



Hot Topic: Coronavirus

Income tax accounting impacts, including interim estimates and valuation allowances



March 20, 2020 (Updated April 22, 2020¹)

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

¹ New guidance or significant updates are indicated with **

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, 30-18, 35-2]

Further, if a company is unable to reliably estimate individual items in consolidated ordinary income or the related income tax expense or benefit, 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 foreign jurisdiction – e.g. due to uncertainty in ordinary income estimates, or foreign exchange rates – the tax in that jurisdiction is recognized in the interim period in which the ordinary income is reported. [740-270-25-3, 30-16 – 30-19, 30-36(b)]

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.

Companies that have been able to make reliable estimates in the past may be faced with new challenges in the current environment – e.g. some companies have recently withdrawn their annual guidance estimates. Further, some companies may experience an overall contraction in their business. Those companies may need to adjust the level of precision at which they estimate income tax amounts because changes to the estimated annual effective rate may be more sensitive to reasonable possible changes in estimated operating results.

We believe a company should consider the following when evaluating its ability to reliably estimate its annual effective tax rate.

Consideration	Example
Has the company been able to prepare reliable income estimates for purposes of evaluating asset impairment?	Reliable income estimates used in impairment analyses (e.g. goodwill, long-lived assets) generally are useful for estimating the annual effective tax rate. We believe the assumptions used in forecasting the estimated annual effective tax rate generally should be consistent with the assumptions used elsewhere in US GAAP for forecasting future operations.
How sensitive is the estimated tax rate to reasonably possible changes in the annual ordinary income estimate?	While annual ordinary income estimates might vary greatly, the effective tax rate under each scenario might not. In that case, the company may be able to reliably estimate the effective tax rate to apply to year-to-date ordinary income even if it cannot reliably estimate annual ordinary income and may have withdrawn annual guidance.
How does the company plan to disclose its inability to reliably estimate the annual effective tax rate?	We believe a company should disclose if it cannot reliably estimate its overall annual effective tax rate in the current reporting period but could reliably estimate it in the past.

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 or benefit 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 Subtopic 220-20 (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.

Estimating the annual effective tax rate: Apportionment

Companies may be experiencing changing levels of operations and profitability in different tax jurisdictions – e.g. domestic versus foreign, State A versus State B. Companies should consider those changes when developing their estimated annual effective tax rate.

Section 3 of KPMG's Handbook, [Accounting for income taxes](#), discusses the income tax calculation, including the effects of apportionment, 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 2019-12.² [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.

² ASU 2019-12 (simplifying the accounting for income taxes) is effective in 2021 for calendar year-end public business entities. 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.

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. A separate estimated annual effective tax rate is computed for that jurisdiction and applied to ordinary income in that jurisdiction [740-270-30-36(a)]

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

On March 27, 2020, President Trump signed the Coronavirus Aid, Relief, and Economic Security (CARES) Act into law. Among other provisions, the law provides relief to US federal corporate taxpayers through temporary adjustments to net operating loss rules, changes to limitations on interest expense deductibility, and the acceleration of available refunds for minimum tax credit carryforwards.

Companies should recognize the effect of the change in tax law on existing deferred tax assets and liabilities in income from continuing operations in the interim period that includes March 27, 2020. We believe the portion of the deferred tax remeasurement to be recognized discretely may be based on balances either at the date of enactment or the beginning of the year. The approach selected represents an accounting policy choice that should be applied consistently. [740-270-25-5, 30-11]

The new legislation is retroactive. As a result, the estimated annual effective tax rate for the current period and income taxes payable or receivable for a prior annual period are adjusted in the interim period that includes March 27, 2020. [740-270-25-5 – 25-6]

The new legislation may change the tax accounting methods that are permissible to be used, or may change the tax accounting methods a company chooses to use, resulting in a company committing to change its tax accounting method. A company generally demonstrates its commitment to making a change in a tax accounting method by preparing and submitting the Form 3115 before the period-end financial statements are issued (available to be issued). However, all facts and circumstances should be considered. In addition, if the change is a non-automatic change, we would expect the change to be more likely than not to be sustained.

Many other jurisdictions around the world have enacted or are contemplating other changes in tax laws or rates.

As a reminder, SAB 118 (income tax accounting implications of the Tax Cuts and Jobs Act) applied only to the application of Topic 740 to the Tax Cuts and Jobs Act. We are not aware of an effort by the SEC staff to extend the guidance to the changes resulting from the CARES Act or any other legislation.

Additional information on the accounting implications of the CARES Act will be issued in a forthcoming KPMG Hot Topic.

