Wayfair: Potential nexus ramifications for income and other taxes

Overview

On June 21, 2018, the US Supreme Court decided what is arguably the most important state tax case of the last 25 years in Wayfair et. al. In a 5-4 split decision, the majority overruled the bright-line rules in National Bellas Hess (1967) and later upheld in Quill (1992).

For further information on the Wayfair decision and the potential implications for remote sellers overall, please see Multistate tax alert, June 26, 2018. For further information on the potential state tax implications of Wayfair for non-US companies with US customers, please see Multistate tax alert June 27, 2018.

Income tax nexus implications of Wayfair

While Wayfair will have a significant impact on sales and use tax collection obligations, the decision may also impact nexus positions taxpayers have taken with regard to other taxes, notably income tax. Since the Court’s decision in Complete Auto (1977), a taxpayer’s activity must have a substantial nexus with the taxing state to support the imposition of tax. In Quill, the Court drew a distinction between nexus required to satisfy the Due Process Clause versus nexus required to satisfy the Commerce Clause, providing the Commerce Clause’s “substantial-nexus requirement is not, like due process’ minimum contacts requirement, a proxy for notice, but rather a means for limiting state burdens on interstate commerce.” Under the Quill analysis “a corporation may have the ‘minimum contacts’ with a taxing State as required by the Due Process Clause, and yet lack the ‘substantial nexus’ with the State as required by the Commerce Clause.”

Quill overruled the due process nexus holding of Bellas Hess but not the Commerce Clause holding, “grounding the physical presence rule in Complete Auto’s requirement that a tax have a ‘substantial nexus’ with the activity being taxed.” However, the Court in Wayfair has now clearly established that “[p]hysical presence is not necessary to create a substantial nexus.”

Whether physical presence is necessary for the imposition of income taxes has been the subject of uncertainty for the last several decades as well. In 1993 the South Carolina Supreme Court held that physical presence was not required for the imposition of income tax, and that Quill’s physical presence standard was limited to only sales and use tax. To date, however, the Supreme Court has not granted certiorari in any such case pertaining to economic nexus. In recent years, a number of states have enacted so-called “factor-based” economic presence nexus standards for income or gross receipts-type taxes. For example, Alabama law provides, effective for tax years beginning after December 31, 2014, that factor-based presence nexus standards exist for business activity for purposes of business privilege tax, income taxes, and financial institution excise taxes if any of the following thresholds are exceeded during the tax period: (1) $50,000 of property; (2) $50,000 of payroll; (3) $500,000 of sales; or (4) 25% of total property, total payroll, or total sales.

In light of the Court’s unequivocal statement in Wayfair that physical presence is not a necessary element for “substantial nexus,” and the Court’s review and approval of South Dakota’s economic nexus sales tax statute, taxpayers will need to revisit positions they may have taken regarding both sales/use taxes and other taxes and the need for physical presence in order the establish substantial nexus. While the facts at issue in Wayfair involved a statute with prospective application, potential retroactive application and enforcement to the effective date of a state’s applicable income tax nexus statute or rule is possible. This landmark decision will also receive careful consideration by other states which may seek to enforce or adopt economic factor-based presence nexus provisions in light of the Wayfair decision.

Public Law 86-272 considerations should not be overlooked

The Wayfair decision does not overrule P.L. 86-272 in the state income tax setting. While certain states have adopted sales-based nexus provisions for income tax purposes, P.L. 86-272 remains in force and prohibits states from levying a net income tax upon an out of state company if the company’s activities in a state are limited to the solicitation of orders for the sale of tangible personal property and the orders are approved and filled from outside the state. More specifically, P.L. 86-272 states “a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State...”

Financial statement implications

Companies should evaluate the impact of the decision on their existing tax positions involving nexus (i.e., with respect to income taxes, as well as sales/use tax) and consider what impact, if any, the decision has on both their contingent liabilities and liabilities for unrecognized tax benefits.

Because the decision discussed in this tax alert was rendered on June 21, 2018, any impact of this decision on income taxes should be accounted for in the financial reporting period including June 21, 2018.
Brady hints at content, timing of Tax Cuts 2.0 package

House Ways and Means Committee Chairman Kevin Brady, R-Texas, said June 26 that his panel’s next round of tax cut legislation – known informally as Tax Cuts 2.0 – likely will be released in early August and in multiple pieces rather than as a single bill.

