December 5, 2017

To All Tax Accounting Clients

Re: Tax Reform and Potential Accounting Method Changes

1. Repatriation and Controlled Foreign Corporations ("CFCs")

As you are aware, both the House and the Senate have proposed the imposition of a current tax on the "deemed" repatriation of the earnings & profits ("E&P") of CFCs. The base for the tax is the CFC's accumulated post-1986 E&P as of either November 2, 2017, (Nov. 9, 2017, in the Senate bill) or December 31, 2017, whichever amount is greater.

This effective date suggests that it may be too late for most types of tax planning with respect to the E&P of your company's CFCs. However, accounting method changes for the 2017 taxable year may be an exception to that generalization. More specifically, regardless of when during a particular taxable year accounting method change requests are filed, the accounting method change, if the request is granted, becomes effective retroactive to the beginning of the taxable year of change.

Accordingly, for example, an accounting method change request filed after Nov. 2, 2017, for a 2017 accounting method change for a CFC with a calendar year would be effective as of January 1, 2017, well in advance of the effective date of the proposed legislation. There is no indication in the legislation or in the official summaries of the legislation that such accounting method changes for E&P for 2017 would be barred simply because the accounting method change request is filed after Nov. 2, 2017 (or Nov, 9, 2017).

In light of the foregoing, we think it is imperative that every corporation that operates internationally through CFCs review the accounting methods used by their CFCs to assess the possibility of making accounting method changes for the CFCs that would reduce the E&P of the CFCs for the 2017 taxable year. In our experience, many CFCs follow their book accounting methods for tax purposes, and in some cases those book accounting methods may be based on IFRS rather than U.S GAAP.

Moreover, regardless of whether a book accounting method conforms with U.S. GAAP or instead with IFRS, that accounting method may not comply with U.S. tax rules or, even if the accounting method is permissible for U.S. tax purposes, the accounting method that has been used for computing the E&P of the CFC may not be the most favorable accounting method from a U.S. tax point of view. This is particularly true where the CFC has not been a major payer of dividends to its U.S. parent and, as a result, the U.S. parent has not previously focused on the computation of the E&P of the CFC.

We have handled numerous accounting method changes for CFCs and have many ideas for potential accounting method changes. Accordingly, we could provide assistance in the review of your CFCs' accounting methods.

2. Domestic Corporations and Pass-Throughs

In a similar vein, it is expected that tax reform may result in sharply lower tax rates for domestic corporations and pass-throughs, although the effective date of the rate reduction for corporations differs in the House and Senate bills. Accordingly, you should be thinking about potential accounting method changes that either accelerate the timing of deductions from 2018 into 2017 or that defer the recognition of income into 2018 or beyond. In the event the effective date of the rate reduction is postponed until 2019 (as in the Senate bill), the accounting method change could likewise be deferred. Again, we can be helpful in conducting an accounting method review of domestic corporations and pass-throughs to assess the possibility of shifting income into 2018 (or 2019).

Both of these recommendations recognize the possibility that no tax reform may ultimately be enacted or that the effective date of particular provisions might be deferred from 2018 until 2019. Neither automatic, nor advance consent, accounting method changes are binding on a taxpayer at the time of filing of the request; for an automatic change, the new accounting method only becomes binding upon the filing of the tax return for the year of change, and for advance consent accounting method changes, the new accounting method is not binding until the granting and execution by the taxpayer of an IRS consent letter. Accordingly, tentative decisions made at this time could always be reversed or deferred, depending on the outcome of the tax reform legislation.

3. Potential Change to the Recognition of Revenue

The Senate Bill contains an entirely new provision limiting the time for the recognition of revenue for tax purposes to no later than the year of recognition of that revenue in a taxpayer's financial statements. While book/tax conformity has always existed for advance payments, the Senate bill extends the financial conformity requirement much further and, if enacted, would prevent a taxpayer from recognizing revenue for tax purposes any later than when the revenue is recognized for financial reporting purposes. Thus, revenue recognition for tax purposes would be required in a number of situations where the all-events test provides for later recognition of revenue for tax purposes than would be typical in the case of revenue recognition for financial reporting purposes. For example, unbilled receivables for partially-performed services would be required to be recognized for tax purposes at the time when the unbilled receivables are recognized in a taxpayer's financial statements.

This potential change in the tax rules takes on added significance with the adoption in 2018 (2019 for privately-held companies) of ASU No. 606, which imposes new revenue recognition rules for financial reporting purposes. For example, a number of contingencies that affect the recognition of revenue, such as bonuses based on future performance would be required to be recognized by ASU 606 into current revenue, based on the expected outcome of the performance. At this time, it appears that the scope of this book conformity provision would apply in such circumstances. If that provision is retain in Conference in its present form, your company may have to weigh the benefits of earlier revenue recognition for financial reporting purposes with the detriment of greater tax liabilities in deciding whether to change the terms of sales contracts to prevent the earlier recognition of revenue.

Another aspect of this provision in the Senate bill is that Treas. Reg. § 1.451-5 would be repealed and all advance payment deferral (both for goods and services) would be limited to one year. Moreover, there would not appear to be any offset for cost of goods sold prior to the sale of the goods. Accordingly, taxpayers relying on Treas. Reg. § 1.451-5 for longer deferrals should consider whether to restructure sales arrangements, so that amounts previously treated as advance payments may be recharacterized as either loans or deposits.

Give us a call or email us if you are interested in discussing any of these ideas.

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