BDO KNOWS: TAX REFORM

TAX REVENUE RECOGNITION: RECENT DEVELOPMENTS AND PLANNING CONSIDERATIONS

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With you today

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Agenda

- Overview of tax revenue recognition rules
- Quick recap of ASC 606 revenue recognition standard
- Recent accounting method change procedures
- Examples
- Planning considerations and action items

Disclaimer: Today’s webcast is intended to provide a high level overview of certain provisions contained in the new tax law and is not intended to be a comprehensive discussion. For application of the new law to specific cases, a tax advisor should be consulted.
Overview of Tax Income Recognition Rules
Section 451 - General Overview

Overall Cash Method

- Income is included in gross income for the tax year in which actually or constructively received

Overall Accrual Method

- Generally, an accrual-basis taxpayer recognizes income when:
  1. All events have occurred which fix the taxpayer’s right to receive the income

    Event fixing the right to receive is the earliest of when the payment:
    • Earned through the required performance
    • Due (or payable) under the contract
    • Received by the taxpayer

  2. Amount can be determined with reasonable accuracy
Section 451(b) - Tax Cuts and Jobs Act (TCJA)

Affects accrual method taxpayers with “applicable financial statement” (AFS)

- Effective for years beginning after December 31, 2017

- All events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account in an applicable financial statement (“AFS”) or such other financial statement as the Secretary may specify

- Event fixing the right to receive is the earliest of when the payment is:
  - Earned through the required performance
  - Due (or payable) under the contract
  - Received by the taxpayer
  - Taken into account as revenue in an AFS or specified financial statement

- Not a book conformity rule

- Allocation of transaction price provision
Section 451(b) - Applicable Financial Statement

For purposes of section 451(b), an AFS includes the following a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is:

- A 10-K, or annual statement to shareholders, required to be filed by the taxpayer with the United States Securities and Exchange Commission,

- An audited financial statement of the taxpayer which is used for credit purposes, reporting to shareholders, partners, or other proprietors, or beneficiaries, or any other substantial nontax purpose, or

- Filed by the taxpayer with any other federal agency for purposes other than federal tax purposes.
Section 451(b) - Exceptions

Section 451(b) does not apply to:

- Cash basis taxpayers
- Taxpayers with no AFS (e.g., a review or a compilation would not be considered an AFS for purposes of Section 451(b))
- Special revenue recognition methods, such as section 460 (percentage of completion method for long term contracts) and section 453 (installment sales)
- Items of income in connection with a mortgage servicing contract
- Market discount (Notice 2018-80 - proposed regulations forthcoming)
Section 451(b) - Clarification of Scope

- Expected to result in the acceleration of certain income that were previously deferred under the all events test for tax purposes.

- However, Joint Explanatory Statement indicated that section 451(b) does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the income tax realization event has not yet occurred - e.g., mark to market gains, sale vs. lease transaction.

- JCT’s Blue Book further clarifies the scope of section 451(b) through several examples, including two examples that indicate that acceleration is not required if necessary material conditions and requirements for receipt of income have not been met (e.g., performance bonuses or commissions tied to future events).

- COGS offset - Blue Book explanation does not allow acceleration of related COGS in situations involving acceleration of income recognition under section 451(b).
Advance Payments

Rev. Proc. 2004-34

- Allows accrual basis taxpayers a one-year deferral for eligible advance payments, such as services, certain goods, use of IP, sale/lease/license of computer software, warranties, subscriptions, and gift cards

- Advance payment is recognized (in whole or in part) in revenues in AFS for a subsequent tax year (if no AFS, earned in a subsequent tax year)

- Follow financial statement treatment in the year the advance payment is received (book conformity in Year 1) and pick up any remaining amount in income in the next succeeding tax year

- Full inclusion method also permitted

Treas. Reg. section 1.451-5 (pre-TCJA)

- Allows for two-year deferral (book conformity in Year 1 & 2) for inventoriable goods

- Longer deferral period available in limited instances but tax deferral can never be longer than book deferral
Section 451(c) - Tax Cuts and Jobs Act (TCJA)

Section 451(c) added to provide an election of a 1-year deferral for advance payments for goods, services, and other items to be identified by the Secretary