Permanence plus...

In comments at a Washington Post forum marking the six-month anniversary of the enactment of last year’s massive tax cut bill (P.L. 115-97), Brady told interviewer Bob Costa that the Tax Cuts 2.0 package would permanently extend the tax relief provisions that were included in the 2017 legislation but are currently scheduled to expire after 2025. But he added that House taxwriters also intend to propose additional tax relief that wasn’t part of the original bill.

“I see it as a package of two, three, or four approaches with permanency being one of them,” he said. Although Brady did not discuss the specifics of the new proposals, he noted that “we think the timing is right to help families save more and earlier in their life, whether it’s for health care or school for their kids or retirement in the long-term.”

Brady also stressed that offering a second tax major tax bill is part of a larger strategy to encourage Congress to review the tax code every year and update it as needed rather than approach tax reform as a once-in-a-generation undertaking.

“[W]hat I’ve asked our colleagues to do is to mirror what the most successful organizations that we know do, which is they wake up…every day asking, how do we become more competitive, more innovative, better? I want Congress every year to look at the tax code and ask themselves exactly the same three questions. …And so that’s what we’re doing,” he said.

Timing: As to timing, Brady said his committee will circulate a draft of the legislation to House Republicans after the Independence Day recess and spend the rest of July talking to members and finding out what changes they would like to see. He expects to release a ”legislative outline” in early August to allow for House votes “in the fall, depending on when leadership wants to schedule them.”

Brady declined to comment on when a bill would be considered by the Senate.

“Leave that to Leader McConnell. But we will be moving forward in the House this fall,” he said.

Senate hurdles: Brady acknowledged that any bills passed in the House will face difficulties in the Senate, where GOP leaders will have to gain support from Democrats to wrangle the 60 votes they would need to overcome likely procedural hurdles in that chamber. Republicans officially control 51 Senate seats, and with Sen. John McCain sidelined while he undergoes treatment for brain cancer in his home state of Arizona, the GOP as a practical matter has only 50 potential “aye” votes; but at least one Republican – Tennessee Sen. Bob Corker – has already said he would not support a second tax bill and two others – David Purdue of Georgia and Jeff Flake of Arizona – have in the past been reluctant to embrace the idea.
But the Ways and Means chairman appeared to suggest that moving Tax Cuts 2.0 in pieces might make it easier for Senate GOP leaders to secure passage of certain components of the plan if not the entire package.

“Our job is to deliver the very best ideas, and I’m confident Leader McConnell and the Senate Republicans will choose those areas they have the most interest in, and let’s move something to the president’s desk,” he said.

**Impact of the 2017 law**

Brady offered an upbeat assessment of the economic impact of last year’s legislation, saying he expects businesses to continue to “invest in the productivity of their workers,” which will in turn drive economic growth and wage growth for the long term.

“I don’t think it’s going to reappear overnight, but we got the fundamentals right in the new tax code, and over time, it’s going to drive that wage growth up,” he said. Echoing the economic optimism he said he sees in the business community, Brady added that “the best is yet to come on tax reform.”

**Hassett generally on same page:** For his part, White House Council of Economic Advisers Chairman Kevin Hassett, who was interviewed separately at the Washington Post event, had mostly the same positive takeaways from last year’s tax overhaul. He told the Post’s Damian Paletta that the administration’s economic models had correctly predicted the growth in various sectors, and that in the case of structures, growth actually exceeded the models.

“I think that mostly I’m surprised on the upside. The wages have gone up faster than we thought,” Hassett said. He also continued to assert that the tax cuts will, on average, cause wages to grow by $4,000 over the next few years as employers funnel a portion of their tax savings into salary hikes, employee bonuses, and increased contributions to employee retirement plans.

Asked why wages haven’t grown more, alluding to a recent Bureau of Labor Statistics report that they had stayed the same over the year, Hassett argued that nominal wages are a better metric and they are rising even if real wages (those that take inflation into account) are not. He also said it would take time for the effects of tax reform to be distributed to increases in wages.

