Potential Tax Implications Resulting from the New Revenue Recognition Standards

On May 28, 2014, the Financial Accounting Standards Board (“FASB”) and the International Accounting Standards Board (“IASB”) issued new accounting standards\(^1\) that replace existing U.S. Generally Accepted Accounting Principles (“GAAP”) and International Financial Reporting Standards (“IFRS”) guidance and introduce a new revenue recognition model. The effective date for the new guidance is January 1, 2018 for calendar year public companies, and January 1, 2019 for calendar year nonpublic companies. All companies are permitted to adopt the standards early for years that begin on or after January 1, 2017.

**Objectives of the new GAAP Revenue Recognition Standard**

- Remove inconsistencies and weaknesses in existing requirements to improve comparability
- Provide a more robust framework for addressing revenue issues
- Provide more useful information through improved disclosure requirements
- Simplify the preparation of financial statements by reducing the number of requirements by having one revenue framework

**The Core Principle and the Five-Step Model**

The core principle of the new revenue recognition standard is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In this regard, a Five-Step Model is generally considered to:

- Identify the contract(s) with a customer
- Identify the performance obligations in the contract
- Determine the transaction price
- Allocate the transaction price to the performance obligations in the contract
- Recognize revenue when (or as) the entity satisfies a performance obligation

**Tax Revenue Recognition Model**

The accrual basis standard for revenue recognition for tax purposes is generally known as the “all events test” pursuant to Internal Revenue Code\(^2\) (“IRC”) Section 451(a):

- All events have occurred which fix the right to receive the income, AND
- The amount can be determined with reasonable accuracy;
- This generally translates to the earliest of when an amount is received, due, or earned.

The Code, regulations and Internal Revenue Service (“IRS”) administrative pronouncements also provide several instances of specific rules for revenue recognition for certain items or industries. Examples include:

- Deferral of advance payments for goods or services

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\(^1\) ASC 606, Revenue from Contracts with Customers

\(^2\) Unless otherwise indicated, all section references are to “Code” or “section” are to the Internal Revenue Code of 1986, as amended or to the Treasury regulations issued thereunder.
IRS began monitoring the development of the new revenue recognition standard and has asked for public comments on any potential new guidance that may be helpful to taxpayers.

- IRS Notice 2015-40; dated March 29, 2015, invites comments regarding the effect on taxpayers' methods of accounting of new financial accounting revenue recognition standards, titled "Revenue from Contracts with Customers," announced by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB).

Although the official comment period expired on September 16, 2015, the IRS will still entertain the submission of public comments. To date, the authors could only find one comment submission to the IRS.

IRS also indicated that it is reviewing the book accounting rules to determine if there would be instances where tax might be able to follow the new book accounting method. Any new guidance IRS may issue would need to be in conformity with IRC section 451 and regulations thereunder. IRS is also looking at whether it is advisable to issue any new guidance on procedures for requesting a change in tax accounting method and whether it would make sense for the IRS to identify additional method changes that would qualify for automatic changes. From a practical perspective, there may be limited options for tax conformity with the book changes, resulting in new book / tax differences going forward. To-date, the IRS has not issued any new guidance in response to the new revenue recognition standard.

**Implementation Plan for the New Revenue Recognition Standard**

It is important for companies to now begin developing an implementation plan for analyzing the implications of adoption of the new revenue recognition standard considering the available transition methods and length of time remaining on current revenue contracts. Considerations include:

- Process, ERP and information system changes that may be necessary
- Enabling dual reporting during applicable transition periods as well as possible book versus tax methods differences for revenue recognition
- Dealing with potential for unanticipated complexity and technical research and analysis
- Marshalling resources, both internal and external to assign roles, maximize project efficiencies and spread the workload over the length of the transition period.

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3 2004-1 C.B. 991; (6/1/2004)
4 T.D. 7103
6 Texas Society of Certified Public Accountants submitted a comment letter dated October 8, 2015 (See Tax Notes Today 10/9/2015 - 2015 TNT 196-15))
For private companies with December 31 year ends, January 1, 2019 is the effective date of the new revenue recognition standard.