- Codifies the 1-year deferral method or full inclusion methods of Rev. Proc. 2004-34
- Effective for years beginning after December 31, 2017
- Result of section 451(c) is that the deferral methods for advance payments for goods and long-term contracts under Reg. 1.451-5 are overridden. See Notice of Proposed Rulemaking (REG-104872-18), issued 10/12/2018, for proposed regulations to remove Reg. 1.451-5
Notice 2018-35

Notice 2018-35, issued April 2018, allows taxpayers to continue to rely upon Rev. Proc. 2004-34 until the IRS issues future guidance on section 451

- The guidance is intended to address questions such as whether section 451(c) supplants Rev. Proc. 2004-34 and whether taxpayers without AFS can defer advance payments

- Taxpayers may prefer to use Rev. Proc. 2004-34:
  - Expanded list of items for which deferral is explicitly allowed (e.g., use of IP, software)
  - Ability to use the 1-year deferral method for taxpayers with no AFS Short tax year rule - if next subsequent tax year is 92 day or less, that tax year can be ignored (i.e., 2-year deferral)

- Awaiting proposed section 451(b) and section 451(c) regulations
Recap of ASC 606 Revenue Recognition Standard
New FASB Revenue Recognition Standard

“Revenue from Contracts with Customers” Topic 606 and IFRS 15

- A single, principle-based revenue standard for U.S. GAAP and IFRS that replaces almost all existing U.S. GAAP and IFRS guidance
- Applies to all industries, with certain specific transactions excluded:
  - Leases
  - Insurance contracts
  - Financial instrument
  - Guarantees
  - Certain nonmonetary exchanges

- Effective for annual reporting periods beginning after:
  - 12/15/2017 - public entities
  - 12/15/2018 - nonpublic entities
- Taxpayers can early adopt
- Transition options:
  - Full Retrospective, or
  - Modified Retrospective
- Cumulative effect of change at adoption date
New FASB Revenue Recognition Standard
“Revenue from Contracts with Customers” Topic 606 and IFRS 15

Core principle:
Recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Steps to apply the core principle are:

1: Identify the contract
2: Identify separate performance obligations
3: Determine transaction price
4: Allocate transaction price to performance obligations
5: Recognize revenue when each performance obligation satisfied
Key Changes of ASC 606

- Performance obligation vs elements/deliverables
- Determining transaction price - no longer required to be fixed or determinable
  - Variable consideration (e.g., performance bonuses or discounts) may accelerate or defer income
- Focus on transfer of control as the revenue trigger, as opposed to risks and rewards of ownership
- Revenue may be recognized over time or at a point in time, depending on contract
- New requirement for capitalizing costs of obtaining/fulfilling contract
- New gross versus net revenue guidance
Impact of ASC 606 on Tax Accounting Methods

- If tax currently follows books, and books changes to new ASC 606 affecting timing, the options are:
  - Tax stays put (generally no Form 3115; new book/tax differences)
  - Tax changes to follow the new book treatment (Form 3115 required)
  - Tax changes to something completely different (Form 3115 required)
  - Note: Keep in mind section 451(b) limitation rule

- If tax does not follow books, and books changes to new ASC 606 resulting in acceleration:
  - Tax stays put if realization event not yet triggered (no Form 3115; new book/tax differences)
  - Tax changes to follow the new book treatment under section 451(b) (Form 3115 required)

- Advance payments: Taxpayers using one-year deferral under Rev. Proc. 2004-34 may be impacted if books changes how deferred revenue is recognized
Recent Accounting Method Change Procedures

Section 16.07 provides two automatic consent method changes, #83 and #84, for a taxpayer that receives advance payments as defined under Rev. Proc. 2004-34 and wants to change to either the full inclusion method or the 1-year deferral method.

- Form 3115
- Change is made with a section 481(a) adjustment
- Five year eligibility rule is waived for taxpayer’s first or second taxable year ending on or after May 9, 2018

Section 16.10 provides an automatic consent method change #153 for a taxpayer presently on 1-year deferral method under Rev. Proc. 2004-34 that changes the manner in which it recognizes advance payments in revenues in its AFS.

