Adoption of the new revenue recognition standard under ASC 606 could present companies with many unexpected tax technical and technology implications. With the new standard now beginning to take effect for public companies – and just a year away for others – it is important to understand the likely tax impacts of adoption, including potential implications for transfer pricing.

Many companies began assessing the impact of ASC 606 in advance of the adoption date of the new standard. However, it also appears that many others have not fully considered how these changes might affect their current intercompany arrangements, as well as processes for testing intercompany transactions for transfer pricing compliance and documentation purposes both from a U.S. and non-U.S. perspective. Adoption of ASC 606 will have broad impact across industries and could potentially touch most intercompany transactions. Although ASC 606 will be disruptive, there are approaches for mitigating the impact of the new standard.

This article offers an overview of ASC 606, including a comparison of key principles with current U.S. transfer pricing rules. It discusses industry and tax implications and illustrates the potential impact on common types of intercompany transactions, including distribution, shared services, commission agent, license, cost sharing, and other transactions.
Overview of ASC 606

On May 28, 2014, the FASB and the International Accounting Standards Board issued converged guidance on recognizing revenue in contracts with customers (Accounting Standards Codification Topic 606: Revenue from Contracts with Customers). Ten years in the making, this exercise creates a uniform set of standards globally, irrespective of jurisdiction and industry. The effective dates are annual reporting periods beginning after December 15, 2017 for public entities and annual reporting periods beginning after December 15, 2018 for non-public entities.

The new standard requires companies to perform an in-depth analysis of each type of revenue stream for financial statement purposes. Application of the standard could result in numerous tax impacts from both technical and systems perspectives. The standard may accelerate or decelerate revenue recognition for tax purposes, which will be of interest for local taxing authorities. From a systems perspective, adoption of the new standard may impact the information companies must collect and the way they capture it. Tax departments should be involved throughout the analysis to assess the areas of tax compliance and planning affected, as well as the associated magnitudes.

On March 27, 2017, the IRS issued Notice 2017-17, proposing automatic consent procedures for companies to change their tax revenue recognition methods related to ASC 606 adoption. The IRS is soliciting comments on the proposed procedural guidance.

The new revenue recognition model

The core principle of the new standard is recognizing revenue in a way that depicts the transfer of promised goods or services to customers in an amount that reflects the consideration for which the entity expects to be entitled in exchange for those goods or services. This revenue recognition model is based on a control approach, which differs from the risks and rewards approach applied under current U.S. GAAP. The new standard introduces a five-step model to address the book impact of revenue recognition (Fig. 1).

Fig. 1: Five-step model for addressing book impact of revenue recognition

At each step, the impact will depend on facts and circumstances, meaning the devil is in the details – hence the title of this paper. This is particularly true in the case of step 4, allocating the transaction price to performance obligations.

Comparison with current U.S. transfer pricing principles

The economic principles under IRC §482 (Allocation of Income and Deductions Among Taxpayers) and the associated regulations are consistent with the approaches used to allocate transaction price to separate performance obligations. The table below illustrates these points of consistency by comparing some key ASC 606 concepts – standalone selling price, adjusted market assessment approach, expected cost plus a margin approach, and residual approach – to their counterparts from a U.S. transfer pricing perspective. For example, the new standard is grounded in determining the standalone selling price, which is consistent with the principle behind the arm’s length standard.

1 Although the FASB and IASB revenue recognition standards are nearly fully converged, there are some differences between ASC 606 and IFRS 15. After the FASB and IASB issued ASU 2014-09 and IFRS 15, respectively, the boards decided to amend certain aspects of the new revenue recognition standard. In some cases, the amendments retained convergence; in other cases, however, the FASB decided on a solution that differs from IASB’s.
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This alignment is natural but significant because it enables efficiencies between transfer pricing and ASC 606 analyses. The challenge will be the ripple effect that could result from foreseen and unforeseen changes.