Hassett also downplayed the effect of the tax cuts on federal deficits, which he attributed more to the recent two-year spending package passed by Congress. “I think the deficit is skyrocketing, but it’s not a legacy of the tax law. It’s a legacy of the spending deal that just happened that spent a lot more than the president wanted,” he said.

**Outside analysts split:** Policy analysts from outside the government who participated in a separate panel discussion at the Post forum were divided between those who agreed with Brady and Hassett that the 2017 tax cuts are already having a positive impact on the economy and those who contended that the 2017 legislation has been good for large corporations and wealthy individuals but has done little to benefit low- and middle-income workers.

Caroline Harris of the US Chamber of Commerce made the case that wages “are continuing to improve as tax reform works its way through the economy.” Asked if anything in the legislation could be improved, Harris called for making the small business and cost recovery provisions permanent.

Harris also took issue with the argument advanced in some circles that corporations that use their tax savings for stock buybacks are primarily benefiting wealthy shareholders rather than workers.

“When companies do stock buybacks, they see an increase in stock price, they see an increase in stock value. That value goes to the 50 percent of Americans who hold stock. That value goes to the $4 in $10 in market investment that is held in retirement plans,” she said.

Aric Newhouse of the National Association of Manufacturers (NAM) cited the creation of new manufacturing jobs and optimism among members of NAM as evidence the new law is working. “This year, we’ve already created 115,000 jobs,” Newhouse said. “I would make the argument that there is a direct relationship between what we’re seeing in the economy and what Congress and policymakers did on the tax code.”

But Seth Hanlon of the Center for American Progress argued that real wages – which he said is the indicator to watch in gauging the success of the new law – have not increased over the past 12 months.
“So nominal wages have gone up a little bit in nominal terms, but that growth has been entirely eaten up by the rise in prices, you know, gas prices, health care, whatever else,” Hanlon said. He also said a rise in real wages is possible if there is a “huge explosion in business investment”; but he noted that “we certainly haven’t seen it yet.”

Chris Shelton of the Communication Workers of America, meanwhile, argued that the capital that has been returned to corporations since the new law was enacted has not been shared with workers. “When the tax bill – when they were talking about it, employers were coming out saying that they were going to give a $4,000 wage increase. That just has not happened. It’s not on the horizon to happen,” he said.

He also noted that some businesses that netted significant tax savings under the new law have not added jobs but instead have eliminated them.

“[O]ne of our employers...where we have about 110,000 people, said they were going to increase jobs by 7,000 jobs for every billion dollars in tax cut. Well, they got a $3 billion tax cut and we’ve seen 6,000 layoffs since the tax cut happened,” he said.

CBO forecasts long-term fiscal challenges

As policymakers and others debated the merits of last year’s tax bill, the nonpartisan Congressional Budget Office (CBO) on June 26 released a bleak analysis of the economic impact of the nation’s current fiscal policy over the next 30 years. CBO’s long-term budget outlook, covering 2018 through 2048, projects that if current tax and spending law remains unchanged, the federal deficit will increase from 3.9 percent of gross domestic product (GDP) in 2018 to 8.4 percent of GDP in 2048 as relatively modest revenue gains over the budget window are outstripped by spending increases – driven by a spike in Social Security and Medicare outlays related to the aging Baby Boom generation – as well as increased debt service costs.


Tax revenues are projected to total 16.6 percent of GDP in 2018 and increase beginning in 2026 as a number of tax relief provisions for individuals in last year’s tax bill – such as income tax rate reductions, a higher alternative minimum tax exemption, and an increased estate and gift tax exemption – expire and certain business breaks such 100 percent bonus depreciation begin to phase out. Revenue would begin to increase more slowly beginning in 2028, with those gains primarily the result of so-called “bracket creep,” or the tendency of revenues to increase as wage gains outpace the inflation index to which the personal income tax brackets are tied, and is projected to reach 19.5 percent of GDP by 2048. Federal outlays – mandatory spending, discretionary spending, and interest on the federal debt – are projected to rise from 20.5 percent of GDP in 2018 to 27.9 percent of GDP in 2048. The portion of federal debt held by the public – currently 78 percent of GDP, the highest level since the end of World War II – would approach 100 percent of GDP by the end of the next decade and 152 percent of GDP by 2048.

