# Tax Implications of the New Revenue Rules

With the adoption of the new revenue rules right around the corner, companies will need to consider the effect of adoption for financial reporting purposes and the associated effect on the computation of taxable income. Companies should review their existing tax processes in light of the new revenue rules. Considering the tax implications at this point can help ensure a smooth transition.

## Tax Principles for Revenue Recognition

The determination of when revenue is earned for tax purposes can differ from when it is earned for financial reporting. Generally, U.S. taxpayers recognize revenue for tax purposes when:

- The taxpayer has a fixed right to receive the revenue—which generally occurs on the earlier of when the revenue is due, received or earned—and
- The amount can be determined with reasonable accuracy

Revenue from the sale of goods generally is earned when the benefits and burdens of ownership pass to the customer, which could occur upon shipment, delivery, acceptance or title passage. Service revenue generally is earned when performance is complete. License revenue generally is earned over the customer's use term.

The IRS provides certain exceptions for advance payments that consider when amounts are recognized for financial reporting purposes. These provisions allow a limited deferral that cannot exceed the financial accounting deferral. Taxpayers using these exceptions will need to consider the effect an acceleration of book revenue will have on a corresponding acceleration of recognition of income for tax purposes.

The IRS also has special provisions for installment sales and long-term contracts that affect income recognition for tax purposes. Taxpayers can also make elections such as the nonaccrual-experience method for determining collectibility of accrued revenue based on historical experience that can affect the recognition of income for tax reporting purposes. Construction businesses and long-term contract manufacturers frequently use percentage of completion for reporting taxable income. Changes to income recognition for financial statement purposes should be accompanied by an evaluation of their current method of income recognition for tax purposes to achieve a longer deferral period or simplify tax computations. Generally, when changes are made, existing contracts would continue to recognize revenue under the former method and new contracts would use a new revenue recognition method for tax purposes.

Taxpayers can change their tax method for recognizing revenue to allow for the longest deferral of income recognition for tax purposes. These changes generally require IRS consent. Filing procedures and timing vary; depending on the facts, consent may be required in advance of the change or may be automatically granted if eligibility criteria are met.

*In March 2017, the IRS requested comments on a proposed revenue procedure that, if finalized, would provide procedures for how a taxpayer may request consent to change an accounting method for recognizing income when the change is made for the same taxable year as the taxpayer adopts the new revenue recognition standard. The comment period closed on July 24, 2017. As of October 2017, no final ruling has been issued.*

## Timing Differences

Upon adoption of the new revenue rules for book purposes, taxpayers may have new temporary differences or be required to compute an existing temporary difference for tax purposes in a different manner.

Common examples include:

- A company may identify more performance obligations for financial reporting purposes than the number of deliverables it identified under current guidance, *e.g.*, identification of sales incentives in the form of free goods or services, customer award credits or loyalty programs or options for additional goods or services. Separation of different performance obligations may result in timing differences in how revenue is recognized for each performance obligation for financial reporting purposes. This could result in additional computations for income recognition for tax purposes.
- The transaction price may differ due to variable consideration—including rebates, price concessions, performance bonuses and rights of return—noncash consideration, consideration payable to a customer and significant financing components. A different transaction price for financial reporting purposes under the new revenue rules may result in increased computations of temporary differences for tax purposes because of a different pattern of revenue recognition.
- The new standard requires significant judgment in distinguishing between customer credit risk, *e.g.*, bad debt, and implied price concessions, *e.g.*, transaction price. The new revenue standard removes the existing collectibility threshold so revenue may be recognized sooner with a corresponding credit impairment loss. Because tax deductions for bad debt generally occur when a receivable is deemed to be partially or totally worthless, a deferred tax asset would exist for the allowance for doubtful accounts on the balance sheet.
- Contract costs may differ because the new revenue standard changes capitalization requirements. Incremental costs to obtain a contract would be capitalized for financial reporting unless the contract's amortization period is less than a year. Cash-basis and accrual-basis taxpayers generally capitalize and amortize contract acquisition costs over the contract's term, with several exceptions including employee sales commissions. As a result, there will not be a temporary difference associated with amortization expense for contract acquisition costs.

Entities must retrospectively apply the new revenue standard using either a full or modified retrospective approach. Depending on the method chosen, the new standard could result in a cumulative-effect adjustment. Entities electing a full retrospective approach would record a cumulative catch-up adjustment as of the first day of the first year presented. For modified retrospective adoption, an entity would make adjustments as of the first day of the year of adoption. Entities need to consider the current and deferred tax consequences associated with the individual items included in the cumulative-effect adjustment they will need to make at the date of initial application. An entity that applies the full retrospective method of adoption may also need to adjust its previously reported tax provision and temporary differences for purposes of recasting the 2016 and 2017 financial statements. The current and deferred tax consequences associated with the cumulative-effect adjustment should be reported in the period of adoption and may require careful consideration of the income tax accounting effect of individual items included in the adjustment.

## State Income Tax

Companies will need to assess the effect on state taxes, including sales/use or gross receipts taxes. Many states require apportionment of federal taxable income to the states where a company operates. Federal taxable income is typically apportioned based on the sales, payroll costs and assets located in each state. To the extent that revenue for federal tax purposes is changed, a company may need to review its methodology for compiling sales apportionment data.

## Indirect Taxes

An indirect tax is a tax paid to the government by an entity in the supply chain, but it is passed on to the consumer as part of the price of a good or service. Companies should review provisions of states that impose indirect taxes on gross revenue, especially if the tax is computed based on amounts reported for financial reporting purposes. Entities also should consider the potential effect on state net-worth taxes, as the cumulative effect of adopting the new standard will be recorded to retained earnings.

## International Subsidiaries

The income of a foreign subsidiary or a controlled foreign corporation could be affected by their adoption of the new revenue recognition standard. When a foreign subsidiary's earnings are repatriated or included on a federal tax return, the amount of distribution taxable as a dividend depends on the foreign subsidiary's underlying earnings and profits, which may be affected by the new revenue standard. A jurisdiction-by-jurisdiction assessment will be needed.

A change in a foreign subsidiary's local tax could affect foreign tax credits and the information included on certain U.S. information returns. In some international jurisdictions, a foreign subsidiary's local tax liability is based on the subsidiary's statutory financial statements, which may change with the standard's adoption in that jurisdiction. Taxpayers will need to determine when and how any such change in statutory financial reporting is recognized for tax purposes.

## Transfer Pricing

For multinational companies, transfer pricing could generally be affected by the new standard in one of two ways. The new standard could affect the underlying inputs to a company's internal transfer pricing calculations. The standard also could change the results of the comparables used in transfer pricing analyses, with a resulting effect on the company's transfer pricing. Companies may need to review transfer pricing policies and related documentation that demonstrate how their strategy meets local requirements for intercompany transactions. Transfer pricing frequently is based on the revenue or profit measures reported in the financial statements, which may change when the new revenue standard is adopted.

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