**Transition alternatives**

GAAP-side controllers, chief accounting officers, and chief financial officers must determine whether to use a full retrospective approach or a modified retrospective approach in the transition. Under the full retrospective approach, companies will restate prior periods as required by ASC 250 (Accounting Changes and Error Corrections). Generally, they will need to restate the previous two (and potentially three) comparative years, whether or not contracts are still in place as of the effective date. The cumulative catch-up adjustment is recorded through equity. Under the modified retrospective approach, a company will only apply the revenue standard to contracts not completed as of the effective date and record the cumulative catch-up (Fig. 2). Required disclosures include the amount of each financial statement line item affected in the current period and explanations of any significant changes. This approach sacrifices some transparency because the comparable financials are not restated.

From a tax perspective, the choice of approach will not change the tax due. If a company is entitled to $100 of revenue, the amount remains the same whether realized yesterday, today, or deferred to the future. Under IRC §481(a), the company will have a catch-up adjustment under either methodology.

<table>
<thead>
<tr>
<th>January 1, 2018</th>
<th>2018</th>
<th>2017</th>
<th>2016</th>
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<tr>
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<td><strong>Current Year</strong></td>
<td><strong>Prior Year 1</strong></td>
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<tr>
<td>New contracts</td>
<td>New ASU</td>
<td>Legacy GAAP</td>
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<td>Existing contracts</td>
<td>New ASU + cumulative catch-up</td>
<td>Legacy GAAP</td>
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<td>Completed contracts</td>
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**Fig. 2: Modified retrospective approach**
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Widespread industry impact
Certain industries are impacted more than others due to the changes in recognized revenue or increased compliance burden. Industries that should expect the most material impact include those where contracts cover multiple deliverables or multiple years, as well as those where variable consideration, such as licensing revenue, is common. Examples include:

- Software/high technology: ASC 606 eliminates industry-specific approaches, including vendor-specific objective evidence (VSOE), third-party evidence (TPE), and estimated selling price (ESP) methods for determining transaction price.
- Aerospace and defense: ASC 606 will affect multi-year contracts.
- Construction and engineering: ASC 606 modifies considerations for measuring progress and eliminates the completed contract method.
- Retail and distribution: ASC 606 could impact customer loyalty and other incentive programs.
- Manufacturing: Manufacturers that currently recognize revenue when products are delivered may need to recognize revenue over time. ASC 606 may also affect warranty or service contracts.
- Value-added resellers/solutions: Multiple performance obligations for bundled service/hardware will become more common. In addition, there could be potential changes to principal/agent analysis.
- Media and advertising: ASC 606 replaces industry-specific media/entertainment guidance. Additionally, IP licensing arrangements will require deeper examination.

Implications for tax revenue recognition
ASC 606 does not fundamentally change basic criteria for tax revenue recognition. In general, revenue is recognized under the accrual method for tax purposes at the earliest of when 1) performance has occurred, 2) payment is due, or 3) payment is received. For tax purposes, performance generally occurs as follows: for services, when completed; for goods, when delivered, shipped, or accepted, or when title passes; and for licenses, ratably over the period the licensee is entitled to use the property. Payment is generally due at the time stipulated in the payment terms of the contractual agreement. Advance payments (or amounts due or paid prior to being earned) may be eligible for deferral in certain cases. Tax deferral cannot be longer than book deferral.

The potential for revenue acceleration under ASC 606, however, will accelerate taxation for companies that currently have advance payments eligible for deferral under Treas. Reg. Sec. 1.451-5 (advance payments for sale of goods by taxpayer) or Rev. Proc. 2004 – 34 (advance payments for services, goods, use of certain intellectual property, and other eligible offerings).