The report suggests that reducing the federal debt by 2048 to 41 percent of GDP (its average over the past 50 years) would require policymakers to increase revenues, cut noninterest spending, or enact a combination of tax increases and spending cuts equal to 3.0 percent of GDP each year beginning in 2019. (In dollar terms that would translate to $630 billion in 2019, CBO says.) Keeping debt at its current level of 78 percent of GDP by 2048 would require changes totaling 1.9 percent of GDP a year from 2019-2048 (about $400 billion in 2019).

The report also warns, without going into detail, that the fiscal outlook would become even more dire if Congress makes certain changes to current law – for example, by making the temporary provisions in last year’s tax bill permanent rather than allowing them to expire or phase out as currently scheduled. (Making those provisions permanent without offsetting them would wipe out the revenue gains that are currently expected beginning in 2026 as certain income tax rates and other temporary provisions revert to prior law.)

CBO indicated that it will look at the effects of so-called alternative fiscal scenarios in a forthcoming publication.

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Michael DeHoff (Washington, DC)
Senior Manager
Deloitte Tax LLP
mdehoff@deloitte.com
CFOs’ plans for repatriated cash focus on core business

Many CFOs in North America expect to raise their domestic investment, hiring, and wages, as well as accelerate earnings repatriation, as a result of US tax reform, according to Deloitte's first-quarter 2018 CFO Signals™ survey. Forty-six percent of the 155 CFOs responding to the survey expect higher investment in US operations, with only 6 percent expecting higher investment outside the US. Further, 38 percent expect to front-load capital investment, and 32 percent expect higher R&D/innovation investment.

“The passage of tax reform in the US appears to have further bolstered confidence among finance chiefs – with growth expectations for revenue, earnings, capex, and hiring all rising to multi-year highs and CFOs’ optimism about their companies’ prospects hitting its highest-ever level,” observes Sandy Cockrell III, national managing partner of the US CFO Program, Deloitte LLP.

“Investment in both core and new businesses and also in R&D is far and away CFOs’ top expected use for repatriated cash,” notes Rochelle Kleczynski, national tax reform leader, Deloitte Tax LLP. “Many surveyed CFOs indicate that some repatriated cash will be used for hiring and pay, but more extensive use appears focused on debt repayment, buybacks, and dividends,” she adds.

Of the CFOs who plan to accelerate repatriation, 63 percent expect to pay down debt, 54 percent say they will buy back shares, and 39 percent indicate they will pay dividends. In addition, 55 percent of surveyed CFOs say their company plans to use repatriated earnings to hire new employees, while 43 percent cite wage increases and 23 percent cite one-time bonuses.

Business impacts across industries

Of the CFOs who plan to increase investment in their US operations, expectations to do so are generally similar across industries, but CFOs from the Services and Healthcare/Pharma sectors have higher-than-average expectations for investment.

Following are additional industry highlights from the survey related to the business impacts of US tax reform.

Investment: Expectations for the Services and Energy/Resources industries are high for front-loading capital investment compared to other industries, while Healthcare/Pharma and Technology CFOs expect higher investment in R&D/innovation.

Talent: For CFOs in the Retail/Wholesale sectors, expectations to use repatriated cash for hiring are low, but their expectations to use for wages are high. CFOs in the Healthcare/Pharma sectors indicate high expectations for using repatriated cash for hiring, and have lower expectations to use it for wages. Expectations to use repatriated cash for hiring are high among CFOs in the Services industry.

Capital: Forty-four percent of CFOs agree or strongly agree that they expect to accelerate repatriation of foreign earnings. Expectations among CFOs in the Manufacturing and Technology industries are higher than in other industries; they are lower among Financial Services and Energy/Resources CFOs.

Tax function: Sixty percent of CFOs expect high complexity in implementing new tax laws, and one-third cite the need to strengthen or restructure their tax function.

Plans for repatriated cash by industry

Among CFOs planning to accelerate cash repatriation, there were several industry differences related to how they expect to use the cash. Following are industry highlights.

