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Tax Implications of ASC 606

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David Strong

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Today’s Speaker

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Agenda

- New Revenue Recognition Standard
- Tax Rules for Revenue Recognition
- Tax Evaluation of the Five-Step Model
- ASC 606 Adoption – Tax Implications
- ASC 606 Adoption Considerations

Objectives

As a result of participating in this session you should be able to:

- Determine the potential tax impact of the new revenue recognition standard
- Identify the steps in evaluating the tax impact
- Recognize potential method changes required
- Determine the potential tax impact of a change in method of recognizing revenue
- Identify applicable change procedures and timing

Polling Question #1

Do you think that the implementation of ASC 606 will have a significant impact on your company's financial reporting?

A. Yes

B. No

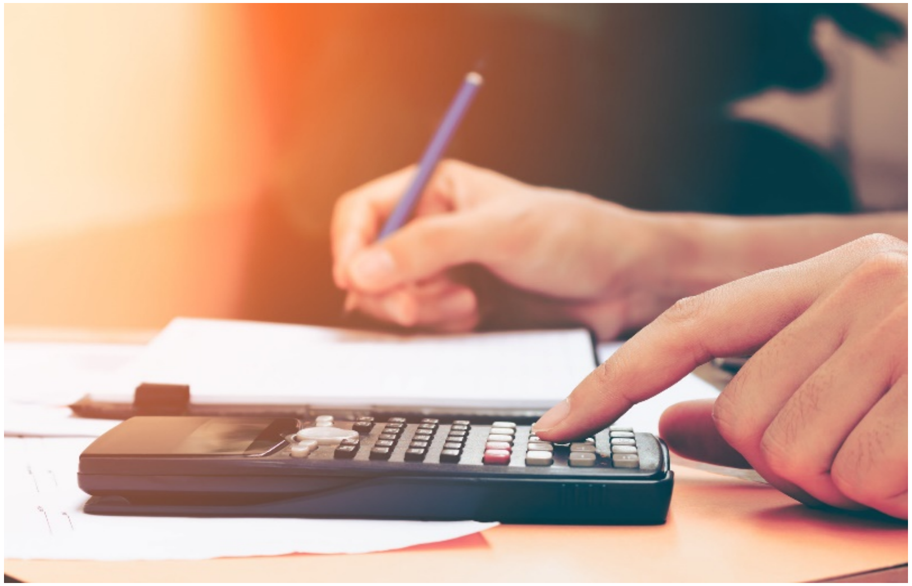
C. Maybe; still evaluating

D. Don't know

New Revenue Recognition Standard

Tax Implications – High Level

- Federal & State Income Taxes
- Financial Reporting for Income Taxes
- Indirect Taxes
- International Jurisdictions / Transfer Pricing / Foreign Earnings



Tax Implications – Specific Considerations

- Is income recognition accelerating or decelerating?
- How does the new standard align with the tax rules?
- What changes in revenue recognition result in a change for tax reporting, if any?
- How will the change impact the deferred tax provision calculations and the need for new book-to-tax differences?
- How will the change be implemented for tax reporting purposes?
- Will a method change be required?
- Will there be an adjustment to taxable income in implementing the change?
- When will the change take place?
- What are the costs of the change?
- What jurisdiction might be impacted?

The Tax Approach for the New Revenue Model

Step 1 – Identify the contract(s) with a customer

Step 2 – Identify the performance obligations in the contract

Step 3 – Determine the transaction price

Step 4 – Allocate the transaction price to the performance obligations in the contract

Step 5 – Recognize revenue when (or as) the entity satisfies a performance obligation