Potential tax considerations of ASC 606
The table below outlines several potential areas of impact from a tax perspective and potential actions to take as a result. While it is natural to focus on the technical tax aspects of change – such as GAAP revenue recognition, tax provisions, and tax accounting methods – more often than not, addressing these tax technical issues in turn requires adjustments to data, systems, and processes. Companies will need to collect new information or collect existing information in different ways to achieve tax compliance results. There may also be state and local tax issues that arise due to ASC 606, as well as global tax implications.
<table>
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<tr>
<th>Area</th>
<th>Common tax considerations</th>
<th>Anticipated action items</th>
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| GAAP revenue recognition    | • Current types of revenue streams and related GAAP treatment  
  • Assess how the GAAP change in method of accounting under the new standards for each of the various revenue streams will impact the current tax method                                                                 | • Opportunity to leverage financial statement revenue stream analysis to proactively generate additional cash and fund project implementation costs                                                                 |
| Tax Provision                | • Any changes to tax accounting methods or book tax difference computations must be incorporated into the tax provision process  
  • Consideration should be given to the correct period to reflect the change                                                                                                                                         | • Computation and tracking of new or altered book-tax differences                                                                                                                                                      |
| Tax accounting methods       | • Changes to revenue recognition will impact some combination of:  
  − The amount of book-tax differences,  
  − A change in the calculations of existing book-tax differences,  
  − Creation of a new book-tax difference, or  
  − Require a tax accounting method change  
  • Timing and impact of method changes must be considered (automatic vs. manual, and section 481 adjustment calculation)  
  • Enactment of tax reform could convert the timing benefits to permanent benefits thereby increasing the impact of tax planning                                                                 | • Analysis of relevant tax accounting methods and potential requests for changes in Tax Method of Accounting                                                                                                                                 |
| Tax data and process/systems | • Systems will need to be evaluated to confirm that the software solutions used by accounting will provide the necessary data for tax analysis  
  • Identify additional data needed to support tax accounting                                                                                                                                                        | • Reconciliation of the book restatement with tax’s lack thereof and associated tracking considerations                                                                                                                    |
| Indirect and multistatetax   | • Sales tax, VAT, Telecom taxes, fuel taxes, etc.  
  • Impact to indirect tax varies greatly by industry and type of taxes imposed.  
  • Impacts generally expected in areas where the basis tax is book revenue or where the tax base is not well defined.  
  • Changes to the basis of tax could impact the amount of tax reported as well as collections. In some instances, there may be a disconnect between the basis on which a company collects and the base on which it remits to the taxing authorities (e.g. telecom taxes imposed on book revenue but collected on billings to the customer which may not change due to the adoption process)  
  • Many tax types are based upon billed revenues, which underlies the importance of reducing changes to the billing systems.                                                                 | • Indirect tax reporting  
  • Multistate allocation and apportionment                                                                                                                                                                             |
| Global tax implications      | • Any changes to the statutory financial statements can potentially impact tax measures based upon the financial statements, such as: thin capitalization limits, distributable reserves and transfer pricing  
  • Since both IFRS and US GAAP are changing, cash taxes may be impacted in local countries due to changes in statutory financial statements. For jurisdictions where the statutory filings form the basis of tax with few modifications, cash taxes paid to the jurisdiction may be impacted | • Thin capitalization limits, distributable reserves, foreign tax credits and transfer pricing                                                                                                                                 |
Impact on transfer pricing and intercompany transactions

ASC 606 (and IFRS 15) affects the timing and classification of revenue recognized for every key transfer pricing transaction but not the amount of revenue earned from customer contracts. For example, accelerated revenue affects intercompany royalties based on revenue. Uneven revenue recognition across jurisdictions affects allocation keys used in cost-sharing arrangements or shared services agreements based on revenue. Reclassification of certain revenue to interest income affects the profitability of related entities. Additionally, evaluation of performance obligations may result in a new or different categorization of revenue (e.g., product revenue or service revenue), which may be subject to different transfer pricing methods.

ASC 606 may also affect application of the cost plus method/transactional net margin method (CPM/TNMM), which relies on the financial results of unrelated companies for benchmarks. Companies previously selected as comparable that have significant long-term contractual obligations may become less comparable, causing the pool of benchmark companies to shrink and ultimately affect the reliability of the CPM/TNMM. Examples of factors that can affect comparability include accounting standards followed by benchmark companies (U.S. GAAP vs. IFRS vs. local GAAP) and adoption of the full retrospective approach versus modified retrospective approach. ASC 606 requires additional disclosures related to contracts with customers, application of the new revenue recognition standard, and assets that are recognized costs required to fulfill a contract. These factors warrant greater care in selecting benchmark companies in order to maintain comparability.

