Tax Insights
from Washington National Tax Services

New FASB, IASB revenue recognition rules could have significant US tax implications

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In brief

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) on May 28 published their long-awaited joint revenue recognition standard titled "Revenue from Contracts with Customers" (Topic 606 and IFRS 15).

The largely principles-based standard (hereafter the new standard) provides a framework to address revenue recognition issues comprehensively for all contracts with customers regardless of industry-specific or transaction-specific fact patterns for both US Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), with certain limited exceptions. The new standard, many observers believe, will affect the financial reporting practices of almost every company. Importantly, when a change in the recognition of revenue is required, the change often will result in recognizing revenue sooner, though certain cases could result in later recognition of revenue compared to the current standard.

Although the US tax law contains specific rules with respect to the recognition of revenue for tax purposes, there are certain instances in which revenue recognition for tax purposes depends on revenue recognition for financial accounting purposes (e.g., for advance payments). In these instances, the new standard could have a significant impact on a company's cash tax position. In other instances, financial accounting changes as a result of the new standard could affect book-tax differences and deferred taxes related to revenue recognition.

The new standard generally is effective for annual reporting periods beginning after December 15, 2016 (public companies), and December 15, 2017 (nonpublic companies). Companies must apply the new standards either (1) retroactively to each prior reporting period presented or (2) retroactively with the cumulative effect of initially applying the standard recognized at the date of initial application.

Observation: To understand the possible effects of the new standard, it is important for each company's tax department to be closely involved in the analysis of the new standard, which could be a significant effort at many companies.

In detail

Highlights of the new standard

To increase consistency in the recognition and presentation of revenue, the new standard employs a single, principles-based model for recognizing revenue that can be applied 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). The new standard supersedes the industry-specific standards that currently exist under GAAP, including those for the software and construction industries.

Under the new standard, companies 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, a company must apply the following five steps:

1. Identify the contracts with the customer,
2. Identify the performance obligations in the contract,
3. Determine the transaction price,
4. Allocate the transaction price to the performance obligations in the contract, and
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

The new standard provides guidance as to how to apply each of these five steps. For example, the standard explains that a performance obligation is satisfied when (or as) the customer obtains control of the good or the service. For each performance obligation, the company must determine whether the obligation is satisfied over time or at a point in time based on the criteria provided. If performance occurs 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.' In contrast, if a performance obligation is satisfied at a point in time, then revenue is recognized when control is transferred to the customer based on the presence of certain 'indicators.'

Overview of tax revenue recognition principles

Under general tax principles, a taxpayer must recognize revenue when it has a fixed right to receive the revenue — which generally occurs the *earlier* of when it is due, paid, or earned — and the amount can be determined with reasonable accuracy. Revenue generated from the sale of goods generally is earned when the benefits and burdens of ownership of the good passes to the customer, which could occur upon shipment, delivery, acceptance, or title passage. Revenue generated from the provision of services generally is earned when performance of the required services (or divisible services) is complete.

Amounts that are due or paid before they are earned (known as advance payments) may be eligible for deferred recognition for tax purposes under specific provisions, such as the Section 451 regulations for goods and integral services and Rev. Proc. 2004-34 for goods, services, use of certain intellectual property, and other eligible payments, both of which allow limited tax deferral that cannot exceed the financial accounting deferral.

Impact on cash taxes

Because the tax law contains specific rules with respect to the timing of the recognition of revenue, the new standard generally is not expected to change the recognition of revenue for tax purposes and thus generally will not affect cash taxes. However, in certain circumstances, such as when a company receives advance payments, a change in the recognition of revenue for financial accounting purposes will affect tax recognition because the tax deferral for advance payments cannot exceed the book deferral.

For example, the new standard is expected to accelerate the recognition of revenue from certain software contracts. Under the current rules, software contracts containing multiple-element deliverables must be treated as a single unit of account unless there is vendor-specific objective evidence of the value of each deliverable, which generally has the effect of deferring revenue from such contracts. Under the new standard, the transaction price is allocated to each deliverable based on relative stand-alone selling prices. To the extent the acceleration of software revenue affects the recognition of advance payments, it will result in an acceleration of any advance payments that are deferred for tax purposes.

In addition, the new standard could accelerate the recognition of revenue from the sale of goods in certain circumstances. Under current GAAP, revenue from the sale of goods is recognized when risks and rewards of such goods are transferred to a customer. Under the new standard, revenue generally will be recognized when control of the goods is transferred to the customer, which is determined considering indicators, such as right to payment, title, physical possession, risks and rewards of ownership, and customer acceptance. To the extent this transfer of control standard accelerates the recognition of advance payments for financial accounting purposes, it likewise will accelerate recognition of advance payments for tax purposes.

Note that the IRS treats a change in the timing of the recognition of advance payments as a change in method of accounting.

Impact on tax accounting

As outlined above, the tax law prescribes specific rules with respect to the recognition of revenue for tax purposes. Consequently, most changes in the recognition of revenue for financial accounting purposes that result from the new standard likely will affect only the computation of a book-tax difference and the related deferred taxes. Nonetheless, the new standard could change the manner in which revenue is recognized for book purposes and complicate the determination of book-tax differences.

For example, the tax law requires recognition of revenue from the sale of goods when the 'benefits and burdens of ownership' of the property are transferred to the customer, which generally is more consistent with the current GAAP 'risks and rewards' model. As a result, the new 'transfer of control' model for goods could result in new book-tax differences.

Similar complexities could arise if the transfer of control model changes the timing of the recognition of services, long-term contract, or licensing revenue for financial accounting purposes but not tax purposes. To the extent the timing of an item of income changes, companies would need the capability to track book-tax differences.

In addition, under the new standard, an estimate of variable consideration such as refund rights, incentives, performance bonuses, or penalties must be included in the transaction price if it is probable (GAAP) or highly probable (IFRS) that the amount will not result in a significant revenue reversal when the uncertainty is resolved. In contrast, under current rules, variable consideration generally is not recognized as revenue until the contingency is resolved, which is consistent with the tax treatment. As a result, the new standard could create additional book-tax differences with respect to variable consideration that also must be tracked.

The takeaway

The new standard could affect the revenue recognition practices of many companies that have contracts with customers to provide goods, services, or non-financial assets, with a corresponding impact on cash taxes (generally in situations involving advance payments), book-tax differences, and deferred tax positions.

Implementation of the new standard also could potentially require companies to request tax accounting method changes, such as when the book recognition of advance payments is changing or when implementation highlights use of an improper revenue recognition method for tax purposes.

As companies prepare to implement the changes in the revenue recognition model, it is important that companies do not overlook any changes that are required for tax purposes, as well as any changes to accounting procedures or systems that will be necessary to ensure that they have the capability to track and report changes required to comply with tax revenue recognition requirements.

Resources to help you

Additional PwC Insights on the new standard will be issued in the coming weeks. These Insights will contain more in-depth analysis of the new guidance and its implications for taxpayers.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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