification of an existing debt results in a deemed exchange of the old debt for a new debt instrument. A debtor may therefore realize COD income when the terms of a debt instrument are modified if the modification constitutes a significant modification, even if no amount owed (that is, principal and accrued interest) is legally discharged. A modification is a "significant modification" if the legal rights or obligations are altered and the degree to which they are altered are economically significant. The regulations provide bright-line tests for (i) a change in yield (for instance, interest rate); (ii) changes in the timing of payments; (iii) a change in the obligor or security; and (iv) a change in the nature of a debt instrument. A modification that adds, deletes, or alters customary accounting or financial covenants is generally not considered to be a significant modification, but any fees paid to a lender related to a modification must be assessed as a change in the yield. Two or more modifications over any period constitute a significant modification if the modifications would have resulted in a significant modification had they been amalgamated into a single change.

Differences between the financial reporting and tax basis of debt instruments are fairly common. The impact of debt instruments may include a current income tax liability from COD income and/or a reduction in the amount or utility of an entity's deferred tax assets and liabilities. Attribute reduction may also require an entity to consider the impact of gain recapture under Section 1245 of the IRC. In addition, a debt modification may require an entity to reassess the deductibility of interest expense and the original issue discount as well as the deductibility of deferred financing costs. The tax impact, including related changes in the valuation allowance assessment, should be considered if the financial accounting treatment changes.

Uncertain tax positions

Entities should review each tax position in light of the Act to determine if the position continues to meet the more-likely-than-not threshold that is outlined in ASC 740-10-25-6, defined as a greater than 50 percent likelihood of being sustained upon examination. An entity may record the financial statement effects of a tax position only if it meets the more-likely-than-not threshold. Tax positions that meet this criteria are measured at the largest amount of tax benefit that is greater than 50 percent likely to be realized upon settlement with a taxing authority that has full knowledge of all relevant information. The impact of a change in tax law on an entity's uncertain tax positions should be evaluated and, if necessary, recorded and disclosed in the period of the enacted change in tax law. In addition, any anticipated changes that are reasonably possible within the next 12 months should be qualitatively disclosed as required under ASC 740-10-50-15(d).

State income tax implications

The implications of state and local tax obligations became considerably more complex with the enactment of the TCJA. A reduced federal tax rate meant that the impact of state and local tax was a proportionately higher component of overall income taxes. As a result, additional focus has generally been given to state and local tax effects in recent years. The CARES Act adds an additional layer of complexity as entities begin to evaluate (a) how state and local jurisdictions align with both the TCJA and the CARES Act, and (b) how planning actions, such as an NOL carryback, may impact state and local income tax obligations.

States generally conform with the IRC either on a static or a rolling basis. States with static conformity maintain alignment with the IRC as it existed prior to federal tax reform. In these states, entities should monitor the state's legislative activities to advance the conformity date to align with the provisions in the Act. For states with rolling conformity, the provisions of the Act will automatically be adopted and applied, although this could be more complex based on whether states have decoupled their regulations from any specific regulations within the IRC. States may then react in various ways to the provisions of the Act. Entities should closely monitor the legislative process for all states where they file returns and calculate state income tax provisions to ensure that the requirements are properly reflected in the appropriate period.

I. Multinational considerations

Governments around the world are actively taking steps to stabilize their economies as entities confront the changes caused by COVID-19. Temporary or permanent tax concessions and stimulus packages play a significant part in helping alleviate these economic stressors, and many countries, like the United States, are passing legislation daily that includes stimulus measures such as tax waivers, tax holidays, or investment incentives that are intended to help alleviate the economic downturn.

ASC 740 does not contain specific guidance for determining the enactment date in jurisdictions other than the United States. As a result, entities need to understand other legislative processes to determine when a tax law change is enacted in another jurisdiction for purposes of ASC 740. Therefore, policy changes should be carefully monitored so that these changes can be incorporated in the interim period when they are considered enacted.

Grant Thornton insights: Annual effective tax rate

An entity subject to income tax in multiple tax jurisdictions generally computes one overall (that is, worldwide) estimated annual effective tax rate, which is applied to consolidated ordinary income (loss) for the year-to-date period. However, multinational companies experiencing losses due to COVID-19 in only some tax jurisdictions where they operate may need to estimate a separate annual effective tax rate for those loss jurisdictions under ASC 740-270-30-36.

J. Internal control considerations

As part of its system of internal control, entities should evaluate the risk assessment around income taxes to ensure they identify the relevant tax laws, the timing implications of those laws and rates, and the appropriate data necessary to account for any new or different tax laws and rates. The CARES Act and the COVID-19 environment might impact internal controls over financial reporting since new data, estimates, and information may be needed to prepare tax provisions and related disclosures. Whenever new or different data is necessary, the entity must ensure the completeness and accuracy of that data and its suitability for the intended purpose. Entities then need to determine whether their existing internal controls related to income taxes are designed properly to accommodate the new or different laws. In addition to controls over income tax accounting, entities also need to assess the need for new or modified internal controls related to new or additional income tax disclosures, especially involving management's judgments related to valuation allowances.

Grant Thornton insights: Internal control considerations

Current market conditions may heighten the significance of previously identified risks or may result in new risks. Changes in risks might prompt management to respond by changing the design of its internal controls. For example, personnel may not be able to perform controls in the same manner because they are absent or lack the information necessary to perform controls effectively in the current environment. If a control cannot be performed, appropriate compensating controls at the same level of precision will need to be identified.

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