Hot Topic: Coronavirus

Income tax accounting impacts, including interim estimates and valuation allowances

March 20, 2020

KPMG discusses possible impacts to companies' income tax accounting from the effects of COVID-19.

Background

The COVID-19 outbreak is having a significant impact on global markets driven by supply chain and production disruptions, workforce restrictions, travel restrictions, reduced consumer spending and sentiment, amongst other factors, which are negatively impacting companies' financial performance.

These effects, and a company's actions in responding, may impact the company's income tax accounting. In this Hot Topic, we address possible income tax accounting impacts stemming from the economic and financial markets effects of the COVID-19 outbreak.

Key income tax accounting impacts

Income taxes in interim periods

Estimating the annual effective tax rate: Inability to make reliable estimates

Companies that are experiencing near break-even operations due to the COVID-19 outbreak may conclude that they cannot reliably estimate their annual effective tax rate. Other companies whose operations are being affected differently in different tax jurisdictions may conclude that they are unable to use one overall estimated annual effective tax rate and must prepare separate computations for one or more individual tax jurisdictions.

A company recognizes income tax expense in interim periods based on the view that each interim period is an integral part of the annual period. To do so, a company estimates its annual effective tax rate and applies that rate to the year-to-date interim period's ordinary income. However, if a company is unable to reliably estimate its annual effective tax rate, the actual effective tax rate for the year-to-date period may be the best estimate of the annual effective tax rate. This may be the case when a small change in estimated ordinary income would result in a large change in the estimated annual effective tax rate. [740-270-25-2 – 25-4, 30-2 – 30-8]

Further, if a company is unable to reliably estimate individual items in consolidated ordinary income, the tax effect of those items should be recognized in the interim period in which the items are reported. For example, if a company is unable to estimate the annual effective tax rate for a particular jurisdiction – e.g. due to uncertainty in ordinary income estimates, or foreign exchange rates – it uses a separate effective tax rate for that jurisdiction. As noted above, the actual effective tax rate for the year-to-date period in that jurisdiction may be the best estimate of the annual effective tax rate if the company is unable to reliably estimate the annual effective tax rate. [740-270-25-3, 30-16 – 30-19, 35-2]

A company may identify conditions after the balance sheet date but before the financial statements are issued that:

— affect its estimate of the annual effective tax rate; and
— are nonrecognized subsequent events under Topic 855 (subsequent events).

We believe those conditions may be retroactively incorporated in the annual effective tax rate in the interim period being reported on or incorporated in the interim period they were identified. A company should consistently apply its policy.

Section 10 of KPMG's Handbook, Accounting for income taxes, discusses estimating the annual effective tax rate in additional detail.

Estimating the annual effective tax rate: Items excluded from ordinary income

Significant unusual or infrequently occurring items that a company may identify in connection with the COVID-19 outbreak include goodwill and asset impairments, major loan and lease modifications, and debt restructurings. A company may need to recognize those items and their related tax effects entirely in the interim period in which they occur.

If a company 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 fiscal year. However, ordinary income excludes significant unusual or infrequently occurring items. Significant unusual or infrequently occurring items are excluded from the estimated annual effective tax rate only when they are separately presented either on the face of the financial statements or in the notes under Topic 220 (reporting comprehensive income). The tax effects of significant unusual or infrequently occurring items are recognized in the interim period in which the transaction arises. [740-270 Glossary, 740-270-30-4]

Section 10 of KPMG's Handbook, Accounting for income taxes, discusses estimating the annual effective tax rate in additional detail.

Interim period losses

Companies that are experiencing unexpected ordinary losses due to the COVID-19 outbreak may need to adjust their estimated annual effective tax rates, limit their year-to-date tax benefits, or both, if those ordinary losses exceed the ordinary losses expected for the full fiscal year.

