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Cash Flow Planning for COVID-19: Leveraging Tax Accounting Methods and Credits to Generate Cash Flow (Revised)

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The new CARES Act includes tax provisions designed to support the efforts of companies to preserve and perhaps enhance cash flow. This, along with traditional tax accounting method and credits techniques and procedures, can provide companies with means to support cash management efforts. Consider this summary of 15 opportunities (some time sensitive) that can help drive cash flow.

This *What's News in Tax* article revises and supersedes the original article published on March 30, 2020. On April 9, 2020, the IRS released Notice 2020-23, which postpones the due date for Form 4466, *Corporation Application for Quick Refund of Overpayment of Estimated Tax*, for tax year 2019 to July 15, 2020. The relief extends to any Form 4466 due between April 1, 2020, and July 15, 2020. This revised article is updated to account for the relief afforded by Notice 2020-23.

As the COVID-19 pandemic continues to create economic strain and uncertainty for businesses in virtually every sector, there is an acute focus by these businesses on effectively managing cash. President Trump signed on March 27, 2020, H.R. 748, the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act")—a bill that includes numerous tax provisions designed to support the efforts of businesses to preserve and perhaps enhance cash flow. Traditional tax accounting method and credits techniques and procedures in general, in addition to the various business tax provisions of the CARES Act, may provide companies with efficient and effective means to support cash management efforts during these uncertain times. Although by no means exhaustive, this article provides a summary of 15 opportunities (some of which are time sensitive) that use accounting methods and credits to help drive cash flow.

1. Immediate Cash Flow Enhancement with Accounting Method Changes

Companies should consider opportunities to generate cash savings with traditional accounting methods planning that includes deferring income and/or accelerating deductions through a wide array of available method changes, some of which can be made automatically (either for the current tax year or for the prior tax year, until that return is filed) and some of which require advance consent of the IRS National Office (for the current tax year only). Traditional accounting methods planning often generates favorable section 481(a)[1] adjustments that significantly reduce taxable income. Accounting method changes eligible for the automatic consent procedures can still be made for the 2019 tax year (until the 2019 return is due, including extension), permitting the cash benefit to be realized sooner, or alternatively for the 2020 tax year to permit a potential refund of estimated taxes.

Examples of common beneficial method changes include:

- Accelerating deductions for self-insured medical expenses (particularly relevant currently)
- Identifying prepaid expenses eligible for immediate expensing
- Increasing “de minimis” threshold for expensing certain acquisition costs
- Accelerating certain deductions under the recurring item exception of section 461(h)
- Evaluating section 263A methods for indirect costs, including interest expense, for inventory and self-constructed assets
- Deferring income recognition of certain “advance payments,” such as gift card sales
- Deferring income that is recognized for books but remains contingent for tax
- Evaluating fixed asset costs for potential acceleration through bonus depreciation (note that the CARES Act fixes the qualified improvement property (QIP) glitch), cost segregation studies, class-life reviews, and other means of accelerating cost recovery or permitting immediate deductions
- Triggering unrealized losses through sales or dispositions of property

[1] Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

2. Methods Planning and the Five-Year NOL Carryback—Rate Arbitrage

The CARES Act allows certain net operating losses ("NOLs") generated in 2018, 2019, or 2020 to be carried back five years. In addition to cash generation via carryback, this provision may allow for permanent cash tax savings from traditional accounting methods planning opportunities. Companies could identify the methods planning opportunities described above in item one and file method changes for either 2019 or 2020 to increase NOLs in those years and to carryback the losses to higher tax rate, profitable years (for example, year prior to 2018 when the 35 percent corporate rate was in effect).

Reverse planning (described below in item five) for 2019 may also push greater losses into 2020 and allow for a greater carryback.

3. Methods Planning and Accelerated Calculation of 2020 Tax Liability

If a company has determined that it overpaid its estimated taxes by at least 10 percent of its anticipated final tax liability for the current tax year, the company may be entitled to file a "quickie refund" claim on Form 4466. IRS Notice 2020-23 postpones the due date for Form 4466 for taxable year 2019 to July 15, 2020. The relief extends to any Form 4466 due between April 1, 2020, and July 15, 2020. Accordingly, Form 4466 must be filed by July 15, 2020, for a 2019 calendar year company.

An opportunity exists for companies to quickly identify and file automatic accounting method changes that reduce 2019 taxable income below the total amount of 2019 estimated tax payments, thereby allowing the companies to file Form 4466 and request refunds of 2019 estimated taxes. This process is a faster way to obtain cash than filing an NOL carryback for 2020.

Also, a fiscal year company that has not yet paid all estimated taxes and expects an NOL carryback for 2020 could file Form 1138, *Extension of Time for Payment of Taxes by a Corporation Expecting a Net Operating Loss Carryback*, to stop future estimated tax payments in anticipation of the expected NOL carryback.

4. Election to Deduct 2020 "Disaster Losses" in 2019

Section 165(i) permits companies to claim losses attributable to Presidentially declared disasters on the prior year's return. The President made the required declaration on March 13, 2020, declaring the entire nation to be a federally declared disaster area by reason of COVID-19.

