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Revenue Standard Portends Potential Tax Changes

The FASB's revenue standard supersedes substantially all existing U.S. GAAP on revenue recognition, thus, companies may need to change the timing or amount of revenue recognized in their financial statements.[1] These financial reporting changes may affect the calculation and financial reporting for income taxes and other types of taxes.

Key Impacts

Changes in financial reporting for revenue may affect taxes by:

- Requiring the tax accounting method to change if financial statement income recognition is accelerated or deferred;
- Creating or changing existing temporary differences which will affect the income tax provision;
- Requiring revisions to transfer pricing strategies and documentation;
- Requiring updated policies, systems, processes, and controls surrounding income tax accounting and financial reporting; and
- Changing the presentation of sales or excise taxes because revenue may be recharacterized between product and service revenue.

Companies should begin to plan sooner rather than later for the adoption of the revenue standard. The standard is effective for:

- Public business entities and certain not-for-profit entities applying U.S. GAAP in interim and annual periods in fiscal years beginning after December 15, 2017; and
- All other entities applying U.S. GAAP for annual periods in fiscal years beginning after December 15, 2018, and for interim periods in fiscal years beginning after December 15, 2019.

Early application is permitted for years beginning after December 16, 2016.

Contents

[1] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org.

Financial accounting and tax professionals should work together during the assessment phase of adopting the revenue standard.

Federal and State Income Tax Accounting Methods

U.S. federal income tax law contains specific rules for recognizing revenue for items such as sales, licenses of intangible property, income from long-term contracts, and advance payments for goods and services. These rules also may apply for informational reporting for foreign subsidiaries. To apply the income tax law correctly, a company must determine whether the transaction is a service, sale, license, or lease transaction.

In some circumstances, the revenue recognition criteria under the Internal Revenue Code are consistent with a taxpayer's financial reporting treatment. If so, the company uses the same revenue recognition method (e.g., sales upon shipment or the cost-to-cost method for tax and financial reporting). The effect on state taxable income generally follows federal tax laws.

In other situations, the Internal Revenue Code does not require a company to report taxable income using the same methods that are used for financial reporting purposes. Instead, adjustments are made on Schedule M-3 to the financial reporting records to calculate income for tax purposes. However, not all methods used to report income for financial reporting are permissible for federal income tax purposes, which creates temporary differences. If a new financial accounting method is acceptable, but not required, for federal income tax purposes, a company may choose to voluntarily change its tax accounting method to avoid book-tax differences.

The following are examples of situations that may result in new temporary differences. Some of the differences may justify or require a change in the tax accounting method that companies use.

Tax Income Recognition

Adopting the new revenue standard likely will result in timing differences between recognizing revenue in the financial statements and paying income taxes.

Federal Income Tax Treatment	
Current Treatment – Accrual Method	
Companies generally recognize income in the period in which the right to the income becomes fixed and can be determined with reasonable accuracy.	• Goods – income is earned when the benefits and burdens of ownership of the goods passes to the customer on shipment, delivery, acceptance, or when title passes • Services – income may be recognized as the services are rendered, or may be deferred until completion and acceptance of discrete deliverables.

Federal Income Tax Treatment
Changes Caused by the Revenue Standard
• A company recognizes revenue when or as it satisfies a performance obligation by transferring a good or service to a customer. A good or service is transferred when the seller transfers control of the goods to the customer or as the seller provides the services. • The transaction price is not required to be fixed or determinable and will often require the use of estimates. Variable consideration is included in the transaction price to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty is resolved. • Under the all-events test for tax purposes, amounts are included in income the earlier of when they are received, due, or earned, if there are no material contingencies related to the right to the income. • The shift toward using more estimates to determine variable consideration for financial reporting purposes runs counter to the all-events test used for tax purposes and will likely create additional differences between when revenue is recognized for financial reporting and when it is recognized for tax purposes for many arrangements that include variable consideration.

Implementation Guidance. The revenue standard provides specific implementation guidance on whether revenue related to a license of intellectual property is recognized over time or at a point in time. A company may be required to recognize the income in the period in which the license is granted for federal tax purposes and recognize revenue over time for financial reporting purposes. This change may create additional book-tax timing differences.

Advance Payments

If the contract with the customer involves advance payments, the tax rules generally require the advance payment to be included in income when it is received. However, several exceptions permit tax deferral in the year of payment to the extent that the amount is not recognized for financial reporting purposes. Therefore, if the standard requires revenue to be accelerated (the advance payment) for financial reporting purposes into the year of payment, income also will be accelerated for tax purposes.[2] This rule could significantly affect the software industry.

