Tax Executives Institute

Tax Implications of Adopting Revenue Recognition Standard ("ASC 606") and the New Leasing Standard

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Agenda

• New GAAP Leasing Standard

• Changing Recognition Standards:
  -- Income Recognition provisions: Code Sections 451(b)/(c)
  -- Revenue Recognition provision: ASC 606
  -- ASC 740 Considerations
New GAAP Leasing Standard
The FASB’s new leasing standard, ASU No. 2016-02 (Topic 842), was issued on February 25, 2016.

The primary objective of the new standard is to introduce a lessee model that brings most leases onto the balance sheet.

The lessor model is largely unchanged (some changes result from alignment with the new revenue recognition standard).

The new standard is effective for public entities for calendar years beginning on January 1, 2019, and January 1, 2020 for all other entities.

- Early adoption is permitted.
- Modified Retroactive Transition Method: apply new standard to earliest year presented in the financial statements (i.e., calendar year beginning 1/1/2017 for public entities).
**Classification criteria**

- Lease classified as either a finance lease (lessee) or a sales-type lease (lessor) when...
  - Lease transfers ownership of the underlying asset to lessee by the end of the lease term
  - Lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise
  - **Lease term** is for a major part of the remaining economic life of the underlying asset
  - Present value of the lease payments and any residual value guaranteed by the lessee equals or exceeds substantially all of the fair value of the underlying asset
  - Leased asset is so specialized in nature that it is expected to have no alternative use to the lessor at the end of the lease term

The standard states that the bright-line thresholds that exist under ASC 840 could be a reasonable approach to evaluate whether a lease would be classified as a finance lease.
Lease characterization for federal income tax purposes has not changed (e.g., true lease vs. sale) as a result of Topic 842. For tax, the focus remains on which party bears the benefits and burdens of ownership.

Topic 842 does not contain tax accounting guidance and only includes minor, conforming amendments to ASC Topic 740, “Accounting for Income Taxes”, that do not change the basic requirements of current accounting.

Topic 842 will create book/tax differences consistent with current GAAP. However, since the new standard may result in the recognition of more assets and liabilities, ASC 842 may require entities to record new or adjust existing DTAs and DTLs.

Topic 842 may also impact the computation of state and local income-based taxes as a result of changes to the apportionment formula.
Common book-tax differences

Operating lease (book)/True lease (tax)

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<th><strong>BOOK</strong></th>
<th><strong>TAX</strong></th>
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<tbody>
<tr>
<td><strong>LESSEE</strong></td>
<td>• Lessee expenses rent on a straight line basis over lease term</td>
<td>• Lessee expenses rent as payments are made (subject to section 467)</td>
</tr>
<tr>
<td><strong>LESSOR</strong></td>
<td>• Lessor depreciates property on a straight line basis over the useful life</td>
<td>• Lessor depreciates property over applicable recovery period</td>
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Common book-tax differences

Tenant construction allowances

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<th>BOOK</th>
<th>TAX</th>
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<tr>
<td><strong>LESSEE</strong></td>
<td>• Lessee records allowance as an incentive that reduces the ROU asset that is recorded</td>
<td>• Lessee includes allowance into income on receipt; depreciates property over applicable recovery period</td>
</tr>
<tr>
<td><strong>LESSEE-OWNED</strong></td>
<td>• Resulting asset is generally amortized over the lesser of the life of the asset or the lease term</td>
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<tr>
<td><strong>LESSOR</strong></td>
<td>• Lessor depreciates property on a straight line basis over the useful life</td>
<td>• Lessor depreciates property over applicable recovery period</td>
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<tr>
<td><strong>LESSOR-OWNED</strong></td>
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## Common book-tax differences

