TAX EXECUTIVES INSTITUTE
Annual Meeting

Tax Ramifications of New FASB
Pronouncement on Revenue Recognition

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MODERATER:

Barbara Young, Vice President,
Global Tax Accounting & Compliance
Marriott International

PARTICIPANTS:

Leslie J. Schneider, Partner

Ivins, Phillips & Barker

Christine Turgeon, Partner

Washington National Tax Services

PriceWaterhouseCoopers

Tax Ramifications of New FASB Pronouncement

Overview of New Standard

Convergence of Standards for Revenue from Contracts

- On May 28, 2014, the FASB and IASB issued a new joint standard to address revenue recognition issues comprehensively for all contracts with customers regardless of industry-specific or transaction-specific fact patterns for both US GAAP and IFRS, with certain limited exceptions
  - FASB Accounting Standards Topic 606 and International Financial Reporting Standard 15, Revenue from Contracts with Customers
  - Still certain differences between GAAP and IFRS (e.g., meaning and function of notion of probability used in assessing collectability)
- Effective (after one year delay) for annual reporting periods beginning after Dec. 15, 2017 (public) and Dec. 15, 2018 (nonpublic), with optional early adoption.

Applicability

- Applies to all contracts with customers to transfer goods, services, or nonfinancial assets, except contracts within the scope of other standards such as:
  - Leases,
  - Insurance contracts,
  - Certain financial instruments,
  - Guarantees, and
  - Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers.
- Replaces numerous, industry-specific GAAP revenue recognition requirements

Core Principle

- Recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services.
- To achieve this core principle, an entity must:
  - Identify the contract with customer,
  - Identify performance obligations in contract,
  - Determine transaction price,
  - Allocate transaction price to performance obligation(s) in contract,
  - Recognize revenue when (or as) the entity satisfies a performance obligation.
- Also includes guidance for certain costs to obtain or fulfill a contract with a customer (e.g., incremental costs of obtaining a contract).

Determine Transaction Price

- The transaction price is the amount of consideration that an entity expects to be entitled in exchange for transferring promised goods or services to a customer.
- The consideration promised in a contract with a customer may include fixed amounts and/or variable amounts.
    - In contrast, current GAAP requires recognition of revenue when it is fixed and determinable.
- Examples of variable consideration include volume discounts, incentive awards, bonuses, and rights of returns.
    - However, sales- or usage-based royalties (if not bundled with a tangible good) are recognized only when the later of the following events occurs:
        - The subsequent sale or usage occurs; or
        - The performance obligation to which some or all of the royalty has been allocated has been satisfied (or partially satisfied).
    - Variable consideration included only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty of the variable consideration is resolved.

Recognition of Performance Obligations

- Performance obligations are satisfied when (or as) the entity transfers control of the good or service, which can occur over time or at a point in time.
- An entity satisfies performance obligations over time if:
  - Customer simultaneously receives and consumes benefits provided by the entity's performance as entity performs
  - Entity's performance creates or enhances an asset that customer controls as the asset is created or enhanced
  - Entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date
- If performance obligations are satisfied over time, revenue is recognized by applying a method of measuring progress toward completion of the performance obligation, such as 'output methods' and 'input methods' (including a percentage of completion method).

Recognition of Performance Obligations

- If a performance obligation is not satisfied over time, an entity satisfies the performance obligation at a point in time.
- To determine point in time at which control transfers, consider presence of certain indicators:
  - Present right to payment,
  - Legal title,
  - Physical possession,
  - Risks and rewards of ownership, and
  - Customer acceptance.
- For licenses, whether performance obligations are satisfied over time or at a point in time depends upon whether the agreement grants:
  - Right to *access* IP, then recognize over time
  - Right to *use* IP, then recognize at a point in time

