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Snapshot

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Impact of CARES Act on accounting for income taxes

In reaction to the effects of the COVID-19 pandemic, many countries are considering, or have already enacted, legislation providing stimulus and relief for affected entities and individuals. On March 27, President Trump signed into law a massive bill, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act or Act), which is a $2 trillion relief package comprising a combination of tax provisions and other stimulus measures. The Act broadly provides tax payment relief and significant business incentives, and makes certain technical corrections to the 2017 Tax Cuts and Jobs Act (TCJA).

The tax relief measures for businesses include a five-year net operating loss carryback, changes in the deductibility of interest, acceleration of alternative minimum tax credit refunds, payroll tax relief, and a technical correction to allow accelerated deductions for qualified improvement property. The Act also provides other non-tax benefits, including federal funding for a range of stabilization measures and emergency funding to assist those impacted by the pandemic.

Recognition of changes in tax laws and tax 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 the guidance on interim reporting for income taxes 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 laws or rates cannot be anticipated in the financial statements, so the effect of these changes should be recognized in the period when the change is enacted—for the CARES Act, the period that includes March 27, 2020.

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. 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 effect may be based either on the deferred tax balances at the date of enactment or as of the beginning of the year.

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 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, and, as a result, 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.

Key provisions of the Act

Net operating losses

Under the TCJA, net operating loss (NOL) deductions arising in tax years beginning after Dec. 31, 2017, can offset only up to 80% of future taxable income. The TCJA also prohibits NOL carrybacks for NOLs arising in tax years ending after Dec. 31, 2017, but allows indefinite carryforwards.

The Act provides that NOLs arising in tax years beginning after Dec. 31, 2017, and ending before Jan. 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. Generally, any NOL carried back 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 carry these losses forward indefinitely.

Further, the 80% limitation enacted under the TCJA is temporarily suspended for tax years beginning before 2021 and will be reinstated beginning in 2021. The Act also 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% 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% 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 created in a year that has a 21% federal income tax rate. If these NOLs are carried back to years before 2018, the resulting refund would be in a 35% tax year, resulting in potential 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 impacts 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 year’s amended tax return.

Entities may need to update their analysis of whether and how much of the deferred tax assets are realizable, 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 less NOLs to carry forward into future periods.

Interest deduction

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

The Act allows an entity to make an election to limit its deduction for net business interest expense to 50% of adjusted taxable income instead of 30% for tax years beginning in 2019 and 2020. For 2019, this provision does not apply to partnerships. Partners may instead deduct 50% 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 utilize taxable income from its tax year beginning in 2019 in calculating its 2020 limitation—a potential benefit if the entity has

significantly reduced taxable income in 2020 compared to 2019.

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 modelling 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.

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, 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 may claim the remaining AMT credit in full on its 2019 tax return or amend its 2018 tax return to claim any remaining credit in full.

Depreciation of qualified improvement property

The provisions of the TCJA originally provided for 100% expensing, or bonus depreciation, of qualified assets placed in service after Sept. 27, 2017 and before Jan. 1, 2023. An error in the legislative language omitted qualified improvement property (QIP) from the list of properties that qualify for bonus depreciation. As a result, the TCJA required entities to depreciate QIP over 39 years. The CARES Act includes a technical correction to the TCJA that provides that QIP is eligible for bonus depreciation retroactively. QIP includes almost any improvement to the interior of leased or owned space. Because the correction in the Act was made retroactive to the TCJA, entities will likely have the option of either amending prior tax returns to claim the additional depreciation deduction or taking the benefit on their next tax return by filing for a change in tax accounting method.

Entities will need to evaluate the impact on the overall income tax provision of (1) creating an additional deferred tax liability for depreciation or (2) creating 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 limitation on charitable contribution deductions for corporations making cash contributions in 2020 from 10% to 25% of taxable income, as well as deductions for contributions of certain food inventory from 15% to 25%.

Deferral of employer payroll taxes

Under the Act, employers are allowed to defer deposits of the 6.2% employer portion of the Social Security tax from the date of enactment through the end of the year. Half of the deferred payment amount is due by Dec. 31, 2021, with the remainder due by Dec. 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.

Tax 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 to take advantage of the extended carryback period. For example, an entity may change its method of capitalizing costs to inventory under Section 263A of the Internal Revenue Code or the timing of deducting prepaid expenses to a more favorable method.

Changes from one proper tax method of accounting to another may be either automatic or non-automatic under tax authority regulations. 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 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 income tax accounting impact of non-automatic-method changes in the financial statements until approval is granted.

Evaluating the realizability of 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 resulting change in the estimated realizability of deferred tax assets related to the various provisions of the Act. This may require extensive scheduling and modelling 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.

State income tax accounting implications

Entities need to consider the impact of the Act on state tax provisions. States might maintain conformity with the Internal Revenue Code either on a static or a rolling basis. States with static conformity maintain alignment with the Internal Revenue Code as it existed prior to the Act. 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 a state has decoupled its regulations from any specific regulations within the Internal Revenue Code. Entities should closely monitor the legislative process for all states where they file income tax returns to ensure that the requirements are properly reflected in the state income tax provisions in the appropriate period.

For more on the impact of the COVID-19 pandemic on other accounting topics, see "COVID-19 impact on accounting, financial reporting" and "Impact of COVID-19 on income tax accounting".

Visit Grant Thornton's COVID-19 Resource Center for in-depth coverage of the pandemic's impact.

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