The transition options available for private companies include full retrospective application where revenue recognition is restated in 2017 and 2018 with a cumulative effect adjustment as of January 1, 2017, or alternatively retrospective modified by election of certain practical expedients, or non-retrospective, where a cumulative effect adjustment to retained earnings for existing contracts is made on January 1, 2019.

**Tax Considerations**

The new revenue recognition standards will impact virtually every organization that enters into contracts for the delivery of goods or services – affecting how and when revenues are recognized. Moreover, implementation of the new revenue recognition standards is not limited to financial reporting only; the new standards can have a significant effect on an organization’s tax positions, compliance, and planning. Thus, it is important for the organization’s tax function to understand and plan for the impacts of the new financial accounting standards.

The following summarizes some of the potential tax implications of changing to the new financial accounting standards.

**Federal Taxes**

- Potential changes in timing of revenue recognition for financial reporting that may require accounting method changes for tax purposes, thus creating a potential impact on net tax liability.
  - Will the new book method be consistent with tax law to allow the new tax method to conform to the new book method? If not, remain on existing tax method or alternatively, consider changing tax method to another acceptable tax method.
- Tax may not be able to use the method adopted under the new financial reporting model and needs to identify and create a new book-to-tax difference (Schedule M), thus creating a potential impact on net tax liability.
- Impact on data availability, processes, and controls used to support existing or new tax accounting methods. The company may need new or augmented processes for tracking/compliance revenue recognition method for tax which may be different than used for book.
- Creates a need or opportunity to harmonize all tax reporting systems with new or augmented enterprise resource planning (ERP) system or new revenue recognition modules to be used for financial accounting purposes.

**Tax Accounting Method Changes**

In the event the tax method of revenue recognition will change, the company will file Form 3115, Application for Change in Accounting Method pursuant to the applicable IRS revenue procedures as follow:

- Revenue Procedure 2016-29;\(^7\) – Only for automatic changes listed in the appendix
  - For example, this revenue procedure would cover changes for revenue recognition for advance payments for services pursuant to Revenue Procedure 2004-34;
  - Deemed IRS consent at the time of filing – file with tax return, copy to IRS Service Center in Covington, KY.

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\(^7\) 2016-21 I.R.B. 880; (5/5/2016)
• No IRS user fee
• Subject to IRS review on exam
• Revenue Procedure 2015-13;\textsuperscript{8} – all non-automatic changes
  • Absent any forthcoming IRS guidance, most revenue recognition changes will be non-automatic
  • File with IRS National Office by last day of the company’s tax year
  • Subject to IRS National Office review and consent by issuance of ruling letter
  • IRS user fee

Cumulative effect of changes in tax accounting method are generally measured as of the beginning of year of change and are known as “Section 481(a) adjustments”. Positive adjustments are generally recognized into taxable income ratably over four years beginning with the year of change. Negative adjustments are generally recognized in taxable income wholly in the year of change. In certain cases, the taxpayer also obtains audit protection for prior tax years (e.g. IRS exam team would be prohibited from changing prior year’s taxable income for such item).

\textbf{Accounting for Income Taxes}

• Adjustments to temporary differences as of the date of adoption.
• Changes in accounting may impact pretax book income, which may indirectly impact the effective tax rate.
• New or temporary differences may impact deferred taxes.

\textbf{State and Local Taxes}

• Potential effects of determining revenue-based apportionment factors used for calculating state income tax expense and used for determining the applicable rate used to measure state deferred income taxes.
• Federal tax impacts will flow through to the state tax base in most instances.

\textbf{Indirect Tax}

• Impacts on state tax liabilities in gross receipt tax states (i.e., acceleration or deferral of income under new standards).
• Newly created performance obligations may be subject to sales and use taxes in contrast to prior guidance, which permitted aggregation (i.e., software vs. services).
• Potential issues as tax authorities seek to reconcile revenue identified in accounts against indirect tax invoices and filings.
• Potential effects on using revenue-based apportionment factors for calculating the deduction for value-added tax (VAT) and other indirect taxes incurred on costs (typically companies can only take a credit for VAT and other indirect taxes incurred on costs if they can link those costs to specific types of revenue).