Investment: For Financial Services CFOs, expectations are low for investment in core businesses, but high for new businesses, which include M&A and equity stakes. Retail/Wholesale and Energy/Resources CFOs have relatively low expectations for using repatriated cash for new businesses and R&D/innovation. CFOs in the Technology, Healthcare/Pharma, and Manufacturing sectors indicate high expectations for all investment types.
Talent: Manufacturing, Services, and Retail/Wholesale CFO expectations are relatively low for using the cash from repatriation for hiring. Expectations among Energy/Resources CFOs for using repatriate cash for raising wages are high, but low among Manufacturing and Healthcare/Pharma CFOs.

Capital: Healthcare/Pharma CFOs’ expectations are high for dividends, debt repayment, and buybacks. Technology CFOs indicate high expectations to use repatriated cash for buybacks.

ASC 606 and transfer pricing: The devil is in the details

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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 impact of adoption, including potential transfer pricing implications.

Some companies began assessing the impact of ASC 606 in advance of the new standard’s adoption date. However, it appears that others have not fully considered how these changes might affect the reporting of income from their intercompany transactions, as well as processes for testing intercompany transactions for transfer pricing compliance and documentation purposes, both from a US and a non-US perspective. Adoption of ASC 606 will have broad impact across industries and could potentially touch most intercompany transactions. Although ASC 606 may 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 US 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 converged1 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.

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.
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 contracted 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 US GAAP. The new standard introduces a five-step model to address the book impact of revenue recognition (Fig. 1).

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

Comparison with current US 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 US transfer pricing perspective.

<table>
<thead>
<tr>
<th>ASC 606</th>
<th>US Transfer Pricing Rules</th>
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</thead>
<tbody>
<tr>
<td><strong>Standalone Selling Price</strong></td>
<td><strong>Arm’s Length Standard</strong></td>
</tr>
<tr>
<td>The price at which an entity would sell a good or service</td>
<td>The results that would have been realized if uncontrolled</td>
</tr>
<tr>
<td>separately to a customer.</td>
<td>taxpayers had engaged in the same transaction under the</td>
</tr>
<tr>
<td></td>
<td>same circumstances.</td>
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<tr>
<td><strong>Adjusted Market Assessment Approach</strong></td>
<td><strong>Comparable Uncontrolled Price/Comparable</strong></td>
</tr>
<tr>
<td>This method estimates standalone selling price by</td>
<td><strong>Uncontrolled Services Price Method</strong></td>
</tr>
<tr>
<td>estimating the price that the customer would pay for the</td>
<td>This method compares the amount charged in a controlled</td>
</tr>
<tr>
<td>good or service in the entity’s market. From a practical</td>
<td>transaction with the amount charged in a comparable</td>
</tr>
<tr>
<td>perspective, this would likely include reference to the</td>
<td>uncontrolled transaction.</td>
</tr>
<tr>
<td>price an entity’s competitors charge for similar goods or</td>
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</tr>
<tr>
<td>services adjusted to reflect the entity’s costs and margins.</td>
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<td></td>
<td><strong>Comparable Profits Method (NCPM as a profit level indicator)</strong></td>
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<tr>
<td></td>
<td>This method and profit level indicator compares the cost</td>
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<td></td>
<td>plus a markup earned by controlled taxpayers with the</td>
</tr>
<tr>
<td></td>
<td>amount earned by uncontrolled taxpayers that engage in</td>
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<tr>
<td></td>
<td>similar business activities under similar circumstances.</td>
</tr>
<tr>
<td>ASC 606</td>
<td>US Transfer Pricing Rules</td>
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<td>----------------</td>
<td>---------------------------</td>
</tr>
<tr>
<td>Residual Approach</td>
<td>Residual Profit Split</td>
</tr>
<tr>
<td>This method estimates the standalone selling price by subtracting the sum of all observable standalone selling prices of other goods or services promised from the total transaction price.</td>
<td>This method determines the value of the residual non-routine contribution by first allocating all routine income.</td>
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</tbody>
</table>

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**

On the 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 apply the revenue standard only 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.