Under the revenue standard, software companies no longer will be required to have vendor-specific objective evidence (VSOE) of fair value to separate the elements of a software contract from the license. Instead, a company generally will allocate the transaction price to all distinct goods or services based on the relative stand-alone selling prices. Therefore, revenue may be recognized earlier

[2] Reg. §1.451-5 of the income tax regulations applies to advance payments for prepaid merchandise. Rev. Proc. 2004-34, modified by Rev. Proc. 2011-18, applies to prepaid services and mixed prepayments.

for the amount allocated to the software license for book and tax purposes for software companies that do not currently have VSOE for their other deliverables.

Percentage of Completion

Companies, including those that have long-term construction or manufacturing contracts, may be required for federal income tax purposes to report taxable income on the basis of percentage-of-completion. The standard requires a company to determine first whether control is transferred over time or at a point in time. If the criteria for over-time recognition are met, the company determines the appropriate measure of satisfaction of its performance obligation. This could require a company to change from recognizing revenue under the percentage-of-completion method for some arrangements to recognizing revenue at a point in time (e.g., upon delivery). It could also require a company that currently recognizes revenue when products are shipped to recognize revenue as products are being produced.

In other circumstances, a company may use a different pattern for recognizing revenue from the pattern it uses to recognize expense because the revenue standard is not a profit recognition standard. Additionally, the company may incur costs that meet the *uninstalled materials* recognition guidance in the standard. For tax purposes, many of those items are recognized using the percentage-of-completion method. As a result, additional book-tax differences may result.

Change in Tax Accounting Method

The IRS generally treats a change in method for financial reporting purposes as a change in accounting method for tax purposes. If a new tax accounting method is required or desirable because the financial reporting accounting method changes, a company must obtain permission from the IRS.[3] The filing procedures and timing vary based on whether the change is automatically approved or requires specific advance consent from the IRS.

If a company changes to a tax accounting method that is identified in published IRS guidance (i.e., Rev. Proc. 2015-14), the IRS is deemed to automatically approve the change when the copy of Form 3115 is filed and, at the same time, provide audit protection for prior years. For financial reporting purposes, the recognition of temporary differences will depend on the timing of the tax method change.

However, a company that changes its tax accounting method outside the automatic procedure must obtain IRS approval. The company may need to consider the U.S. GAAP requirements for accounting for tax uncertainties to determine whether it is appropriate to account for the change before it receives IRS approval.[4]

If adopting the revenue standard results in accelerated income and the company files a tax accounting method change, an unfavorable tax adjustment may be required. That catch-up adjustment (i.e., the income inclusion that is the difference between the old and new tax accounting as of the beginning of the year of change) would generally be spread over four years for tax purposes.

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[3] IRS Form 3115, Application for Change in Accounting Method, must be filed to obtain permission.

[4] FASB ASC Subtopic 740-10, Income Taxes – Overall, available at www.fasb.org.

If the IRS allows a company to change its accounting method, the change is generally made on a cut-off or prospective basis. This requires old contracts to be accounted for under the former accounting method, and new contracts to be accounted for under the new method for tax purposes. For financial reporting purposes the change will be made either retrospectively or through a cumulative-effect adjustment to retained earnings at the date of adoption of the revenue standard. Regardless of the transition method used for financial reporting, the catch-up adjustment for tax purposes will be computed using different periods (the change applies only to contracts entered into in the year of change) and a book-tax difference will exist for some period of time.

Transfer Pricing

The transfer pricing strategy of a multinational entity can have significant tax implications and can require extensive documentation to demonstrate how its strategy meets the local requirements for intercompany transactions. Changes in the amount and timing of revenue recognition as a result of adopting the revenue standard may have a significant effect on transfer pricing as it relates to using revenue or profit-based methods such as the Comparable Profits Method or Profit Split Method for establishing the transfer pricing used to set or test transfer prices.

Additionally, intangible valuations may use income approaches based on operating profit or cash flow measures. A multinational entity may need to consider whether its transfer pricing strategies and supporting documentation should be updated and consider the effect on the transition period if its transfer pricing analysis uses multiple years of data.

Accounting for Income Taxes

The revenue standard may have implications on the accounting for income taxes beyond those related to the tax accounting method changes and transfer pricing issues, which are discussed in the following sections.