A company recognizes the tax effects of losses that arise in interim periods only if the benefits are more likely than not to be realized during the year – e.g. through ordinary income expected in later interim periods – or in a future year – e.g. through recognition of a deferred tax asset with no valuation allowance. As a result, if a company expects a loss for the full fiscal year, it must include in its estimated annual effective tax rate the amount of the valuation allowance it expects it will need at the end of the year. [740-270-25-9, 30-7, 30-30 – 30-31]

Further, if a company's year-to-date ordinary loss exceeds its expected annual ordinary loss, the year-to-date tax benefit for the interim loss is limited to the amount that would be recognizable if the year-to-date loss was the expected annual loss. This limitation does not apply if the company has adopted ASU 2019-12.[1] [740-270-30-28]

Section 10 of KPMG's Handbook, Accounting for income taxes, discusses the effects of losses in interim periods in additional detail.

Interim period losses in only certain tax jurisdictions

Multinational companies may be experiencing losses due to the COVID-19 outbreak in only some of their tax jurisdictions. Those companies may need to estimate a separate annual effective tax rate for those jurisdictions.

A company subject to income tax in multiple tax jurisdictions generally computes one overall annual effective tax rate. However, it must exclude from its overall estimated annual effective tax rate the ordinary loss and the related tax effect for a tax jurisdiction if that jurisdiction (1) experiences a year-to-date loss or (2) anticipates an annual loss, and no benefit from those losses is more likely than not to be realized. [740-270-30-36]

Section 10 of KPMG's Handbook, Accounting for income taxes, discusses the effects of losses in interim periods in additional detail.

Changes in tax law

The US government is considering a variety of economic aid proposals to respond to the COVID-19 outbreak. The aid may take the form of corporate tax cuts, tax credits or government grants.

Companies should recognize the effect of a change in tax law or rate on existing deferred tax assets and liabilities in income from continuing operations in the interim period that includes the enactment date of the change. [740-270-25-5 – 25-6, 30-11]

If a company has not adopted ASU 2019-12[2], it adjusts the estimated annual effective tax rate in the later of the interim period that includes the (1) enactment date or (2) effective date. If the effective date of the new legislation is retroactive to earlier interim periods in the fiscal year, the estimated annual effective tax rate and current income taxes payable or receivable are adjusted in the interim period that includes the enactment date. If not, the adjustments are made in the interim period in which the new legislation is administratively effective. [740-270-25-5]

If a company has adopted ASU 2019-12, it adjusts the estimated annual effective tax rate in the interim period that includes the enactment date.

Tax credits and government grants

Credits that are provided under the tax law generally are in the scope of Topic 740. These credits are recognized as a reduction of income tax expense and classified as deferred tax assets. However, the government might provide non-income-tax aid in a form that is outside the scope of Topic 740, including:

— refundable tax credits that do not depend on the company's ongoing tax status;
— nonrefundable tax credits that are transferable and that the company expects to sell; and
— cash grants.

We believe companies generally account for such non-income-tax aid as a gain contingency under Topic 450 (contingencies). A company recognizes a gain contingency through pretax income when it is realized. However, if a government grant compensates a company for expenditures associated with an

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[1] ASU 2019-12, Simplifying the Accounting for Income Taxes, is effective in 2021 for calendar year-end public companies. ASU 2019-12 allows early adoption, including in an interim period. However, if a company elects to early adopt the ASU, it must adopt all amendments at the same time.

[2] See Footnote 1.

asset on the company's balance sheet, the benefit generally is recognized over the period the costs associated with the asset are recognized. [450-30-25-1, 740-10-25-46]

An abatement or refund of non-income-based taxes is also outside the scope of Topic 740. We believe companies generally account for such aid as a loss recovery. A company recognizes a loss recovery through pretax income when recovery is probable. [410-30-35-8]

Sections 5 and 10 of KPMG's Handbook, Accounting for income taxes, discuss changes in tax laws in interim periods in additional detail.

Sections 3, 9 and 10 of KPMG's Handbook, Accounting for income taxes, discuss non-income-based tax abatements, refundable tax credits and government grants in additional detail.

Valuation allowance

Companies that are experiencing unexpected ordinary losses due to the COVID-19 outbreak or capital losses due to its effect on the markets may need to analyze whether those conditions result in the inability to realize deferred tax assets. Deferred tax assets that are the most vulnerable are those that expire in the near term or that are capital in nature and therefore rely on capital gains for support.