<table>
<thead>
<tr>
<th>January 1, 2018</th>
<th>2018 Current Year</th>
<th>2017 Prior Year 1</th>
<th>2016 Prior Year 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>New contracts</td>
<td>New ASU</td>
<td>Legacy GAAP</td>
<td>Legacy GAAP</td>
</tr>
<tr>
<td>Existing contracts</td>
<td>New ASU + cumulative catch-up</td>
<td>Legacy GAAP</td>
<td>Legacy GAAP</td>
</tr>
<tr>
<td>Completed contracts</td>
<td>Legacy GAAP</td>
<td>Legacy GAAP</td>
<td>Legacy GAAP</td>
</tr>
</tbody>
</table>

*Fig. 2: Modified retrospective approach*

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 and will need to report favorable adjustments on the schedule M of the IRS form 1120 in the year of the change and unfavorable adjustments over four years on the schedule M of the IRS form 1120. However, in light of the recent changes to IRC §451, many of these changes will be subsumed. Consequently, depending on the approach chosen, it may impact the comparability of companies used to benchmark the return earned on intercompany transactions because the comparables’ financials may not be restated.

**Widespread industry impact**

Certain industries may be impacted more than others due to the changes in recognized revenue or increased compliance burden. Industries that should expect a more significant 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 multiyear 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). Many companies will also have to assess and factor in the resulting impact of the recent changes to IRC §451, which in many cases will result in additional accelerated revenue for tax purposes over and above the impact of ASC 606.

**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 meet tax compliance requirement. There may also be state and local tax issues that arise due to ASC 606, as well as global tax implications.

<table>
<thead>
<tr>
<th>Area</th>
<th>Common tax considerations</th>
<th>Anticipated action items</th>
</tr>
</thead>
<tbody>
<tr>
<td>GAAP revenue recognition</td>
<td>• Current types of revenue considerations streams and related GAAP treatment</td>
<td>• Opportunity to leverage financial statement revenue stream analysis to proactively generate additional cash and fund project implementation costs</td>
</tr>
<tr>
<td></td>
<td>• 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</td>
<td></td>
</tr>
<tr>
<td>Tax Provision</td>
<td>• Any changes to tax accounting methods or book tax difference computations must be incorporated into the tax provision process</td>
<td>• Computation and tracking of new or altered book-tax differences</td>
</tr>
<tr>
<td></td>
<td>• Consideration should be given to the correct period to reflect the change</td>
<td></td>
</tr>
<tr>
<td>Tax accounting methods</td>
<td>• Changes to revenue recognition will impact some combination of:</td>
<td>• Analysis of relevant tax accounting methods and potential requests for changes in Tax Method of Accounting</td>
</tr>
<tr>
<td></td>
<td>o The amount of book-tax differences,</td>
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<td>o A change in the calculations of existing book-tax differences,</td>
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<td>o Creation of a new book-tax difference, or</td>
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<td>o Require a tax accounting method change</td>
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<td>• Timing and impact of method changes must be considered (automatic vs. manual, and section 481 adjustment calculation)</td>
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<td>• Enactment of tax reform could convert the timing benefits to permanent benefits thereby increasing the impact of tax planning</td>
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<tr>
<td>Area</td>
<td>Common tax considerations</td>
<td>Anticipated action items</td>
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</table>
| 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 multistate tax  | • 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 similar to the US, tax methods may need to be reviewed. For jurisdictions where the statutory fillings 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 third party customer revenue may affect intercompany royalties based on revenue. Uneven revenue recognition across jurisdictions affects revenue based allocation keys used in cost-sharing arrangements or shared services agreements. Reclassification of certain revenue to interest income affects the profitability of related entities and may need to be tested separately from the underlying transaction. Additionally, evaluation of performance obligations may result in a new or different categorization of revenue (for example, 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 (US 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 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 and related services. A common transfer pricing policy for such transactions is that the distributor earns a routine return that is typically a percentage of its revenue, and the principal is entitled to the residual profits. 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 a distributor’s ASC 606 analysis indicates that revenue should be allocated from the goods transaction to the services transaction, 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. Other implications such as Customs and VAT should also be considered.

