KNAV
PARTNERS BEYOND BOUNDARIES

Impact of Inflation Reduction Act, 2022 on Tax Laws

The Inflation Reduction Act (IRA) was signed into law on August 16, which includes a new alternative minimum tax, stock buyback excise tax, and significant tax incentives for energy and climate initiatives. US GAAP accounts for changes in income tax rates and law in the year they are enacted. Most of the provisions in the IRA that are accounting-related will affect financial statements prospectively, despite some entities determining that certain provisions require accounting in the period of enactment.

Impact of IRA on Tax Laws

A. **Corporate Alternative Minimum Tax (CAMT)** (As on September 28th, 2022)

The CAMT imposes a minimum tax on "applicable corporations" with average annual adjusted financial statement income (AFSI) over a three-year period exceeding $1 billion. A corporation which is a member of a foreign-parented multinational group, as defined, it must include the AFSI of all members of the group (with some modifications) for this criterion, but only if the three-year average AFSI of its US members, the effectively connected income of the foreign members that are not subsidiaries of US members, and its foreign subsidiaries of US members exceeds $100 million, it would be subject to CAMT.

AFSI refers to net income adjusted for certain items. The adjustments are as follows:

- Using income or deductions from tax laws to replace book income or expenses related to covered benefit plans (e.g., fair value adjustments about defined benefit plans)
- By replacing the entity's book depreciation for certain property, plant, and equipment with its tax-law-calculated depreciation
- Federal income taxes and income taxes paid to a foreign country or a U.S. possession are disregarded.

The IRA imposes a tentative minimum tax equal to 15% of the applicable corporation's AFSI over the CAMT foreign tax credit (CAMT FTC) for the tax year. It is only due when a taxpayer's tentative minimum tax exceeds their regular tax plus the base erosion and anti-abuse tax (BEAT). For CAMT-paying entities, the excess tax paid over the regular tax plus BEAT amount will be carried forward (CAMT credit carryforward). CAMT credit carryforwards can be used against regular tax in future years (when regular tax plus BEAT exceeds tentative minimum tax). From December 31, 2022, onwards, this provision will take effect.

Aspects of tax accounting

US GAAP explicitly addressed AMT in the US before the 2017 US tax reform. When both a regular tax system and an alternative minimum tax system have the capability of generating a credit against regular tax liabilities in future years, ASC 740 requires that deferred taxes be measured using the regular tax rate, even if the company anticipates continuing to be subject to AMT for the foreseeable future (see ASC 740-10-30-10 through 30-11). Further, ASC 740 requires the AMT is recorded as a current tax expense in the

period incurred and a deferred tax asset to be recognized for AMT credit carryforwards. Also, the guidance requires companies to recognize valuation allowance, if required, against the recorded AMT credit carryforward deferred tax assets similarly to other deferred tax assets.

The company that expects to be a perpetual CAMT taxpayer has the risk of not realizing the full benefits of its regular deferred tax assets (deferred taxes excluding CAMT carryforwards). According to the Financial Accounting Standards Board (FASB), the codification does not explicitly address whether a company should anticipate future years' CAMT in its valuation allowance assessment. Companies should elect whether to consider future years' CAMT in valuing their regular deferred tax assets according to their expectations for CAMT. Transparency is crucial to the consistency and effectiveness of accounting policy elections.

B. Excise Tax on Corporate Stock Repurchases (As on August 31st, 2022)

A covered corporation (a domestic corporation, the stock of which is traded on an established securities market) repurchasing certain stock during a tax year is subject to a nondeductible 1% excise tax imposed by the IRA. Corporation's repurchases that are subject to tax are reduced by the value of any stock it has issued during the tax year. During the tax year, this includes stocks issued or provided to shareholders or employees of a specified affiliate of the corporation, whether or not such stock was issued on the exercise of options to acquire stocks.

Exceptions to the law include special rules for foreign-parented domestic corporations that would treat repurchases of stock by certain affiliates of publicly traded foreign companies (including domestic corporations, domestic partnerships, and foreign partnerships with domestic partners) as if they were repurchases by publicly traded US companies. Stock repurchases after December 31, 2022, are subject to this provision.

Aspects of tax accounting

ASC 740 does not apply to taxes other than income taxes. The excise tax is levied on the gross amount, which excludes any expenditures and other adjustments, so its effects are not expected to be reflected in an entity's income tax provision.

Taxes that are not based on income are not covered by ASC 740. An entity's income tax provision under ASC 740 will not include the effects of the excise tax because the excise tax is imposed on the gross amount (i.e., it excludes expenditures and other adjustments).

US GAAP does not contain explicit guidance for taxes that are not subject to ASC 740, but most are reflected as an additional cost of the underlying pre-tax transaction that gives rise to the tax. Under US GAAP, many stock repurchases are accounted for as equity transactions with no income statement consequence. However, certain equity transactions may have income statement consequences and not all shares of stock are classified as equity instruments for accounting purposes. As a result, the US GAAP accounting treatment for a stock buyback transaction may be relevant in determining the appropriate accounting for excise tax.

C. Provisions for climate and clean energy

The IRA creates new tax credits in multiple categories, including advanced manufacturing production credits, energy-related fuel credits, hydrogen credits, and nuclear power credits, as well as extensions, expansions, and enhancements of numerous energy-related tax credits. In certain credits, a "direct-pay election" allows the taxpayer to receive a current benefit without generating taxable income or owing taxes. In most cases, the population of taxpayers eligible for direct-pay options is fairly limited, generally limited to tax exempt and government entities, as well as rural electric cooperatives, depending on the credit. The definition of an "eligible taxpayer" varies with the credit. Additionally, the law allows taxpayers to transfer (sell) certain credits. Credits transferred in exchange for cash are not taxable income for the transferor nor are they deductible for the transferee. There are various effective dates for the provisions related to the impacted credits. Direct-payment and transferability of credits will be available after December 31, 2022.

Aspects of tax accounting

Using the ASC 740 income tax accounting model is necessary if a credit or incentive can only be claimed on an income tax return and realized only through taxable income. Typically, for-profit businesses recognize government assistance using IAS 20, Accounting for Government Grants and Disclosures of Government Assistance. To determine when a credit should be recognized in financial statements under the IAS 20 accounting model, a reporting entity must identify, understand, and evaluate all conditions of the credits for which it may be eligible. Several energy-related tax credits require prevailing wages and apprenticeships, domestic content, or critical minerals to qualify. A bonus credit rate can be claimed instead of the base credit rate if these conditions are met. Accounting amounts will be determined by the requirements of the relevant credits.

The classification of income from a tax credit in the income statement will vary depending on the facts and circumstances that give rise to the credit. Sometimes, it may be reported as other income while some other times it may be reported as a reduction to the related expenditures that generated the credit.

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