  NOTE: Subject of proposed ASU

Update of FASB and IASB Tentative Decisions

FASB	IASB
Two proposed Accounting Standards Updates (ASUs)	One package of proposed amendments
1. Proposed ASU: - Amend licenses guidance - Amend guidance for identifying performance obligations and add examples	• Amend licenses guidance • Provide additional examples for identifying performance obligations • Provide two new practical expedients for application of new standard upon adoption
2. Proposed ASU: - Provide new practical expedients for contract modifications upon transition and sales tax presentation - Amend guidance on noncash consideration - Amend guidance on collectibility	

Potential Areas of Difference

"Cash cap" guidance	Allocation of discounts	Bill and hold arrangements	Certain POC methods	Certain Subscriptions	Combining contracts
Consignment arrangements	Contingent revenue	Collectability	Contract modifications	Customer loyalty programs	Customization implementati on
Discounted goods or services	Distributor revenue	Elimination of industry guidance	Extended payment terms	Extended Warranties	Funded R&D arrangements
In-transit loss coverage	Learning Curve	Licenses	Other contract costs	Performance fees	Sales commission
Sell through	Service level agreements	Time value of money	Units of delivery method	Vendor protection clauses	Volume Discounts

Disclosures

Tax Ramifications of New FASB Pronouncement

Overview of Tax Considerations

Overview of Tax Revenue Recognition Rules

- The tax law contains specific revenue recognition rules, under which revenue generally is recognized the earlier of when it is due, paid or earned.
- Amounts due or paid in advance of being earned (advance payments) may be eligible for tax deferral under specific provisions, but tax deferral generally cannot exceed the book deferral. For example:
  - Section 451 regulations for goods and integral services
  - Rev. Proc. 2004-34 for goods, services, use of certain intellectual property, and other eligible payments
- Revenue generally earned for:
  - Goods, when benefits and burdens of ownership of good transfers
  - Services, when services (or divisible services) are complete
  - Licenses, over the period the licensee has the right to use the property
  - Long-term contracts, as costs are incurred

Potential Tax Accounting Methods Impact

- Financial accounting changes will impact cash taxes in certain instances:
  - Recognition of advance payments deferred to extent of book deferral
  - Treatment of additional items as deferred revenue as opposed to as accrued liabilities
  - Identification of impermissible tax methods
- Changes could impact book-tax differences and deferred taxes, including:
  - Recognition of sale of goods, services, long-term contracts, licensing revenue
  - Contingent consideration
  - Time value of money adjustments
  - Costs of obtaining/fulfilling contracts
- Changes also may require tax accounting method changes
  - Change in the recognition of advance payment for books
  - Identification of improper tax revenue recognition methods

Other Tax Considerations

Compliance and provision processes:

- Availability/integrity/maintenance of data needed to enable the accurate computation of taxable income and reliance on automation/technology
- Potential change to/establishment of internal controls
- Year one accounting and financial statement disclosures

Accounting for income taxes:

- Adjustments to deferred tax balances (creation, modification, and/or elimination)
- Changes in current/non-current deferred classification
- Impacts on any valuation allowances, uncertain tax positions
- Effect on intra-period allocations
- Financial statement disclosures

Potential federal effective tax rate implications:

- Section 199 deduction computation
- Charitable contributions deduction
- Calculation of credits (e.g., R&E, FTC)

Other Tax Considerations

State income taxes:

- Potential sales and use tax implications
- Income and net worth implications, including potential impact on tax base and apportionment
- State effective tax rate

International taxes:

- Effect of any book and/or tax method changes on E&P
- Impact on the determination of foreign source income
- Effects to controlled foreign corporation debt netting calculation
- Impacts to allocation of interest expense under fair market value apportionment method

Other Tax Considerations

Value added taxes:

- VAT implications (e.g., as whether principal or agent for VAT reporting)

Transfer pricing:

- Impact on benchmarking analyses (e.g., timing of impact on comparables)
- IP ownership and cost share computations
- Impact on intercompany invoice amounts
- Need to allow additional lead in case for year-end transfer pricing adjustments
- Necessary changes to documentation and additional clarifications in policies

Tax Ramifications of New FASB Pronouncement

Illustrating the Impact

ASU 606 Examples

- **Example 1 – Doubtful Collectability**

  - **Books:** Developer receives $50,000 deposit towards sale of restaurant building to customer for non-recourse note. Developer determines that collection of full consideration is doubtful because of non-recourse note, source of funds for payment of note is income from restaurant and buyer has no other funds. Deposit is not included in income, but is treated as a liability, as is balance of payments of principal and interest until it is determined that full payment is probable.