ASC 606 has a particular impact on several types of intercompany transactions, including buy/sell transactions, shared services, commissions, licenses/royalties, and cost sharing/platform contribution transactions. The following sections illustrate the potential issues and solutions associated with each.
**Buy/sell transactions**

In this example (Fig. 3), a principal sells goods to a distributor, and the distributor sells goods to unrelated parties. The distributor earns a routine return that is typically a percentage of its revenue, and the principal is entitled to the residual return. Adoption of ASC 606 may accelerate revenue or decelerate previously earned revenue. Under ASC 606, the distributor’s profitability may vary greatly due to contract acquisition costs being capitalized rather than expensed. Additionally, returns and allowances (variable consideration) may also affect revenue.

Potential solution(s): If distributor profitability is higher now because of rate of revenue after transfer pricing or expense classification, it may be necessary to reassess the intercompany cost of goods sold or the price at which the principal is selling to distributors. Additionally, since companies often test distributor transactions on the CPM/TNMM, it may be necessary to reassess comparable companies and make other adjustments to address comparability, such as using a longer testing period.

**Shared services transactions**

This example (Fig. 4) is a typical shared services arrangement under which the provider earns a routine return based on costs. ASC 606 affects transactions that include allocation keys based on net revenue or entities that engage in multiple functions that have different revenue recognition principles. If shared services are allocated based on relative revenue and the service recipients have customer contracts with significantly different performance obligations, the allocation of costs based on recognized revenue might be distorted.

Potential solution(s): If the taxpayer adopts the partial retrospective approach, distortion would be for only one year. The taxpayer may want to adjust the allocation to eliminate the impact in that year. If the taxpayer adopts the full retrospective approach, distortion will impact previous years and, depending on the impact, may not be adjusted through amended returns under Treas. Reg. Sec. 1.482-1(a)(3). The taxpayer should also review the customer contracts and applicable performance obligations to determine if there is a way to optimize income recognition.
Sales agent/commission transactions

These transactions are similar to distributor transactions in that they involve the sales of contracts. While contracts may be recognized over a period of time, a principal or commission agent may do all of its work at the beginning to generate the sale — presenting issues when timing of revenue recognition is different than the activity that produces revenue. This may result in commissions being capitalized instead of being a current period expense and/or revenue recognition timing that results in a loss position.

In this example (Fig. 5), a principal engages a sales agent to sell goods to unrelated parties. The principal pays the sales agent a fee, typically equal to a percentage of the sales revenue. Adoption of ASC 606 may accelerate revenue or decelerate previously earned revenue. Because the taxpayer relies on benchmarks of period-by-period returns from comparable companies, ASC 606 may trigger a large variance in operating results of the comparable companies, particularly in the year of adoption.

Potential solution(s): Similar to buy/sell transactions, these transactions may require care in selecting comparable companies and other adjustments to address comparability, such as using a longer testing period.
License transaction/royalty
ASC 606 affects situations where the royalty is based on revenue, such as sale- or usage-based royalties, or reclassification of revenue type and bifurcation of revenue streams. In this example (Fig. 6), a U.S. company licenses its intellectual property (IP) to an international company for consideration. Payment for the license is in the form of a royalty, which is typically measured based on revenue projected over the life of the license, with the license rate based upon the residual profit associated with the IP.

Under ASC 606, revenue recognition may change materially from the revenue projected at the time of the original license. Changes to revenue recognized may cause a discrepancy between revenue recognized under the existing system and under ASC 606 and affect previous valuations of the licensed IP. A material difference between recognized revenue and forecasted revenue might result in a royalty payment in a taxable year that does not meet the safe harbor of the commensurate with income (CWI) rule.