Tax Rules for Revenue Recognition

Tax Principles of Revenue Recognition

- IRC Section 451 – Income
  - Advance Payments

- IRC Section 460 – Long Term Contracts

- Other Considerations
  - Rebates
  - Discounts
  - Warranties
  - Commissions

IRC Section 451 – Income

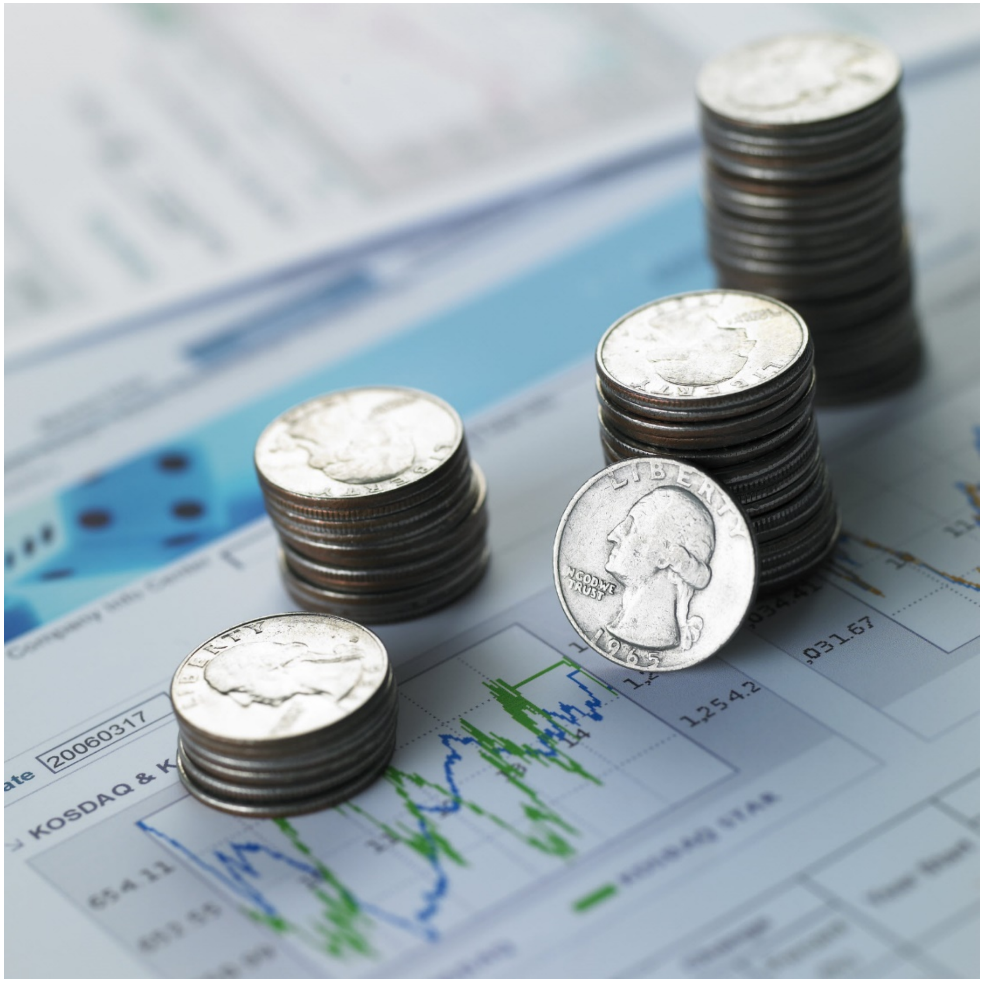
General rule for tax year ending on or before Dec. 31, 2017

"All Events Test"

Fixed Right to Receive & Reasonably Estimated

Earliest point of time when amount is:

- Earned
- Due or
- Paid



IRC Section 451 – Income

Tax Cut and Jobs Act 2017

The new rules are effective for tax year beginning after Dec. 31, 2017 for taxpayer's with applicable financial statements

For an accrual basis taxpayer, revenue is recognized no later than it is recognized in its applicable financial statements.

Taxpayer will follow financial statements in determining the allocation of the transaction price for each separate performance obligation identified.

Exceptions for certain special methods of accounting.

The Act changes the treatment of advance payments for goods and services limiting the deferral of income.

IRC Section 451 – Income

Tax Cut and Jobs Act 2017

Applicable Financial Statement is defined as:

- Certified as being prepared under GAAP
  - A 10K or annual statement to shareholders required to be filed with the SEC
  - An audited financial statement used for
    - credit purposes,
    - reporting to shareholder, partners or other proprietors or to beneficiaries
  - Filed by the taxpayer with any other Federal agency for other than a Federal tax purpose
  - Prepared on the basis of IFRS filed with a agency of a foreign government which is the equivalent of the SEC
  - Filed with any other regulatory or governmental body specified by the Secretary

IRC Section 451 – Income

Advance Payments

Prior to law change:

1. Full Inclusion
2. 1 year Deferral (Services)
3. 2 Year Deferral (Goods for tax years beginning on or before Dec. 31, 2017)

Tax years beginning after Dec. 31, 2017

1. Full Inclusion
2. 1 year Deferral (Goods and Services)

Long Term Contracts

IRC §460

I. Percentage of Completion Method (PCM)
II. Percentage of Completion Capitalized Cost Method (PCCM)
III. Completed Contract Method (CCM)

The Tax Cut and Jobs Act of 2017 doesn't impact the methods of accounting for long term contract under IRC §460.

Other Items

Variable Conditions

I. Discounts

II. Rebates

III. Price Concessions

Commissions

Polling Question #2

What steps has your company taken to determine the impact that the Tax Cut and Jobs Act of 2017 will have on the company's financial reporting?

A. Completed our analysis

B. In the process of assessment

C. Still gathering information regarding tax reform

D. Have not started

Tax Evaluation of the 5-Step Model

ASC 606 – 5 Step Model

Step 1 – Identify the contract(s) with a customer

Step 2 – Identify the performance obligations in the contract

Step 3 – Determine the transaction price

Step 4 – Allocate the transaction price to the performance obligations in the contract

Step 5 – Recognize revenue when (or as) the entity satisfies a performance obligation

Step 1 – Identify the Contract(s) with the Customer

The new revenue model will be applied to a contract only when all of the following conditions are met:

- Each party has approved the contract and is committed to perform their respective obligations
- Each party's rights regarding the goods or services to be transferred can be identified
- The payment terms for the goods or services to be transferred can be identified
- The contract has commercial substance
- Collection is probable
- A contract does not exist if each party can terminate the contract prior to any performance occurring without having to compensate the other party

Collectability of Consideration - Walkthrough

An entity, a real estate developer, enters into a contract with a customer for the sale of a building for $1 million. The customer intends to open a restaurant in the building. The building is located in an area where new restaurants face high levels of competition, and the customer has little experience in the restaurant industry.