### Finance lease (book)/Asset sale (tax)

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<tr>
<td><strong>LESSEE (ONLY)</strong></td>
<td>• Lessee expenses interest component of payment as payments are made</td>
<td>• Lessee expenses interest component of payment as payments are made</td>
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<tr>
<td></td>
<td>• Lessee uses lessor’s implicit rate, if readily determinable, or incremental borrowing rate</td>
<td>• Interest imputed using AFR under OID rules</td>
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<tr>
<td></td>
<td>• Lessee depreciates ROU asset on a straight line basis or using another systematic basis, if appropriate.</td>
<td>• Lessee depreciates property over applicable recovery period</td>
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Changing Recognition Standards:

-- Income Recognition provisions: Code Sections 451(b)/(c)

-- Revenue Recognition provision: ASC 606
Revenue Recognition Overview

- New Rules for Taxable Year of Inclusion - Code Sections 451(b) and (c)

- New Rules for Financial Accounting Revenue Recognition - ASC 606, “Revenue from Contracts with Customers”

  - Potential Tax Accounting Methods Impact of Section 451(b)/(c)
  - Potential Tax Accounting Methods Impact of ASC 606
New Rules for Taxable Year of Inclusion

— Tax Cuts and Jobs Act ("TCJA") made some fairly sweeping changes in how the US taxes individuals, partnerships, and businesses, however one fairly innocuous change is poised to have a dramatic impact on corporate income recognition, Section 451(b).

— New Section 451(b) modifies income recognition by providing that under All Events Test, no item of income shall be treated as met any later than when such item is taken into account as revenue for financial accounting purposes.

— Changes to Section 451 will have significant consequences for certain companies.

— Reuters has reported that JP Morgan is forecasting that the new income recognition provision will increase the company’s 2018 revenue by $1.2 Billion.
New Rules for Taxable Year of Inclusion

– Statutory change is at odds with duality explained by the Supreme Court in *Thor Power*:
  • Financial accounting is based on the principle of conservatism so that corporate earnings are not overstated.
  • Tax accounting is based on the principle of clear reflection of income to ensure equitable collection of income.
  • “Diversity, even contrariety, of objectives” means any equivalency of these principles “would be unacceptable.”

– Changes the All Events Test from facts and circumstances standard (depending on the taxpayer’s method, business, and practices) to an objective one.
New Rules for Taxable Year of Inclusion

– Section 451(b) directs TPs to apply income recognition rules before special rules of rules regarding OID, which will affect late-payment fees, cash advance fees, and interchange fees.

– Does not change realization, so no acceleration of characterization (e.g., convert a sale to a lease); gain or loss on securities subject to mark to market; income from investments in corporations or partnerships that are accounted for under the equity method.

– Exceptions:
  • TPs without applicable financial statements
  • Income in connection with a mortgage servicing contract
  • Provision should NOT apply to taxpayers using “special methods of accounting” other than one in Sections 1271-1288
Section 451(c) codifies the Deferral Method from Rev. Proc. 2004-34, which allows one year income deferral for advance payments for goods and services, provided such income is also deferred for financial accounting purposes.

Excluded from the definition of advance payments, including but not limited to: rent, insurance premiums, payments with respect to financial instruments, payments with respect to warranty or guarantee contracts when a third party is the primary obligor.

Income deferral was previously available under:
- Certain special accounting methods;
- Rev. Proc. 2004-34 (now codified as 451(c));
- TR 1.451-5 (allows two year or more deferral for sale of certain goods, which Conference Agreement indicates has been effectively repealed); and
- TR 1.451-4, which allows an accelerated COGS deduction for fulfillment of items (e.g., rewards programs) may also be repealed.
New Revenue Recognition Standard

• Implementation of Sections 451(b)/(c) has to be considered in relation to ASC 606, “Revenue from Contracts with Customers.”

• ASC 606 is a principles-based standard replaces nearly all existing industry-specific or transaction-specific guidance for both US GAAP and IFRS.

• Like tax law changes, ASC 606 will have significant consequences for certain companies.