Potential solution(s): Options for addressing changes in revenue recognition may include:

- Adjusting the terms of the contract to determine the revenue consistent with pre-ASC 606 methodology. This would eliminate the mismatch in revenue recognition between the original projections and actual results, so it is unlikely to trigger a CWI adjustment. However, it will add the burden of carrying two sets of books.
- Determining revenue in accordance with ASC 606 and adjusting in the year of adoption. This may result in a large revenue adjustment in the year of adoption and a corresponding increase or decrease in the royalty payment.
- Determining revenue in accordance with ASC 606 and making incremental prospective adjustments. This method will require more work up front to estimate the “catch-up” adjustments, but it will provide a smooth transition from the existing revenue methodology to ASC 606 methodology without large single-year adjustments.
- Exploring exceptions that grant taxpayers an exemption to an adjustment under the CWI rule, such as extraordinary events beyond the taxpayer’s control.

![Fig. 6: License transaction/royalty example](image-url)
Cost-sharing transactions

In this example (Fig. 7), two or more entities enter into a cost sharing arrangement to jointly bear the cost of developing IP and sharing the benefits. IP development costs are allocated between the entities based on each entity’s share of reasonably anticipated benefits (RAB). RAB shares are typically measured based on current, past, and/or future revenue. Under ASC 606, revenue may be recognized unevenly between the cost sharing participants, resulting in a change to RAB share. If the international company and the U.S. company use standard contracts, then there may not be an issue, as the impact on the RAB share from ASC 606 will be the same or similar for both parties. If the performance obligations differ significantly between the parties, then the impact to the RAB may be distorted.
Potential solution(s): The solutions are similar to some of those already discussed. A company may keep RAB consistent with existing (pre-ASC 606) methodology. The RAB share will be relatively consistent year over year, but this requires two sets of records. The company may determine RAB in accordance with ASC 606 and make an adjustment in the year of adoption. This may result in uneven acceleration of revenue between cost sharing participants, which will affect the RAB share and require a large adjustment in the year of adoption. On the other hand, the company could determine RAB in accordance with ASC 606 and make incremental prospective adjustments. This approach will require more work upfront to estimate the “catch-up” adjustments, but it will provide a smooth transition from the existing revenue methodology to ASC 606 methodology, without large single-year adjustments. Those differences in timing might require compensating one party or the other if the change in contract materially puts one party at a disadvantage.

Platform contribution transactions (PCTs)

In conjunction with a cost-sharing arrangement, parties may enter into a PCT transaction (Fig. 8) to contribute existing IP or newly acquired IP to be jointly developed. Payments for the PCT may be measured based on discounted future earnings. Under ASC 606, changes to revenue recognized may cause a discrepancy between revenue recognized under the existing system and under ASC 606. Similar to a licensing transaction, a material difference between recognized revenue and forecasted revenue could result in a royalty payment in a taxable year that does not meet the safe harbor under the trigger test.

![Platform contribution transaction example](image)
Potential solution(s): The solutions are similar to those in the licensing scenario. The company can keep revenue consistent with existing (pre-ASC 606) methodology. Because there is no mismatch in revenue recognition, no adjustment is required. Another solution is to determine revenue in accordance with ASC 606 and adjust it in the year of adoption. This may result in a large revenue adjustment in the year of adoption and a corresponding royalty payment. Alternatively, the company may determine revenue in accordance with ASC 606 and adjust prospectively. This method will require more work upfront to estimate the “catch-up” adjustments, but it ultimately will result in a smooth transition from the existing revenue methodology to the ASC 606 methodology. Finally, it may be prudent to look for potential exceptions to the trigger test, such as extraordinary events beyond the taxpayer’s control.

Impact on global transfer pricing compliance

While adoption of ASC 606 increases alignment between U.S. GAAP and IFRS, there are issues with respect to how local GAAP will treat recognition. For example, there may be a difference in the revenue and costs recognized locally on statutory books versus what is recognized in GAAP. This could lead to double taxation.