- Change is made on a cut-off basis
- Statement in lieu of a Form 3115
- Five year eligibility rule is waived

Provides a new automatic consent method change #231 under section 16.11 of Rev. Proc. 2018-31 to change the tax method of accounting for revenue recognition to a method under ASC 606 for:

- Identifying performance obligations
- Allocating transaction price to performance obligations, and/or
- Considering performance obligations satisfied

Procedural Considerations:

- Year of change must be same year as ASC 606 implementation for books
- New tax method of accounting must be otherwise permissible for Federal income tax purposes (including amended section 451)
- Option of section 481(a) adjustment or cut-off basis
- Waiver of requirement to file duplicate Form 3115 copy with IRS Covington, KY
- Applies to taxable years ending on or before May 10, 2021 (Rev. Proc. 2018-49 - for early adopters of ASC 606)
Certain changes are scoped out of Rev. Proc. 2018-29:

- Changes involving identifying contracts or determining the transaction price (including the inclusion and exclusion of variable consideration)
- Changes in method of accounting that does not comply with section 451 or other guidance
- Changes that qualify under another automatic change described in Rev. Proc. 2018-31 (or any successor)

Notable Caveats

- Consent granted is not a determination that the new method of accounting is permissible
- No presumption that the allocation method is a permissible method of accounting under any provision of the Code
- No determination that the amount of income included in taxable income using an allocation method described in the New Standards is correct
Rev. Proc. 2018-60 (issued November 2018)

Provides a new automatic consent method change #239 under Section 16.12 of Rev. Proc. 2018-31

- Effective for taxable years beginning after December 31, 2017 (for income from debt instruments having OID, after December 31, 2018)
- Applies to an accrual method taxpayer with an applicable financial statement that:
  - wishes to change to a method of accounting that treats an item of gross income, or portion thereof, as meeting the all events test no later than when such item, or portion thereof, is taken into account as revenue in its applicable financial statement under Section 451(b)(1)(A), and/or
  - is not adopting the New Standards for the year of change, and wants to allocate the transaction price to performance obligations under Section 451(b)(4)

- Possible interpretation that this auto change #239 is broad enough to cover all changes to properly comply with section 451(b)(1)(A) (which contains the all events test) for taxpayers with an AFS
Rev. Proc. 2018-60 (continued)

Procedural considerations:

- Generally implemented with a section 481(a) adjustment
- “Streamlined” approach under which the requirement to file a Form 3115 or attach a separate statement is waived for taxpayers with average annual gross receipts of $25M or less; or taxpayers with a $0 section 481(a) adjustment
- Requirement to mail a duplicate copy of the Form 3115 to the IRS Covington, KY office is waived for this change. Therefore, the Form 3115 need only be attached to the timely filed (including extensions) federal income tax return for the year of change.
- A taxpayer may concurrently file automatic change #239 with automatic change #231 (changes in the timing of income recognition due to the New ASC 606 Standards) for the same year of change on a single Form 3115.
# Tax Revenue Recognition

## Summary of Method Change Options

<table>
<thead>
<tr>
<th>Change Number</th>
<th>Rev. Proc.</th>
<th>Type of Change</th>
<th>Section 481(a) or Cut-off</th>
<th>Filing Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>#83</td>
<td>2018-31</td>
<td>Change to full inclusion method for advance payments</td>
<td>Section 481(a)</td>
<td>Attach 3115 to return; duplicate copy filed with Covington, KY</td>
</tr>
<tr>
<td>#84</td>
<td>2018-31</td>
<td>Change to one-year deferral method for advance payments</td>
<td>Section 481(a)</td>
<td>Attach 3115 to return; duplicate copy filed with Covington, KY</td>
</tr>
<tr>
<td>#153</td>
<td>2018-31</td>
<td>Change in how revenue is recognized in AFS for taxpayers currently on one-year deferral method</td>
<td>Cut-off</td>
<td>Attach 3115 (in the form of one-page statement) to return</td>
</tr>
<tr>
<td>#231</td>
<td>2018-29</td>
<td>Change to comply with ASC 606 book method (if permissible under section 451)</td>
<td>Section 481(a) or cut-off</td>
<td>Attach 3115 to return</td>
</tr>
<tr>
<td>#239</td>
<td>2018-60</td>
<td>Change to comply with section 451(b)</td>
<td>Section 481(a)</td>
<td>Attach 3115 to return; no 3115 required for small taxpayers or $0 481(a) adjustment changes</td>
</tr>
</tbody>
</table>
Examples
Example 1 - Provision of services

