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Defining Issues®

August 2014, No. 14-36

# New Revenue Recognition Standard: Potential Tax Implications

Changes in the timing or amount of revenue recognized by some entities under the revenue recognition standard recently issued by the FASB and IASB (the Boards) may affect both the calculation of and financial reporting for income taxes as well as other types of taxes.[1] This edition of *Defining Issues* discusses some of the potential tax consequences entities should consider when evaluating the potential implications of adopting the new standard.[2]

## Key Facts

Under the new revenue recognition standard entities may be required to change the timing or amount of revenue reported in financial statements for a variety of reasons, including the following.

- The seller's price is no longer required to be fixed or determinable.
- Software companies are not required to have vendor-specific objective evidence (VSOE) of the fair value of undelivered items to separate the undelivered items from the delivered software license.
- Revenue may be recognized over time or at a point in time depending on the circumstances and terms of the contract. In some cases, entities that currently recognize revenue upon delivery may recognize revenue over time while some entities currently recognizing revenue over time may recognize revenue at a point in time.
- There are new requirements for capitalizing costs of obtaining or fulfilling a contract.
- There is new gross versus net revenue guidance that may change the gross/net analysis for some entities.

**Contents**



[1] FASB Accounting Standards Update No. 2014-09, Revenue from Contracts with Customers, available at www.fasb.org, and IFRS 15, Revenue from Contracts with Customers.

[2] The effective date for public business entities and certain not-for-profit entities applying U.S. GAAP is fiscal years, and interim periods within those years, beginning after December 15, 2016. Early application is not permitted. The effective date is one year later for all other entities applying U.S. GAAP but they may adopt on the same date as public business entities.

## Key Impacts

Changes in financial reporting for revenue may affect taxes by:

- Accelerating taxable income because tax accounting methods change;
- Creating or changing existing temporary differences in accounting for income taxes for financial reporting purposes;
- Requiring revisions to transfer pricing strategies and documentation;
- Requiring updated policies, systems, processes, and controls surrounding income tax accounting and financial accounting; and
- Changing sales or excise taxes because revenue may be recharacterized between product and service revenue.

# Federal and State Income Tax Accounting Methods

U.S. federal income tax law contains specific rules for revenue recognition for certain items such as sales of inventory, 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. For tax purposes, an entity must determine whether the transaction is a service, sale, license, or lease transaction to apply the income tax law correctly. In some circumstances, the recognition criteria under the Internal Revenue Code are consistent with a taxpayer's financial reporting treatment. In other circumstances, if a new financial accounting method is acceptable for federal income tax purposes, an entity may choose to voluntarily change its tax accounting method to avoid book-tax differences. In those cases, the taxpayer simply uses the same revenue recognition method, such as sales upon shipment or the percentage of completion method for both tax and financial reporting. The effect on taxable income for state tax purposes generally follows federal tax laws.

The Internal Revenue Code does not require an entity to report taxable income using the same methods that are used for financial reporting purposes such as U.S. GAAP and not all methods used to report income for financial reporting are permissible for federal income tax purposes. If the same methods are not used for financial reporting and tax purposes, adjustments (on Schedule M-3) are made to the financial reporting records to calculate income for tax purposes.

The following are examples of situations that may justify or require a change in tax accounting method.

## Tax Income Recognition

For federal tax purposes, an entity using an accrual method generally reports income in the period in which the right to the income becomes fixed and the amount can be determined with reasonable accuracy. For sales of goods, income may be taxable upon shipment, delivery, acceptance, or title passage. For services, income may be taxable as the services are rendered, or may be deferred until completion and acceptance of discrete deliverables. Under the new revenue recognition standard, the transaction price is not required to be

fixed or determinable. Instead, 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. This change may create book-tax differences because variable consideration may be recognized as revenue for financial reporting purposes before it is fixed or determinable.