\textbf{Foreign Taxes and U.S. Taxation of Foreign Operations}

• For local country reporting purposes, some foreign jurisdictions will require a change to the new model while other may maintain local statutory accounting, or allow for optional adoption of the new standards.
• Potential effects on the amount and timing of income recognition for controlled foreign corporations (CFC), which could impact earnings and profits, foreign tax credit pool rates (and repatriation

\textsuperscript{8} 2015-5 I.R.B. 419; (1/17/15)
planning), and the calculation of subpart F income (including the potential need to record deferred tax liabilities on subpart F income expected to be realized in the future).

- Potential effects on deferred tax liabilities recorded on outside basis differences for which the indefinite reversal criterion cannot be met.

**Transfer Pricing**

- Changes to the amount and timing of revenue recognition could affect intercompany transfer pricing policies and amounts, particularly when the transfer prices are set or tested using revenue or profit-based formulas.
- Companies may need to consider whether their strategies and documentation supporting transfer pricing needs to be revised or updated to account for the new standards.

**Executive Compensation**

- Performance metrics for long-term bonus compensation and equity compensation grants may be affected by the new standards.
- Section 162(m) performance-based compensation arrangements may need to be re-thought under the new standards.

**Some Examples where Book and Tax Revenue Recognition are likely to Differ**

The new GAAP revenue recognition standard requires an estimate of variable consideration to be included in the transaction price if it is probable that amount will not result in significant revenue reversal when uncertainty is resolved. An example of this may be where a retailer provides price protection for a period of time after the sale. In such case, books may reduce gross $100 current revenue at the time of sale by an estimated amount of reimbursement (say $3) to the customer for expected price protection after the sale and book the revenue at $97. However, for tax, revenue from the sale under the all events test at the time of sale would require the full $100 inclusion in revenue. The company would not receive a tax deduction for the $3 price protection until such liability became fixed and determinable under the all events and economic performance tests of IRC section 461.

Another example of a difference in treatment with regard to estimated variable consideration would be a multi-year contract for the sale of goods say over a three year period where the seller receives a bonus in year four in event delivery of the goods over the three year period are delivered on-time. Under the new revenue recognition standard, book treatment would require inclusion of the expected bonus in revenue over the three year period as the goods are delivered. Whereas for tax, such bonus would not be included in tax revenue until year four, after all contingencies are resolved (e.g. all requirement to receive the bonus are satisfied).

**Cooperative Considerations**

In evaluating the implications of the new revenue recognition standard, a cooperative should consider how implementation of the revenue recognition changes will affect the accounting for the determination of annual patronage net earnings for fiscal years beginning with the year of adoption, including the amount of any required cumulative retrospective adjustments to retained earnings.

- For cooperatives that determine patronage dividends on a book basis, how will the cooperative handle the retrospective adjustment to retained earnings? Will such
amount be retained? If the cooperative desires to allocate the adjustment to patrons, how will this be accomplished in the case where patronage dividends are determined on the basis of GAAP net earnings? Consider whether bylaws would permit such allocation or whether bylaws should be amended to provide for a modification of GAAP patronage net earnings to account for such retrospective adjustments. Whether or not this type of bylaw modification would be desirable would include consideration of how significant in amount the retrospective adjustment will be. Also, consider IRC Subchapter T requirements for the pre-existing legal obligation for a deductible patronage dividend to the extent such retrospective adjustment will be included in the patronage dividend determination.

- Also for book basis cooperatives, consider how the future timing of revenue recognition will affect future projections of patronage earning that would have an effect on timing of patronage dividends to patrons.
- Depending on how significant book revenue recognition changes, consider whether it would be desirable to may a change to determine patronage dividends on a taxable income or modified basis of accounting.

- For cooperatives that determine patronage dividends on a tax basis, there generally should be very limited implications for the determination of taxable income and patronage dividends unless there are expected changes in tax accounting methods and therefore, section 481(a) adjustments, either positive or negative. In such case, the cooperative should consider the spread of the timing of these adjustments into taxable income, whether in one year or over a four year spread and the adjustment’s inclusion in tax basis distributable patronage earnings.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.

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