A valuation allowance is required for deferred tax assets if it is more likely than not that all or some of the assets will not be realized. In assessing realization, a company considers whether it will be able to generate sufficient taxable income in the period and of the character (e.g. ordinary, capital, foreign) necessary to use the benefit. [740-10-30-16 – 30-25]

A company recognizes a change in the valuation allowance in an interim period through its estimate of the annual effective tax rate if the change relates to: [740-270-25-14, 30-7]

— deferred tax assets originating during the year; or
— deferred tax assets existing at the beginning of the year that are expected to be realized as a result of current year ordinary income.

A company recognizes a change in the valuation allowance entirely in the interim period if the change relates to deferred tax assets existing at the beginning of the year that are expected to be realized in future years. [740-270-25-7, 30-11]

Sections 4 and 10 of KPMG's Handbook, Accounting for income taxes, discuss valuation allowances and changes in valuation allowances in interim periods in additional detail.

Intraperiod tax allocation

Companies that incur losses from continuing operations due to the COVID-19 outbreak may need to recognize a tax benefit in continuing operations even if they expect to recognize no total tax expense.

Topic 740 requires companies to allocate total tax expense using the step-by-step approach. Under this approach, a company: [740-20-45-2, 45-6 – 45-7, 45-10 – 45-14]

1. Determines total tax expense.
2. Computes the amount allocable to continuing operations.
3. Allocates certain amounts directly to shareholders' equity – e.g. tax effects of transactions with shareholders or other changes in contributed capital.
4. Proportionally allocates the residual to items other than continuing operations.

When computing the amount allocable to continuing operations, a company generally does not consider the tax effect of items that are not in continuing operations – e.g. discontinued operations, items recorded in equity. However, there is an exception. Companies are required to consider all components, including those outside continuing operations, when computing the tax effect of a loss in continuing operations. The result of the requirement is that a company may have no total tax expense, but allocate a tax benefit from the loss in continuing operations and an offsetting tax expense from a gain outside continuing operations. This exception does not apply if the company has adopted ASU 2019-12.[3] [740-20-45-7]

There are additional exceptions to the step-by-step approach. For example, some items are always allocated to continuing operations, including (not exhaustive): [740-20-45-8]

- A change in the beginning-of-year valuation allowance due to changes in judgment about realization of deferred tax assets in future years (see above);
- The tax effects of changes in tax laws or rates (see above);
- The tax effects of changes in tax status; and
- The tax effects of deductible dividends paid to shareholders.

Section 10 of KPMG's Handbook, Accounting for income taxes, discusses intraperiod tax allocation in additional detail.

Indefinite reversal criterion

Companies that are experiencing domestic cash shortages due to the COVID-19 outbreak may conclude that they can no longer assert indefinite reinvestment of their foreign earnings, which generally results in a charge to income tax expense in the interim period in which the change in judgment occurs.

A company may elect to not recognize a deferred tax liability for an excess of the financial statement carrying amount over the tax basis of an investment in the stock of a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration if it meets the indefinite reversal criterion. The criterion is met only if the company provides sufficient evidence to show that the subsidiary or corporate joint venture has invested (or will invest) the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation. [740-30-25-17]

If circumstances change and it becomes apparent that some or all of the undistributed earnings of a subsidiary or corporate joint venture will be remitted in the foreseeable future, we believe the company generally should recognize a deferred tax liability through a charge to income tax expense in the interim period in which the indefinite reversal criterion is no longer met. However, we believe it is also acceptable for a company to recognize the portion of the deferred tax liability that relates to current year undistributed earnings through an adjustment to the estimated annual effective tax rate. [740-30-25-19]

Sections 7 and 10 of KPMG's Handbook, Accounting for income taxes, discuss the indefinite reversal criterion and changes in its application in interim periods in additional detail.

Evolving information

The potential global and economic impacts of the coronavirus continue to evolve rapidly, and companies should monitor the situation. Companies are encouraged to maintain close communications with their board of directors, external auditors, legal counsel and other service providers as the circumstances progress. Stay informed at read.kpmg.us/coronavirus

[3] See Footnote 1.

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