The ability to claim the accelerated loss deduction could potentially immediately reduce a company's final extension payment of tax for 2019 by the amount of the tax impact of deducting the loss one year earlier than the year sustained. The accelerated loss deduction could also potentially lead to a refund of estimated tax payments related to the 2019 tax year. Because of the section 165(a) deductible loss requirement, the provision only applies to the extent the company has remaining tax basis in an asset or capitalized intangible that can be written off. The losses that a company can elect to treat as incurred in the preceding tax year are those otherwise deductible under section 165 and certain regulations thereunder, including losses from the sale or exchange of property, the termination of business locations, worthless securities (but not bad debts), the sudden obsolescence of non-depreciable property, casualty losses, and theft losses.

Note that pushing 2020 losses into 2019 may also enhance the taxpayer's ability to obtain cash on previously paid 2019 estimated taxes by filing Form 4466, as discussed above.

5. Prospective "Reverse" Accounting Methods Planning

Significant losses in 2020 may increase the risk of expiration of attributes such as credit carryforwards and pre-2018 NOL carryforwards. For companies in this situation, it may be advantageous to engage in reverse planning, including deferral of deductions, increased capitalization of costs, and acceleration of income. Examples of potential method changes and elections include:

- Changing to the section 263A direct reallocation method to capitalize indirect production costs
- Electing out of bonus depreciation
- Capitalizing and amortizing software development and research and development ("R&D") costs
- Making a section 59(e) election to amortize R&D costs over 10 years
- Changing to the ADS depreciation method to reduce annual depreciation deductions
- Analyzing production costs for items that can be re-characterized as COGS rather than current expenses (including certain production royalties)
- Changing to a method deferring deductions for prepaid expenses
- Changing to current inclusion method for advance payments, such as gift card sales
- "Reverse" cost segregation studies to identify property eligible for a more protracted depreciable life

6. Tax Treatment of COVID-19 Mitigation, Prevention, and Treatment Costs

Careful consideration should be given to ensuring that a company is striving to maximize current-year deductions for extraordinary costs incurred to mitigate against COVID-19 or that are taken in response to government orders, as well as charitable contributions. Examples might range from inventory and supply management (e.g., large-scale purchases of hand-sanitizer and hand-sanitizer dispensers, costs incurred to clean and disinfect company facilities, and costs incurred to purchase equipment or to make structural changes to facilities to reduce the risk of spreading the COVID-19 virus in corporate facilities).

7. Current and Prior Year Scrubs for Missed "Permanent Items"

Another source of cash flow could exist within potentially overlooked permanent items (such as section 199 deductions, bad debts, casualty losses, theft losses, etc.) that may have been passed over or miscalculated on a prior year return for which the statute of limitations remains open. For some fiscal year taxpayers, "quickie refunds" may still be available for items related to the 2019 tax year.

8. Lease Review

Either independently, or in the context of an organization's adoption of the financial accounting leasing standards under either ASC 842 or IFRS 16, a company may identify leases that are treated as capital leases for federal tax purposes and instead, through an accounting method change, classify the leases as operating leases. Depending on a company's facts, this may result in an immediate benefit in the form of a favorable section 481(a) adjustment expensing monthly costs attributable to use of the property rather than capitalizing the costs and recovering them through depreciation. This effort would provide additional side-benefits, including potentially lowering the amount of interest expense otherwise subject to the section 163(j) interest limitation (now modified under the CARES Act for 2019 and 2020), as well as a "health-check" for the company's tax positions for leases in light of the recent financial accounting changes in the treatment of leases.

9. R&D Expenditure Planning

There are a number of options (pre-2022) available to companies for recovery of R&D expenditures, including whether to accelerate or to defer deductions. Additionally, qualified research expenses for purposes of the research credit potentially include those related to medical research as well as those for certain information technology activities.

10. Inventory Planning

Treasury regulations under section 263A issued in late 2018 are mandatory for most producers and require a method change to be filed in 2019. Thus, many companies should already be evaluating their current tax inventory costing and valuation methods. In light of COVID-19, this analysis could be tailored to decrease or increase capitalization of costs, and likewise can take into account specific business factors such as supply chain disruption or temporarily idled assets.

11. Mitigation of Interest Expense Limitation

Companies may consider implementing methods of accounting to properly capitalize interest expense so that it is not subject to the section 163(j) limitation, or to employ reverse methods planning techniques to increase the company's deductible interest expense limitation. Interest capitalization method changes under section 263A(f) are eligible for the automatic consent procedures.

12. Structuring of Governmental Incentives

Companies should carefully analyze any governmental payments (such as incentives to locate a new or expand an existing manufacturing or distribution facility in a specific location) to confirm the payments are structured in a manner so as to avoid or minimize the inclusion of all or a portion of the incentive in gross income.

13. Capital Loss Carrybacks

Companies may consider their facts and circumstances to identify potential ways to trigger current-year capital losses and carry those losses back to prior tax years, generating potential cash refunds.

14. Accounting Period Tax Planning

Companies may consider whether they are eligible to change to a different tax year in a manner generating potential current-year tax benefits.

15. Business Interruption Insurance Proceeds

For the minority of companies whose business interruption insurance includes coverage of COVID-19-related lost profits, the companies will need to carefully and thoroughly quantify the net profit lost as a consequence of the pandemic. This could become relevant even if business interruption insurance does not explicitly cover COVID-19—to the extent state legislatures enact laws requiring insurance companies to waive policy provisions that currently exclude COVID-19 from the scope of policy coverage.

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