Costs of Obtaining a Contract

Incremental costs that a company incurs solely as a result of obtaining a contract (e.g., sales commissions) will be capitalized for financial reporting purposes if the company expects to recover these costs. As a practical expedient, a company is not required to capitalize the incremental costs of obtaining a contract if the amortization period would be one year or less. Once capitalized, the costs are amortized over the period of future benefit, which includes anticipated renewals of the contract.

For cash-basis and accrual-basis taxpayers, the default U.S. federal income tax treatment is to capitalize and amortize the costs of obtaining a contract over the contractual term. However, several exceptions (e.g., sales commissions to employees) to that treatment permit a current deduction.

Thus, the existence and magnitude of differences in the basis for financial reporting and tax amounts of capitalized contract acquisition costs and the related deferred tax assets and liabilities will depend on the specific facts and circumstances. A company will need to evaluate its particular circumstances to determine what action it needs to take.

Investments in Foreign Operations

Adopting the revenue standard may affect the opening balance sheet of a company's foreign subsidiaries. This in turn may affect the outside-basis difference in investments in foreign operations on the date of adoption. The outside-basis difference is the difference between the basis of a company's investment in a subsidiary for financial reporting purposes and the tax basis of the investment.

When the financial reporting basis of an investment in a foreign subsidiary exceeds the tax basis, a deferred tax liability is recognized unless the indefinite reversal criteria are met. The criteria include evidence of specific plans for indefinite reinvestment or plans to remit the earnings in a tax-free liquidation.[5] Changes in the investment in a foreign subsidiary on adoption of the standard may affect the amount of the deferred tax liability when the indefinite reversal criteria are not applied, or may require assessment of the effect of the change on the indefinite reversal criteria when they are applied.

A company that maintains a deferred tax liability on some, but not all, of the outside-basis difference in foreign subsidiaries may have additional considerations. For example, if the deferred tax liability established for a portion of the outside-basis difference is determined based on the basis difference above a specific amount to be indefinitely reinvested, adopting the revenue standard may affect the deferred tax liability. However, if the deferred tax liability was established for a specific amount that was expected to be repatriated, with the remainder subject to the indefinite reversal criteria, the deferred tax liability may not be affected.

Deferred tax assets generally are not recognized for deductible outside-basis differences in investments in subsidiaries that will not be realized in the foreseeable future (generally interpreted to be within one year). If a company does expect to realize the deferred tax asset within the foreseeable future, it also will need to consider what effect the standard will have on the temporary difference and the recoverability of deferred tax assets.

Taxes Not Based on Income

The revenue standard also may affect non-income taxes.

Income Statement Presentation

Sales taxes have a different income statement presentation from production taxes, which are treated as a cost of sales. It may be necessary to analyze for each jurisdiction in which the company operates whether certain taxes are sales or similar taxes or production taxes to determine the accounting treatment. For example, excise duty paid by tobacco and alcohol manufacturers is a sales tax in some jurisdictions and a production tax in others. In some jurisdictions, it may be difficult to determine the exact nature of the tax and will require judgment to determine its classification. Other taxes that may need to be evaluated include value-added taxes, use taxes, withholding taxes, and gross receipts taxes.

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[5] FASB ASC Section 740-30-25, available at www.fasb.org.

Contracting Practices

Generally, indirect taxes, such as sales or value added taxes, are determined based on contractual amounts for a specific good or service. Any changes in contracting practices may affect the amount of tax assessed because it may change whether the item is subject to tax for the sale of goods versus the sale of services. If a company uses the amounts recognized in its financial statements to support what it allocates to goods or services for tax purposes, the revenue standard may affect sales taxes because the consideration allocated between the goods and services may change.

Other Considerations

To prepare to adopt the revenue standard, a company should thoroughly evaluate how it may affect other aspects of its operations in addition to the tax considerations discussed above. Management should evaluate these areas.

- Training and communication needs;
- Contract practices and potential changes that would affect financial reporting if a company chooses to revise contracts;
- Potential changes to foreign tax accounting methods, particularly if statutory reporting changes;
- Specific contractual terms that may result in a difference between the allocation for tax and financial reporting purposes when accounting for contracts with multiple performance obligations;
- Inconsistencies between financial and tax reporting that would require dual accounting records;
- New data or information system requirements resulting from different tax and financial accounting methods;
- Income tax reporting, compliance, and planning;
- Determining revenue-based apportionment factors used for calculating state income taxes and used for determining the applicable rate used to measure state deferred income taxes; and
- Implications on net worth or capital-based taxes, if any.

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