Sections 5 and 10 of KPMG's Handbook, [Accounting for income taxes](#), discuss changes in tax laws in interim periods 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 source) necessary to use the benefit. [740-10-30-16 – 30-25]

Changes in interim periods

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]

Changes in tax laws

As discussed above, companies should recognize the effect of a change in tax law or rate on existing deferred tax assets and liabilities in the interim period that includes the enactment date of the change. This includes a change in a company's valuation allowance that is attributable to the change in tax law. [740-270-25-5 – 25-6, 30-11]

Scheduling

As discussed above, in assessing realization of deferred tax assets, a company considers whether it expects to generate sufficient taxable income in the period and of the character (e.g. ordinary, capital, foreign source) necessary to use the benefits. [740-10-30-16 – 30-25]

Although Topic 740 does not require a company to prepare a detailed schedule of the reversal of its temporary differences, it may need to schedule in certain circumstances. For example, a company historically may have supported realizability of its deferred tax assets solely based on a straightforward forecast of future taxable income exclusive of reversing temporary differences. However, if its forecast of future taxable income is no longer sufficient or has become increasingly subjective in the current environment, it must evaluate other sources of taxable income – e.g. carryback availability, reversal of existing taxable temporary differences and tax-planning strategies.

If the reversal of existing taxable temporary differences is the only source of future taxable income, a company may need to schedule the reversal of its temporary differences and carryforwards. The purpose of scheduling is to determine how much of the benefits from any deferred tax assets will offset taxable income from deferred tax liabilities based on their reversal patterns. [740-10-30-18, 55-15]

If other sources are not sufficient to support the realizability of deferred tax assets, companies must also consider whether prudent and feasible tax-planning strategies are available to generate future taxable income sufficient to realize deferred tax assets. [740-10-30-18]

Unrealized losses on investment securities

Current market volatility has increased the likelihood that companies have unrealized losses on investment securities. Deferred tax assets arising from unrealized losses generally are capital in nature and may be more vulnerable in the valuation allowance assessment. This is because a company will often need to have sufficient capital character income to support realization of the deferred tax assets. The amendments to Topic 740 made by ASU 2016-01 (recognition and measurement of financial assets and financial liabilities) require companies to evaluate the need for a valuation allowance for deferred tax assets resulting from unrealized losses on available-for-sale debt securities in combination with other deferred tax assets. [740-10-30-16]

Other reminders**

Topic 740 requires companies to consider all available evidence in determining whether it is more likely than not that all or some of their deferred tax assets will not be realized. The following are reminders that may be particularly relevant in light of the COVID-19 outbreak.

- A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome when assessing the need for a valuation allowance. Topic 740 provides no guidance on how to determine if a company has a 'cumulative loss in recent years.' In practice, 'recent years' generally has been interpreted to mean the current year and prior two years. 'Cumulative loss' generally has been interpreted to mean pretax comprehensive income for financial reporting purposes adjusted for permanent differences. We believe a company that is not in a cumulative loss but expects to be in the near term – e.g. because it is forecasting near-term losses – should consider that condition to be a significant piece of negative evidence when evaluating the need for a valuation allowance.
- Companies should include in their projections of future taxable income their best estimate of future tax deductions from share-based payment awards. Projected deductions should include expected excess tax deductions, including expected disqualifying dispositions, but exclude expected deficiencies. Companies should estimate the expected excess tax deductions for existing awards based on the fair value of their shares as of the reporting date – i.e. they should not consider possible future changes in the fair value of their stock price or changes after the reporting date but prior to the date the financial statements are issued (or available for issuance). [\[718-740-35-2\]](#)
- Declines in a company's stock price after the reporting date do not reduce the temporary difference or the related deferred tax asset recognized for share-based compensation. Further, such declines should not affect a company's valuation allowance judgment for the share-based compensation deferred tax asset. [\[718-740-25-2, 30-2\]](#)
- We believe a company should make its best estimate of the effect on future taxable income specific to the COVID-19 outbreak based on the economic conditions that exist at the reporting date. Events that depend on future changes in market conditions generally should not be anticipated. For example, a company that has not issued its December 31, 2019 financial statements generally would not incorporate in its projection of future taxable income as of December 31, 2019 changes in US market conditions specifically arising from the outbreak. However, companies should ensure that they properly distinguish COVID-19-specific effects on future taxable income from other company-specific uncertainties that may have existed at the reporting date.
- As discussed above, we believe the assumptions used in forecasting future taxable income generally should be consistent with the assumptions used elsewhere in US GAAP for forecasting future operations – e.g. when evaluating potential impairment of long-lived assets and goodwill.
- Substantial doubt about a company's ability to continue as going concern (e.g. as a result of covenant violations, or negative actual or forecasted operating results) also raises doubt about the ability to generate taxable income. As a result, we believe substantial doubt disclosure generally necessitates a valuation allowance for all deferred tax assets that are not realizable through the reversal of existing taxable temporary differences or taxable income in carryback years.