• Market Watch reported: Uber’s revenue is being reduced by 50% and General Motors may have to reduce its balance of earnings by $1 billion next year.
New Revenue Recognition Standard

Scope of ASC 606 was established to improve consistency and comparability in presentation and reporting of revenue.

Breadth of ASC 606 (applicable to all contracts with customers regarding the transfer of goods, services, or nonfinancial assets) means that it will effect virtually all GAAP taxpayers.

Also includes guidance for certain costs to obtain or fulfill a contract with a customer (e.g., incremental costs of obtaining a contract).

Companies must apply the standard retrospectively and either:
- Apply the standard to only the most current period (Modified Retrospective Adoption); or
- On a cumulative basis (Full Retrospective Adoption)

Effective for Annual reporting periods beginning after: December 15, 2017 (public companies); and December 15, 2018 (non-public companies).
New Revenue Recognition Standard

- 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).
New Revenue Recognition Standard - High Level by Industry

**Aerospace & Defense**
Changes in the recognition of long-term contracts

**Automotive**
Changes in the accounting for pre-production activities and marketing incentives

**Communications**
Revenue may be recorded earlier to reflect bundled sales of hardware and services

**Engineering & Construction**
Elimination of industry guidance may result in earlier revenue recognition

**Entertainment & Media**
New model for license fees could change the timing of revenue recognition

**Pharmaceuticals & Life Sciences**
Changes in the recognition of contingent consideration

**Retail & Consumer**
A new model for customer incentives and loyalty programs

**Technology**
Revenue is no longer deferred due to lack of vendor specific objective evidence of value, which may result in acceleration
Tax Issues Affecting Implementation of the New Rules – Overview of Income Recognition

Using the All Events Test, income is recognized when all events have occurred:
• To fix the right to receive income;
• Amounts can be determined with reasonable accuracy; and
• For Tax Years beginning after 12/31/17, Section 451(b) revisions, which may impact when items are recognized for tax purposes.
• For tax purposes, amounts due or paid in advance of being earned ("advance payments") may be eligible for tax deferral.

- **Services**, when services (or divisible services) are complete
- **Goods**, when benefits and burdens of ownership of good transfers
- **Licenses**, over the period the licensee has the right to use the property
- **Long-Term Contracts**, as costs are incurred to perform
Sections 451(b)/(c) - Potential Tax Accounting Methods Impact

• Effective Date: Tax Years beginning after 12/31/2017

• Change in treatment of various items under Section 451(b) will require accounting method changes

• Certain changes made to comply with amendments in Section 451 will be treated as:
  • an automatic accounting method change
  • with a 6-year Section 481(a) adjustment for certain changes (i.e., adjustments to income related to OID instruments)
  • Election under Section 451(c)

• Government has indicated this is a top priority in their 2\textsuperscript{nd} quarter update to this year’s PGP and guidance should be released by the end of the Service’s business year end, June 30.
Sections 451(b)/(c) - Potential Tax Accounting Methods Impact

Need to consider how to take advantage of deferral opportunities available in 2017

Need to consider effects of 2018 implementation, even if guidance has not been released

Identify possible accounting method changes that may be required under Sections 451(b) and (c) and terms and conditions for change

Determine whether an election is required under Section 451(c)
Examples:

– Change in variable consideration (incentives, performance bonuses, penalties)

Old rules
Variable consideration is not recognized until contingency is resolved.

New rules
Included in transaction price if “probable” (GAAP) or “highly probable” (IFRS) that amount will not result significant revenue reversal with contingency resolution.

– Change in revenue recognition for the sale of goods

Old rules
Revenue recognized when risks/rewards are transferred to a customer.

New rules
Revenue recognized when “control” of the goods are transferred to the customer (payment, title, physical possession, customer acceptance).

– Change in software contracts

Old rules
Software contracts with multiple-element deliverables treated as a single unit of account.