In 2018, a privately owned taxpayer (TP) with an AFS and on the accrual method enters into a 3-year contract to provide construction management services to the customer for $1,500. Under the contract, TP bills $500 in 2018, $500 in 2019, and the remaining $500 in 2020 when services are complete. In addition, the performance of the construction management services is non-severable (i.e., there are no milestones that have to be met before payment is due). Assume ASC 606 will not be implemented until 2019 and the GAAP recognition is as follows:

<table>
<thead>
<tr>
<th>Revenue</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAP</td>
<td>$750</td>
<td>$500</td>
<td>$250</td>
</tr>
<tr>
<td>Current Tax</td>
<td>$500</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>Proposed Tax</td>
<td>$750</td>
<td>$500</td>
<td>$250</td>
</tr>
</tbody>
</table>

For tax purposes, beginning in 2018, income under the all events test is fixed at the earlier of when earned, due, received, or taken into account as revenue on the AFS under section 451(b)(1)(A). Therefore, in 2018 TP cannot defer income later than when books recognizes the income. TP should file an automatic #239 Form 3115 in 2018 to comply with section 451(b)(1)(A).

Under GAAP rules, no book/tax difference would be recorded once the Form 3115 is filed.
Example 2 - Provision of services

- Same as Example 1 except the GAAP recognition is as follows:

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAP</td>
<td>$300</td>
<td>$700</td>
<td>$500</td>
</tr>
<tr>
<td>Current Tax</td>
<td>$500</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>Proposed Tax</td>
<td>$500</td>
<td>$700</td>
<td>$300</td>
</tr>
</tbody>
</table>

- For tax purposes, beginning in 2018, income under the all events test is fixed at the earlier of when earned, due, received, or taken into account as revenue on the AFS under section 451(b)(1)(A). In 2018, because tax is not recognizing the amount under the all events test later than when the amount taken into account as revenue on the AFS, the current and proposed tax recognition is the same. TP should file an automatic #239 Form 3115 in 2018 to comply with section 451(b)(1)(A).

- Under GAAP rules, a book/tax difference would be recorded.
Example 3 - Sale of goods with 1-year warranty

On January 1, 2018, taxpayer (TP), a publicly traded corporation with an AFS and on the overall accrual method, enters into a contract to manufacture and ship 500 widgets and provide a 1-year warranty to customer for a bundled contract price of $1000 payable upon delivery. TP delivers 500 widgets on June 30, 2018. Prior to ASC 606, for both book and tax, the $1000 was recognized upon delivery as a sale of widgets. Under ASC 606, TP identifies two performance obligations, with the widget obligation recognized upon delivery and the warranty obligation recognized over time:

- TP should file automatic change #231 to change its method to the new ASC 606 standard to identifying performance obligations, allocate transaction price to performance obligations, and considering performance obligations satisfied.
- TP can recognize the warranty income under the one-year deferral method under section 451(c).

<table>
<thead>
<tr>
<th>Widget Revenue</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior GAAP</td>
<td>$1000</td>
<td>$0</td>
</tr>
<tr>
<td>ASC 606</td>
<td>$800</td>
<td>$0</td>
</tr>
<tr>
<td>Current Tax</td>
<td>$1000</td>
<td>$0</td>
</tr>
<tr>
<td>Proposed Tax</td>
<td>$800</td>
<td>$0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Warranty Revenue</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior GAAP</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>ASC 606</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Current Tax</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Proposed Tax</td>
<td>$100</td>
<td>$100</td>
</tr>
</tbody>
</table>
Example 4 - Variable consideration

In 2018, accrual method taxpayer (TP) with an AFS enters into a 4-year contract to produce and sell 100 widgets a year for $1 each. TP receives payments as the widgets are delivered. The contract contains a $400 performance bonus to be paid in 2021 if all widgets are delivered on time.

At the time the contract is entered into, TP expects that all necessary conditions and requirements will be met at the end of the contract in 2021 to earn the $400 bonus.