Disclosures

If a company changes its valuation allowance during the reporting period, it should disclose the net change in the total valuation allowance and the effect of the adjustment to the beginning-of-year valuation allowance on income from continuing operations. [\[740-10-50-2, 50-9\(h\)\]](#)

A company should also disclose the facts and circumstances supporting realization of deferred tax assets. We believe the disclosures may include:

- the amount of taxable income, and the period over which it must be earned, to allow for realization of deferred tax assets;
- actual levels of past taxable income;
- the reasons for significant differences between actual levels of past taxable income and pretax financial reporting income;
- known trends, events or transactions that are expected to affect future levels of taxable income; and
- an explicit statement that it is more likely than not that the results of future operations will generate sufficient taxable income to realize the deferred tax assets.

Public companies also are encouraged to disclose the assumptions used in preparing their analysis. These disclosures may include:

- the extent of the increase in future profitability necessary to realize the deferred tax assets if existing levels of pretax income are not sufficient;
- how the company concluded it expects to achieve that increase – e.g. through expansion of gross margins, additional store openings, cost reduction programs, corporate restructuring;
- the historical relationship between pretax income and taxable income and an explanation of the difference;
- the nature of tax-planning strategies that would be available to generate future taxable income; and
- the nature of the positive evidence that the company relied on when deciding a valuation allowance was unnecessary, if significant negative evidence indicates uncertainty about realization of the deferred tax assets.

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. Section 9 of the Handbook discusses disclosure 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 [\[740-20-45-7\]](#)

³ See Footnote 2.

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 the indefinite reversal criterion is no longer met, we believe a 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. We believe the portion of the charge for the deferred tax liability to be recognized discretely in continuing operations may be based on either the amount as of the date of change or the amount at the beginning of the year with the portion that relates to current year undistributed earnings recognized through an adjustment to the estimated annual effective tax rate and the intraperiod tax allocation. [\[740-30-25-19\]](#)

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.

Goodwill impairment

The economic impact of the COVID-19 outbreak increases the likelihood that a company's goodwill may be impaired. There are some unique aspects in the accounting for income taxes when evaluating whether goodwill is impaired and measuring the impairment, including determining the carrying amount and the fair value of the reporting unit.

To determine the carrying amount of the reporting unit, a company will have needed to complete its valuation allowance assessment and will need to assign deferred tax assets and liabilities to reporting units. The assignment of deferred tax assets and liabilities to reporting units is typically based on the assignment of the underlying asset or liability. Assigning temporary differences and related deferred tax assets and liabilities generally is straightforward. However, assigning operating loss and tax credit carryforwards and the valuation allowance may be more complex and require judgment, especially when the reporting unit is part of a larger component that files a consolidated tax return. [\[350-20-35-7, 35-76\]](#)

In determining the fair value of a reporting unit, a company must determine whether the hypothetical disposition would be taxable or nontaxable. A taxable transaction is one in which the tax bases of the assets acquired and liabilities assumed are adjusted to their acquisition-date fair values. A nontaxable transaction is one in which the acquiree's tax bases of the individual assets acquired and liabilities

assumed are carried over by the acquirer. A company determines the fair value of a reporting unit based on which tax structure: [350-20-35-25 – 35-27]

- is feasible;
- results in the highest economic value, including consideration of the related taxes generated by the sale; and
- is consistent with the view of market participants.

When goodwill is impaired, a company initially measures the impairment as the difference between the reporting unit's financial statement carrying amount and its fair value.⁴ If the reporting unit has tax-deductible goodwill, a company may need to calculate the final impairment loss and the related deferred tax effect using the simultaneous equation that is used in business combinations. [350-20-35-73, 805-740-25-8 – 25-9, 55-10]

Whether the simultaneous equation is necessary depends on how a company elects to allocate its impairment loss to the components of its goodwill. We believe a company may elect to allocate the impairment loss:

- first to second component financial statement goodwill, if any, and second to first component financial statement goodwill; or
- on a pro rata basis to first and second component financial statement goodwill.

First component financial statement goodwill equals the lesser of financial statement goodwill or tax-deductible goodwill at the acquisition date. Second component financial statement goodwill is the remaining financial statement goodwill, if any. [805-740-25-8]

Deferred taxes are provided for temporary differences that arise in first component financial statement goodwill but are not provided for second component financial statement goodwill. As a result, allocating all or a portion of the impairment to first component financial statement goodwill triggers the use of the simultaneous equation. This is the case because reducing first component financial statement goodwill creates (or increases) a temporary difference for which deferred taxes must be provided. [805-740-25-9, 350-20-35-8B, 55-23A – 55-23C]

Section 10 of KPMG's Handbook, [Accounting for income taxes](#), discusses goodwill impairment in additional detail. KPMG's Hot Topic, [Increased risk of impairment of goodwill and long-lived assets](#), discusses impairment considerations in light of COVID-19.



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

⁴ This Hot Topic assumes that ASU 2017-04 (simplifying goodwill impairment testing) has been adopted. If it has not been adopted, goodwill is tested for impairment following a two-step process. Section 10 of the Handbook addresses the accounting for income taxes before and after adoption.

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