Shared services transactions

This example (Fig. 4) is a typical shared services arrangement under which the provider earns a routine return based on costs. The adoption of ASC 606 may not necessarily affect the income of the service provider but it will impact the allocation of the service charges among the recipients of the services. Specifically, 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 facts, may not be adjusted through amended returns under Treas. Reg. Sec. 1.482-1(a) (3). It should be noted that the impact of ASC 606 may be limited if due to the use of standard contracts the allocation keys are not materially changed. The taxpayer should also review the customer contracts and applicable performance obligations to determine if there is a way to enhance 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 whereby 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 US 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 on 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 may affect the company’s calculations under the Section 482 periodic adjustments/commensurate with income (CWI) rule.

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

- Adjusting the terms of the intercompany license 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 would 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 would require more work up front to estimate the “catch-up” adjustments, but it would 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.

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 foreign cost share participant company and the US company use standard customer 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 parties use different customer contracts and the performance obligations differ significantly, then the RAB calculations may be impacted.
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 would be relatively consistent year over year, but this would require two sets of records. The company may determine RAB in accordance with ASC 606 and make an adjustment in the year of adoption.

This could result in uneven acceleration of revenue between cost sharing participants, which would affect the RAB share and require a large adjustment in the year of adoption. Alternatively, the company could determine RAB in accordance with ASC 606 and make incremental prospective adjustments. This approach would require more work upfront to estimate the “catch-up” adjustments, but it would 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. As with a licensing transaction, a material difference between recognized revenue and forecasted revenue may affect the company’s calculations under the Section 482 periodic adjustments/commensurate with income (CWI) rule.
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 up front 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 US 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 base erosion and profit shifting (BEPS) project’s Action 13, multinational organizations are required to file a country-by-country report (CbCR) that includes revenue and overall profits by jurisdiction. Tax authorities worldwide will have access to 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 in the CbCR 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 US GAAP as a basis for ASC 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 (US 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 the details.

Tax executives’ perspectives

Deloitte Tax hosted a Dbriefs webcast on February 14, 2018, to provide an overview of 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.
US ends steel and aluminum tariff exemptions for EU, Canada, and Mexico – implements quotas

On 31 May 2018, President Trump issued two Presidential Proclamations amending the Section 232 tariffs on designated steel (25%) and aluminum (10%). (Section 232 of the Trade Expansion Act of 1962, as amended (19 USC. 1862), provides for the implementation of tariffs based on national security concerns.) According to the Proclamations, the temporary exemptions to the Section 232 tariffs on designated steel and aluminum products that expired on 31 May 2018 have not been renewed. From 1 June 2018, US imports from the EU, Canada, and Mexico are subject to the additional safeguard tariffs applicable to all countries except South Korea, Brazil, Australia, and Argentina. Leaders from Canada, Mexico and the EU announced plans for retaliatory tariffs.

The Trump Administration also announced permanent exemptions for Argentina, Australia, and Brazil (steel exemption only). A Proclamation issued on 30 April 2018 had previously created a permanent exemption from the steel tariffs for South Korea. Imports of iron and steel products from Argentina, Brazil, and South Korea will be subject to absolute quotas. Aluminum imports from Argentina also will be subject to quotas.
Calendars to watch

Each edition, be sure to mark your calendars for some of the more important events (recent and upcoming) as well as tax developments making an impact on businesses investing into the United States.

Recent and Upcoming Activities

**June 13**  
2:00 p.m. ET  
*Dbriefs archive:* Transfer pricing update: Focus on Latin America  
Watch  

**July 11**  
2:00 p.m. ET  
*Dbriefs archive:* US tax reform and permanent cash tax impact: The clock is ticking  
Watch  

**July 18**  
11:00 a.m. ET  
*Dbriefs webcast:* Transfer pricing spotlight on the Commonwealth of Independent States  
Register  

**July 24**  
2:00 p.m. ET  
*Dbriefs webcast:* (Special Edition) Digital transformation and tax reform: Time for a new operating model?  
Register  

**July 26**  
2:00 p.m. ET  
*Dbriefs webcast:* Migration to SAP S/4HANA: A rare opportunity for tax  
Register  

**August 7**  
2:00 p.m. ET  
*Dbriefs webcast:* Building the business case for tax analytics  
Register  
August 30
2:00 p.m. ET

**Dbriefs webcast:** US tax reform: Gaining clarity on the international front

**Register**