<table>
<thead>
<tr>
<th>Revenue</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior GAAP</td>
<td>$100</td>
<td>$100</td>
<td>$100</td>
<td>$500</td>
</tr>
<tr>
<td>ASC 606</td>
<td>$200</td>
<td>$200</td>
<td>$200</td>
<td>$200</td>
</tr>
<tr>
<td>Current and Proposed Tax</td>
<td>$100</td>
<td>$100</td>
<td>$100</td>
<td>$500</td>
</tr>
</tbody>
</table>

For tax purposes, TP recognizes $100 per year for the widgets under the all events test in section 451(b)(1)(A). For the performance bonus, section 451(b)(1)(A) is not intended to trigger a realization event and does not apply here to require income recognition at the same time as when it is taken into revenue on the AFS. Because all events occurs in 2021 when all the widgets are delivered on time, current and proposed tax is the same and there is no change in method requiring a Form 3115.

Under prior GAAP rules, no book/tax difference (and no deferred tax asset or liability)

Under new ASC 606 standard, a new book/tax difference will be established.
Example 5 - Gift cards

Accrual method taxpayer (TP) with an AFS operates a clothing retail chain and sells gift cards that are redeemable for inventoriable goods at its store locations. In 2018, TP sells $500 of gift cards. For book purposes, TP recognizes in gift card revenue $250 in 2018, $100 in 2019, $75 in 2020, and $75 in 2021. For tax purposes, prior to 2018, TP historically defers gift card sales under the 2-year deferral method prescribed by Reg. 1.451-5(c). Beginning in 2018, TP wishes to continue deferring.

For tax purposes, beginning in 2018, section 451(c) overrides Reg. 1.451-5 such that the 2-year deferral method is no longer permitted. Therefore, TP must file automatic change #84 to the 1-year deferral method for the 2018 year of change (or change #83 to full inclusion).

Under prior GAAP and new ASC 606, a book/tax difference will be recorded.

<table>
<thead>
<tr>
<th>Revenue</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prior GAAP</td>
<td>$250</td>
<td>$100</td>
<td>$75</td>
<td>$75</td>
</tr>
<tr>
<td>ASC 606</td>
<td>$250</td>
<td>$100</td>
<td>$75</td>
<td>$75</td>
</tr>
<tr>
<td>Current Tax</td>
<td>$250</td>
<td>$100</td>
<td>$150</td>
<td>$0</td>
</tr>
<tr>
<td>Proposed Tax</td>
<td>$250</td>
<td>$250</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>
Planning Considerations and Action Steps
Tax Revenue Recognition
Planning Considerations

- Don't wait - look at revenue recognition methods for tax at the same time you are evaluating for GAAP purposes

- Initiate discussions between tax and finance departments and begin gathering facts related to what will be changing for book purposes

- Evaluate options for changing tax methods
  - Determine if book standard is permissible for tax purposes
  - Assess need to file method change

- Establish Sch. M adjustments going forward if tax differs from book treatment; ensure that systems are in place to track information necessary to compute book/tax difference going forward

- Contact your BDO contact for more details or method change assistance
Tax Revenue Recognition

Action Steps

- Change tax revenue recognition to ASC 606 method in same tax year that ASC 606 is implemented.
  - File automatic change #231 to identify performance obligation, allocate transaction price to performance obligations, and/or consider performance obligations satisfied

- Accrual method taxpayer with AFS that are not in compliance with section 451(b).
  - File automatic change #239 to change to comply with section 451(b)(1)(A)

- Accrual method taxpayer with AFS to concurrently change tax revenue recognition to ASC 606 method in same year that ASC 606 is implemented and comply with section 451(b) if ASC 606 method is impermissible.
  - File combined automatic change #231 and #239 on the same Form 3115

- Advance payments - for taxpayers that are recognizing beyond the 1-year deferral or recognizing in the year of receipt.
  - File automatic change #84 to change to the 1-year deferral method

- Advance payments - for taxpayers that are on 1-year deferral, recognizing beyond the 1-year deferral or want to pick up income immediately in the year of receipt.
  - File automatic change #83 to change to the full inclusion method
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