New rules
Transaction price is allocated to each deliverable based on the relative stand-alone selling price.
ASC 606 - Potential Tax Accounting Methods Impact

- IRS generally treats a change in method of accounting for financial accounting purposes as one for tax purposes.
- If a new tax method is sought or required because of a change in financial reporting, IRS permission is required.
- Procedural requirements and timing for making such a change depends on whether the change is automatic or non-automatic.
- If adoption of ASC 606 accelerates revenue recognition and an accounting method change is required to reflect the change for tax purposes, an unfavorable tax adjustment under Section 481(a) will likely be required.
- Implementation of ASC 606 may identify other items of income or expense that need to be changed.
Notice 2017-17 – Comments Solicited on Revenue Recognition Accounting Method Changes

– Recognizing that companies would prefer to file such accounting method automatically, IRS/Treasury issued a notice inviting comments on a proposed revenue procedure:
  • when the accounting method change is made for the same taxable year;
  • the taxpayer adopts the new financial accounting revenue recognition standards; and
  • change is made as a result of the adoption of the new FASB revenue recognition standards (Revenue from Contracts with Customers).

– Requests comments on conformity between the new FASB standards and Code/regulations.

– Government has indicated this is a top priority in their 2nd quarter update to this year’s PGP and guidance should be released by the end of the Service’s fiscal year, June 30.
What terms and conditions will be provided with respect to these accounting method changes?

Will the Service expand the scope of automatic method changes involving income?

How to treat items of exposure identified when ASC 606 is implemented but unrelated to ASC implementation?

How to address tax treatment of ASC 606 items if guidance is not issued when returns are filed?
Revenue Recognition:

ASC 740 Considerations
ASC 740 Considerations
Systems and Data Availability

— Data availability will be critical
  • Systems may need to be modified to allow for information to be captured for both book and tax purposes
  
  • Last minute system changes likely will not be able to capture the data necessary to gather information to prepare tax calculations
  
  • Takeaway – identify data necessary to prepare tax calculations and ensure the systems are designed to continue to capture this information
ASC 740 Considerations
Process and Controls

— Review and update processes
  • Accumulation of temporary difference support
  • Potential impact on overall effective tax rate – (mix of revenue among jurisdictions)

— Review and Update Sox Controls

— Foreign Jurisdictions
  • Could result in additional Statutory to GAAP differences
  • Will need to review on a jurisdiction by jurisdiction
ASC 740 Considerations
Cumulative Effect Adjustments Upon Adoption

— Cumulative Effect Adjustment
  • Full retrospective approach for all periods presented in the period of adoption, or
  • Modified retrospective approach
    o Either way, a cumulative effect adjustment must be determined at the date of initial application, including the income tax effects of the cumulative effect adjustment
ASC 740 Considerations
Other Potential Rate Considerations

– Retrospective Restatements
  • Impacts on annual and quarterly Effective Tax Rates

– Impacts on any valuation allowances, uncertain tax positions
  • Estimated realization of valuation allowances
  • Could impact scheduling of temporary difference reversals

– State and Foreign effective rate changes
Other Considerations
Other Potential Tax Impacts

— State Income Taxes
  • Potential effects on revenue-based state apportionment factors used for calculating state income tax expense & applicable rate used to measure state deferred income taxes
  • Impacts to state tax liabilities in gross receipt tax states (e.g., acceleration/deferral of income under new standard)

— Indirect Taxes
  • Potential sales and use tax implications
    o Changes to sales and use tax positions and liability on account of changes in how revenues are allocated between separate performance obligations (e.g. software vs. services)
Other Considerations
Other Potential Tax Impacts

─ International Taxes
  • Potential changes to foreign tax accounting methods, particularly to the extent statutory reporting changes, including changes on E&P
  • Impact on the determination of foreign source income

─ Transfer Pricing
  • Changes to the amount and timing of revenue could impact transfer pricing policies to the extent transfer prices are based on the revenue or profit measures reported in the financial statements (intercompany prices, transfer pricing policies and related documentation)
  • Need to determine whether transfer pricing documentation and strategies need to be updated to reflect/account for the new standards
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