Under the OECD’s BEPS (base erosion and profit shifting) Action Item 13, multinational organizations are required to file a country-by-country report (CbCR) that includes revenue and overall profits by jurisdiction. Tax authorities worldwide have information included in the CbCR. Adoption of ASC 606 may cause an acceleration of income, which will show up as a material change in revenue and profitability between FY 2017 and FY 2018 (the year of adoption) with a corresponding functional change. Taxpayers should proactively assess how adoption of ASC 606 will affect the information in the CbCR.

It may be prudent to use some of the explanation sections of those forms to address the fact that there are some material changes to financial statements brought about by changing the accounting standard – especially if a company is using U.S. GAAP as a basis for 606 compliance.

Transfer pricing checklist

The following steps can help assess the potential impact of ASC 606:

1. Review existing intercompany transactions to identify those that depend on third-party revenue or that may be affected by revenue characterization.
2. Identify direct impacts on transactions, such as reduction in royalty base, change in projections for RAB calculations, change in timing of revenue for PCT calculation, or reduction of net profit for residual profit allocations.
3. Identify indirect impacts on transactions, such as trigger test/CWI, comparable company adjustments, or methodology alignment (U.S. GAAP vs. transfer pricing revenues).
4. Quantify tax impacts by transaction.
5. Identify modifications to transfer pricing policies, agreements, and calculations to maintain compliance.

Conclusion

The new standard could have a significant impact on the amount and timing of revenue recognition, which in turn could affect intercompany transactions. It will likely impact companies’ current revenue recognition practices in industries such as aerospace and defense, engineering and construction, entertainment and media, life sciences, and technology. At the same time, it may necessitate changes to information technology systems, as well as increased disclosure requirements. As with many such changes, the devil is in details.
Tax executives’ perspectives

Deloitte Tax hosted a “Dbriefs” webcast on February 14, 2018, to provide an overview of the ASC 606 and the likely impact on transfer pricing that will come with its adoption. More than 3,500 participants shared their own views through polling topics and posed questions to the presenters.

Familiarity with ASC 606 is low. Nearly half – 43 percent – of the webcast participants have not read ASC 606 yet. Another 38 percent of participants have “limited familiarity” with the new standard. Only 11 percent of participants are “very familiar” with ASC 606, while only 8 percent of participants have assessed the impact of the new standard on all revenues.

Accordingly, only 17 percent of participants expect ASC 606 will have “a lot” of impact on their intercompany transactions. About 45 percent of participants expect “a little bit” of impact, while 38 percent of participants believe the impact will be minimal.

Participants considered certain aspects of their intercompany transactions that will experience the greatest impact. About 46 percent of participants believe ASC 606 will have the greatest impact on intercompany services transactions, while another 33 percent of participants expect the most impact on intercompany buy/sell transactions. The remainder – 21 percent – said their cost-sharing RAB share and PCT payments will be most impacted.

At this point, ASC 606 has had little effect on transfer pricing policies. Relatively few – 14 percent – companies have made “a great deal” of change to their transfer pricing policies, while about 40 percent of participants have made “a little bit” of change to their transfer pricing policies.
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Where the new revenue recognition standard impacts your intercompany transactions, where is the most significant impact?

- **Service transactions**: 45.8%
- **Buy-sell transactions**: 33.2%
- **Cost Sharing RAB share**: 12.6%
- **Cost Sharing PCT payments**: 8.4%

To what extent has your company changed its transfer pricing policies as a result of the new revenue recognition standard?

- **Not at all**: 33.4%
- **A little bit**: 39.9%
- **A great deal**: 14.2%
- **The new standard has had no impact on our company's transfer pricing policies**: 12.6%

To what extent are you familiar with ASC 606?

- **I have a limited familiarity with respect to ASC 606**: 38.2%
- **I have not read ASC 606 yet**: 42.9%
- **I have assessed the impact of ASC 606 on all of my company's revenues**: 7.5%
- **I am very familiar with ASC 606**: 11.4%

What is the extent of the impact of ASC 606 on your company's intercompany transactions?

- **A little bit**: 44.7%
- **Not much**: 38.4%
- **A lot**: 16.9%