  - **Tax:** Criteria noted above are not likely to permit deferral of deposit or principal and interest payments. The transaction is an installment sale and would be treated as such for tax purposes. Moreover, if a taxpayer elected out of section 453, it is unlikely that open transaction treatment would be permitted. Must satisfy section 166 standards before writing off any unpaid balance as bad debt.

ASU 606 Examples

- **Example 6 – Transaction Price with Variable Consideration**

  - **Books:** Taxpayer sells two different products, one for immediate delivery and one for deferred delivery. Sales price is a fixed price of $1,000 plus a variable price of $200. Estimate of variable consideration is included in contract price. $600 of revenue is recognized immediately on delivery of first product. Revenue deferred on remaining product until it is delivered.

  - **Tax:** While the first prong of the all-events test is met when each product is delivered, the amount to be received must be reasonably determinable. Many factors go into consideration of whether the $200, or some part of it, is recognized as product is delivered. Where the variable consideration is based on a price yet to be negotiated by the parties, case law delays revenue recognition for the variable consideration until price is fixed and reasonably determinable, notwithstanding that cost of goods sold is deducted at delivery of goods.

ASU 606 Examples

- **Example 11 – Distinct Goods and Services**

  - **Books:** A software developer enters into a contract with a customer to transfer a software license, perform an installation service, and provide software updates and technical support for a two-year period. Each of the foregoing services could be purchased separately. The services are performed at different times. The developer must account for each of these services separately.

  - **Tax:** It is likely that the software license and installation could be accounted for as a single service. Thus revenue might be recognized at the end of installation, unless amounts were billable as the work progresses or as the license was provided. However, if for books, revenue is deferred for the installation portion of the work, deferral for tax might be permitted under Rev. Proc. 2004-34.

    Technical support would probably be recognized for tax ratably over the term of the agreement. However, other possible amortization approaches are possible.

ASU 606 Examples

- **<u>Example 12</u> – Explicit and Implicit Promises in a Contract**

  - **Books Case A:** A manufacturer sells a product to a distributor (the customer), who will then resell it to an end customer. In the contract, the manufacturer promises to provide free maintenance services to the end customer. The manufacturer outsources the maintenance obligation to the distributor and agrees to pay the distributor for the maintenance services. However, if the end customer does not need such maintenance services, the distributor is not paid for undertaking the service obligation. The maintenance obligation is a separate performance obligation and the manufacturer should allocate a portion of the sales price to the maintenance obligation and defer recognition of it until the obligation is performed or expires. It doesn't matter that the obligation was contracted out to a third party.

  - **Tax Case A:** For tax, the entire sales price would probably be recognized upon the sale of the product. Unclear whether revenue would be allocated to "free" maintenance. However, because the amount allocated to the free maintenance is deferred for book purposes, up to a one year deferral would be permitted for tax under Rev. Proc. 2004-34.

ASU 606 Examples

- **<u>Example 15</u> - Asset Has no Use to the Entity**

  - **Books:** Taxpayer enters into a contract with a customer to produce a specialized satellite that is unique to the customer. In order to recognize revenue based on performance (PCM), not only must the work product have no alternative use for the taxpayer, but the taxpayer must have an enforceable right to payment for performance to date.

  - **Tax:** It is likely that under section 460, this would be a long-term contract subject to the percentage of completion method. If not a long-term contract, no revenue recognition until completion, regardless of enforceable right to partial payment for part performance.

ASU 606 Examples

- **Example 19 – Uninstalled Materials**

  - **Books:** Contractor enters into contract with a building owner to refurbish building and install new elevators. A significant cost of the work is the cost of the new elevators. While revenue should be recognized as costs are incurred, including the cost of the elevators in measuring PCM would distort the timing of revenue recognition. In this case, the cost of the elevators should be excluded from the measurement of progress towards completion.