## Advance Payments

If the contract with the customer involves advance payments, tax deferral is generally allowed in the year of payment to the extent that deferral occurs for financial reporting purposes. Therefore, accelerating revenue recognition (the advance payment) for financial reporting purposes may result in acceleration of taxable income.[3] Under the new revenue recognition standard, software entities will no longer be required to have VSOE of fair value to recognize revenue for the undelivered items in a software contract separately from the license. Rather, an entity will allocate the transaction price to all distinct goods or services based on the relative stand-alone selling prices without regard to a VSOE threshold. Therefore, revenue may be recognized earlier for both book and tax purposes.

## Percentage of Completion

Certain entities may be required for federal income tax purposes to report taxable income on the basis of percentage of completion, including those that enter into long-term construction or manufacturing contracts. To the extent that a change in financial reporting accounting methods affects the revenue recognized by entities currently using percentage of completion, a book-tax difference may result. If a change in accounting method for tax purposes is permissible for long-term contracts, it is generally made on a cut-off or prospective basis (i.e., old contracts must be accounted for under the former method and new contracts will be accounted for under the new accounting method for tax purposes). For financial reporting purposes the change will be made either retrospectively or via a cumulative effect adjustment to retained earnings at the date of adoption of the new revenue recognition standard.

## 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 procedural purposes. If a new tax accounting method is required or desirable because the financial reporting accounting method changes, an entity must obtain permission from the Internal Revenue Service.[4] The filing procedures and timing vary based on whether the change is automatic or requires advance consent from the IRS.

If an entity is changing to a tax accounting method that is identified in published IRS guidance (i.e., Rev. Proc. 2011-14), 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 timing of recognition of the effects of a change in tax accounting methods may depend on when the entity determines to make the change, when Form 3115 is

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

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

filed, and whether the entity is changing from an impermissible method to a permissible method.

If an entity is changing its tax accounting method outside the automatic procedures, IRS approval of the change is not automatic. The entity may need to consider the U.S. GAAP requirements on accounting for tax uncertainties to determine whether it is appropriate to account for the change before it receives approval (i.e., the consent letter).[5]

If the adoption of the new revenue recognition standard results in accelerated income and the entity files a tax accounting method change, an unfavorable tax adjustment may be required. That adjustment (i.e., the income inclusion catch-up adjustment that is the difference between the tax accounting on the old method and new method as of the beginning of the year of change) would generally be spread over four years for tax purposes. This would also create an additional temporary difference for the portion of the effect of the tax accounting method change that has not yet been recognized for tax purposes.

## 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 to the amount and timing of revenue recognition from the new revenue recognition standard may have a significant effect on transfer pricing specifically as it relates to using revenue or profit-based methods for establishing the transfer pricing. An entity may need to consider whether its transfer pricing strategies and supporting documentation should be revised or updated.

## Accounting for Income Taxes

The new revenue recognition standard may have implications on the accounting for income taxes in addition to the implications related to the tax accounting method changes and transfer pricing issues discussed above. Some additional potential implications are described in the sections below.

### Cumulative Effect Adjustment

The new revenue recognition standard can be adopted either retrospectively or as a cumulative effect adjustment to retained earnings at the date of adoption. In either case, the adjustment required to adopt the new standard can affect the cumulative temporary differences at the date of adoption. As a consequence, the adjustment to reflect the effect of adoption of the new standard will need to include the tax effects on the transition adjustment.

### Costs of Obtaining a Contract

Incremental costs that an entity incurs only as a result of obtaining a contract (e.g., sales commissions) will be capitalized for financial reporting purposes under the new standard if the entity expects to recover these costs. As a practical expedient, an entity is not required to capitalize the incremental costs of

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

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 both 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, but there are several exceptions that may permit a current deduction (e.g., sales commissions to employees would generally fall within one of these exceptions).

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.