The customer pays a nonrefundable deposit of $50,000 at inception of the contract and enters into a long-term financing agreement with the entity for the remaining 95 percent of the promised consideration. The financing arrangement is provided on a nonrecourse basis, which means that if the customer defaults, the entity can repossess the building but cannot seek further compensation from the customer, even if the collateral does not cover the full value of the amount owed. The entity's cost of the building is $600,000. The customer obtains control of the building at contract inception.

Does a contract exist?

Take a moment in order to determine your own conclusions regarding the question above, we will then spend a moment or two going over the answer to this question.

Step 2 – Identify the Performance Obligations in the Contract

- Performance Obligation – An entity's promise to transfer a good or service
- Each performance obligation is either
  - Distinct (as defined in the standard)
  - A series of distinct goods or services that are substantially the same and have the same pattern of transfer
- Focus is on the customer's point of view – The customer must be able to benefit from the good or service on its own or with other resources that are readily available
- <u>NOT</u> limited to goods or services explicitly stated in the contract. (Consider implicit performance obligations)

Step 3 – Determine the Transaction Price

- Determining the transaction price can be straightforward, such as where a contract is for a determinable amount of consideration in return for a determinable number of goods or services in a reasonably short timeframe.
- Complexities can arise where a contract includes any of the following:
- Variable consideration
  - Expected value method
  - Most likely amount method
- A significant financing component
- Noncash consideration
- Consideration payable to a customer
  - Discounts
  - Rebates

Step 4 – Allocate the Transaction Price to the Performance Obligations

- The transaction price should be allocated to each performance obligation (or distinct good or service) in an amount that depicts the amount of consideration to which the seller expects to be entitled in exchange for transferring the good or service to the customer
- If more than one performance obligation exists, consideration should be allocated based on the relative <u>standalone selling prices</u> of the goods or services at the inception of the contract
- When a purely observable stand-alone price is not available, methods of estimating the stand-alone price include (but are not limited to):
  - Adjusted market assessment
  - Expected cost plus a margin
  - Residual approach

Step 5 – Recognize Revenue

Basic Principle – Revenue is recognized when (or as) performance obligations are satisfied by transferring control (defined as: The ability to direct the use of and obtain substantially all of the remaining benefits from the asset) of a promised good or service (i.e., an asset) to a customer. In determining the proper revenue recognition period, an entity must first decide if control is transferred over time or at a point in time.

Performance obligations may be satisfied *either*:

- At a single point in time (physical delivery)
- Over a period of time (provides services)

A good or service is transferred <u>over time</u> and revenue is recognized over time, if one of the following criteria is met:

- Customer simultaneously receives and consumes benefits
- The entity's performance creates or enhances an asset that the customer controls
- The entity's performance does not create an asset with alternative use to the entity, <u>and</u> the entity has an enforceable right to payment for performance completed to date

Polling Question #3

Where is your company in the process of developing a plan to implement the new standard under ACS 606?

A. Plan is developed

B. In the process of developing a plan

C. Still gathering information

D. This is my first webinar on ASC 606

ASC 606 Adoption – Tax Implications

Implementation Issues

- Evaluation of revenue recognition for book and tax
- Divergence of book and tax methods
- Requirement to file method changes
- Identification of book/tax differences and deferred taxes
- Evaluation of valuation allowances on deferred taxes

Impact on Income Tax Provision

What specific changes have been made in the implementation of the new standard?

- Impact of Collectability on Revenue Recognition
- Changes in Advance Payments
- Difference in Timing of Variable Consideration
- Capitalization of Commission Expense

Other Tax Areas Impacted by ASC 606

What other tax areas may be impacted by the implementation of ASC 606?

- Transfer pricing
- Foreign Operations
- Jurisdictional Apportionment Factors Based on Sales

IRS Proposed Revenue Procedure

Notice 2017-17 requests comments regarding changes in accounting methods resulting from implementing the revenue recognition standard for GAAP and IFRS.

Provides automatic change procedures related to recognizing income for federal income purposes as a result of adoption of the new financial accounting standards for revenue recognition.

- Change made in the same year the standards are adopted
- Method must comply with the rules under IRC Sec. 451
- Multiple changes can be made on a single Form 3115
- Change is implemented with a Sec. 481(a) adjustment (small taxpayer exception $10 million or less in assets or gross receipts)

Polling Question #4

Would you like some one from Crowe to contact you regarding implementation of the new accounting standard?

A. Yes

B. No

C. Maybe at a later date

D. Don’t know

ASC 606 Adoption Considerations

Key Factors in Implementation of ASC 606

Common challenges to timely implementation of the new revenue recognition standard:

- Understand the changes being made to account for contracts and how transactions with customers may differ from the current method accounting.

- Gain an understanding of the steps that will need to be taken to make a change for tax reporting purposes.

- Keep up with developments from a tax perspective

Thank you

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