  - **Tax:** Under section 460, PCM is required and front-end costs are included in measurement of progress towards completion as soon as the materials are dedicated to the contract.

ASU 606 Examples

- **<u>Example 22</u> – Right of Return**

  - **Books:** Taxpayer enters into 100 contracts to sell one product in each contract for $100/product. Each product cost $60 to produce. Payment is rendered as products are delivered, but if customer is unable to resell product within 30 days, customer may return the product and obtain a full refund. Taxpayer estimates based on experience that only three of 100 products sold under contract will be returned. Taxpayer recognizes revenue of $9,700 based on sales price of 97 units x 100 and deducts $5,820 (97 x $60) as cost of goods sold, with the balance ($180) in inventory.

  - **Tax:** Case law on sale or return contracts treats the initial sale as a completed transaction with full revenue recognition. Return of product is treated as a refund and repurchase of product in a separate transaction.

ASU 606 Examples

- **<u>Example 24</u> – Volume Discount Incentive**

  - **Books:** A taxpayer enters into a contract with a customer to sell a product at \$100/unit. However, if during the calendar year, the customer purchases more than 1000 units, the sales price is retrospectively reduced to \$90/unit. The consideration in this arrangement is considered variable. Whenever the taxpayer reasonably foresees that the discount threshold will be reached, the taxpayer reduces the sales revenue from previous sales, as well as future sales, to reduce the expected selling price to \$90/unit.

  - **Tax:** Under the all-events test, the volume discount is not recognized as a reduction in revenue, (*i.e.*, a rebate of revenue) until the 1000 unit discount threshold is reached.

ASU 606 Examples

- **Example 32 - Consideration Payable to a Customer**

  - **Books:** A customer commits to purchasing at least $15 million worth of products from the taxpayer during the year. In exchange therefore, the taxpayer pays the customer a nonrefundable amount of $1.5 million at the inception of the contract to reimburse the customer for the costs of changing its shelving to accommodate the products. The $1.5 million payment is treated as a reduction in the sales price of the products and offsets the $15 million of revenue by 10% as the revenue is recognized.

  - **Tax:** The shelving allowance would be treated as an amount to obtain a sales contract. Its treatment would be governed by the INDOPCO regulations and potentially might be deductible when accrued. If the $1.5 million were denominated as an advance discount and a reduction in the sales price of a specific quantity of units, it might instead qualify as a deferrable advance trade discount.

ASU 606 Examples

- **Example 49** – **Discount on Future Purchases**

  - **Books:** A taxpayer enters into a contract to sell a product for $100. As part of the contract, the taxpayer gives the customer a 40 percent discount voucher for future purchases up to $100 during the next 30 days. The taxpayer intends to offer all customers a 10% discount during the next 10 days, but the customer cannot use both discounts. Only the incremental discount of 30% is treated as a performance obligation. The taxpayer must determine the fair market value of the product and the discount voucher and allocate revenue between the two in proportion to their relative fair market values. The revenue allocated to the product is recognized when the product is sold; the revenue allocated to the voucher is deferred until the discount is used or expires unused.

  - **Tax:** In the past, this type of arrangement has been treated as a deferred promotional discount, with current recognition of the $100. It is possible to argue that tax should follow the new book treatment and defer revenue under Rev. Proc. 2004-34. However, the IRS may view the discount as a rebate and contend that the discount must be taken within 8-½ months to be treated as a reduction in revenue for the preceding year. However, there is a disagreement whether the 8-1/2 month rule should apply in this type of case.

ASU 606 Examples

- **<u>Example 52</u> – Customer Loyalty Program**

  - **Books:** A company maintains a customer loyalty program that awards customers 1 loyalty point for every $10 of purchases. The award points may be redeemed for $1 discount on future purchases. The award points are a deferred performance obligation and the amount that a customer pays for merchandise should be allocated between the current sale and the value of the award points, with the revenue allocated to the latter deferred until the reward points are redeemed. The award points should be valued taking into account both their redemption value and breakage (i.e., the likelihood that some award points will never be redeemed).