## Collectibility

The new revenue recognition standard specifies that collectibility of the consideration to which the entity expects to be entitled must be probable for there to be a contract (Step 1 of the revenue recognition model). If collectibility is not probable, an entity will not recognize revenue until it subsequently concludes that collectibility is probable or other criteria are met. Under federal income tax principles, an entity's rights to income are not fixed until all material contingencies on the receipt of income are removed. If the "not probable" standard now results in the recognition of less revenue than previously allowed, changes in book-tax differences may result. Both the book and tax standards are fact specific and will require analysis to determine the ultimate impact on specific types of contracts. After revenue is recognized, the entity evaluates the receivables for impairment and accrues an allowance for doubtful accounts. Because tax deductions for bad debts generally occur when a receivable is specifically charged off, a deferred tax asset generally exists for the tax effect of the financial statement carrying amount of the allowance for doubtful accounts.

## Investments in Foreign Operations

Adoption of the new standard will affect the opening balance sheet for many entities, which 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 an entity'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 entity has evidence of specific plans for indefinite reinvestment or the earnings will be remitted in a tax-free liquidation.[6] Changes in the investment in a foreign subsidiary upon adoption of the new standard may impact the amount of the deferred tax liability when the indefinite reinvestment criteria are not applied or may require assessment of the effect of the change on the indefinite reinvestment criteria when they are applied.

There may be additional considerations for an entity that maintains a deferred tax liability on some, but not all, of the outside-basis difference in foreign subsidiaries. For example, if the deferred tax liability established for a portion of the outside-basis difference is determined based on the amount of basis difference above a specific amount to be indefinitely reinvested, the deferred tax liability may be affected by the adoption of the new standard. However, if the deferred tax liability was established for a specific amount expected to be

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

repatriated, with the remainder subject to the indefinite reinvestment 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, which is generally interpreted in practice to be within one year. If an entity does expect to realize the deferred tax asset within the foreseeable future, it also will need to consider what effect the new standard will have on the temporary difference and related deferred taxes.

## Taxes Not Based on Income

The new revenue recognition standard also may affect non-income based taxes with respect to income statement presentation and contracting practices.

### Income Statement Presentation

The new revenue recognition standard supersedes accounting guidance on how taxes collected from customers and remitted to governmental authorities should be presented in the income statement (i.e., gross versus net presentation).[7] Current accounting guidance allows a policy election, but the new standard requires an entity to determine whether taxes collected from customers and remitted to governmental authorities should be presented on a gross or net basis based on principal versus agent guidance.

The treatment of sales taxes differs from production taxes, which are treated as a cost of sales. It may be necessary to analyze for each jurisdiction in which the entity operates whether certain taxes are sales 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 require the exercise of judgment to determine its character. When determining whether revenue should be presented gross or net of excise tax, the key consideration is whether the entity is acting as a principal or as an agent on behalf of the government. Other taxes that may need to be evaluated include, but are not limited to, value-added taxes, use taxes, withholding taxes, and gross receipts taxes.

### Contracting Practices

Generally, indirect taxes, such as sales or value added taxes, are determined based on stated contractual amounts for a specific good or service. Any changes in contracting practices may affect the amount of tax assessed because there may be differences in whether an item is subject to tax for the sale of goods versus the sale of services. If an entity uses the amounts recognized in its financial statements to support the amounts allocable to the goods or services for tax purposes, the new revenue recognition standard may have an impact on sales taxes because the amount of consideration allocated between the goods and services may change under the new standard.

[7] FASB ASC Subtopic 605-45, Revenue Recognition – Principal Agent Considerations, available at www.fasb.org.

## Other Considerations

In preparing to adopt the new revenue recognition standard, an entity should evaluate other impacts in addition to those discussed above. Management should consider:

- Training and communication needs;
- Contracting practices and potential changes that would affect financial reporting if an entity chooses to make revisions to contracts;
- Potential changes to foreign tax accounting methods, particularly to the extent 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 systems requirements resulting from different tax and financial accounting methods;
- Effects on income tax reporting, compliance, and planning (e.g., financial reporting for new tax-basis differences, the need to capitalize contract costs for financial reporting purposes, the effect of contract modifications, and the effect on an entity's assessment of whether it is more likely than not that deferred tax assets will be realized for purposes of considering a valuation allowance because the available deferred tax liabilities are changed);
- Potential effects on 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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