  - **Tax:** In the past, most taxpayers have recognized 100% of the revenue upon the sale of the product or service and some taxpayers have attempted to deduct the estimated cost of redeeming the award points at the time the points are issued. However, the case law has tended to support the IRS position that the cost of the award points could not be deducted until the customer redeems the award points.

    Taxpayers should consider an alternative filing position under Rev. Proc. 2004-34 that treats the amount allocated to the award points as deferred revenue.

ASU 606 Examples

- **Example 59 – Right to Use Intellectual Property**

  - **Books:** A music record studio licenses a 1975 recording to a customer. The customer may use the recording for a two-year term. The consideration for the license is $10,000/month over the term of the license. The contract is non-cancellable. Because the licensor has no further obligations and the subject matter doesn't change, the licensor recognizes all of the revenue at the outset of the license.

    NOTE: Proposed ASU could change this result.

  - **Tax:** The licensor would recognize revenue over the term of the agreement. The obligation to continue the license for the duration of the term represents a contingency that prevents recognition of the entire license fee.

ASU 606 Examples

- **<u>Example 63</u> – Bill and Hold Arrangements**

  - **Books:** A manufacturer enters into a contract with a customer to build a machine and spare parts. The lead time is two years. At the end of the two year period, the machine and spare parts are completed and the customer pays for both of them. However, the customer only takes physical possession of the machine and requests that the spare parts be stored in the manufacturer's warehouse, but legal title is in the customer. The manufacturer expects to hold the spare parts for 2-4 years. The obligation to build the machine, the spare parts and custodial services are considered three separate performance obligations. Revenue allocable to the machine and spare parts are recognized when the machine and spare parts are completed and title passes to the customer. The revenue allocable to the storage obligation is recognized ratably over the term of the storage. Previously, many companies deferred the revenue allocable to the spare parts until they were actually transferred to the customer.

ASU 606 Examples

- **Tax:** Heretofore, all of the revenue was allocated to the machine and spare parts and most companies recognized that revenue when title passed to the machine and spare parts. Some companies deferred the revenue allocable to the spare parts deferred for books based on Rev. Proc. 2004-34. Following new standard, a taxpayer instead might defer revenue allocable to the storage obligation by establishing deferral of revenue under Rev. Proc. 2004-34.

Tax Ramifications of New FASB Pronouncement

The Takeaway

Key Takeaways

- Finance and Tax to communicate with each other regarding new standard
  - Understand what will change between current law and the new standard
  - Identify any changes in revenue recognition for financial reporting purposes
  - Identify any changes in capitalization of costs
- Assess impact of changes on current tax accounting methods
  - Understand any impacts on cash taxes
  - Identify how changes in revenue recognition impact current book-tax differences, including the creation or elimination of book-tax differences
  - Identify any system needs to capture data needed to properly report revenue for tax purposes
  - Determine whether any accounting method changes are necessary (or desired)
- Assess impact of any changes on other tax areas, including
  - State and indirect tax
  - International tax
  - Transfer pricing

“Top Ten” Reasons for Tax to Sit at the Table

- Review any impacts to transfer pricing strategy and documentation to determine point in time at which control transfers, consider presence of certain indicators:
- Assess impacts on non-US entity Earnings & Profits and dividend planning
- Consider any impact on state tax base and apportionment
- Consider risk management and uncertain tax positions implications
- Determine adjustments to deferred tax balances and classification of current/non-current, including potential implications on valuation allowances
- Evaluate effect on compliance obligations
  - Creation/modification/elimination of book-tax differences (optimization is key!)
  - Requirement to file tax accounting method change requests
- Identify availability of system information and any desired customization
- Identify any impacts to effective tax rate (e.g., R&D, FTC, IRC Section 199, charitable contributions)
- Consider year one accounting and financial statement disclosure
- Identify impacts to cash taxes