SALT BUZZ HF

Beware - New Revenue Recognition Standard (ASC 606) May Have Commercial Activity Tax ("CAT") Consequences!

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Most publicly-traded companies are currently evaluating the impact of Accounting Standards Codification ("ASC" or "Standard") 606, *Revenue From Contracts With Customers,* on their financial statements. ASC 606 requires that an entity recognize revenue in an amount that reflects the consideration the entity expects to be entitled to in exchange for its sale of goods or services. The Standard could result in a company no longer recognizing certain revenue or it could change the timing of when revenue is recognized. Most companies are also evaluating whether the company should change some of its accounting methods for federal income tax purposes. Companies should also consider the impact these changes could have on taxable gross receipts for Ohio Commercial Activity Tax ("CAT") purposes. There is no existing published guidance describing how changes in revenue recognition for financial accounting or federal income tax purposes impact CAT taxable gross receipts. This SALT Buzz highlights some of the considerations for companies and tax return preparers.

The Financial Accounting Standards Board ("FASB") and International Accounting Standards Board ("IASB") jointly issued the initial guidance on May 28, 2014, but later extended the implementation dates. For public companies, ASC 606 is mandatory for annual reporting periods after December 15, 2017. Early application is only permitted for annual reporting periods beginning after December 15, 2016. The effective date for all other entities (including private companies) is annual reporting periods beginning after December 15, 2019.

CAT "Gross Receipts"

The Ohio CAT is measured by certain "gross receipts," defined as: "[t]he total amount realized by a person, without deduction for the cost of goods sold or other expenses incurred, that contributes to the production of gross income of the person, including the fair market value of any property and any services received, and any debt transferred or forgiven as consideration." The terms "amount realized" and "gross income" are not defined in the CAT chapter. R.C. 5751.01(K) provides that where terms are not defined, the definition applied in the Internal Revenue Code should be applied so long as the term is used in a comparable context and another meaning is not clear. Despite the language in R.C. 5751.01(K), the Ohio Department of Taxation ("Department") argues that "gross receipts" are defined more broadly than the definitions set forth for federal income tax or financial accounting purposes. Thus, depending on the taxpayer or the industry's specific facts and circumstances, the Department may argue that CAT gross receipts are based on the revenue recognition for financial accounting, federal income tax, or legal purposes. During an audit, the Department typically reviews the financial accounting, federal income tax, and the legal treatment of transactions to determine the appropriate CAT gross receipts. In many situations, the revenue recognition standards are consistent. For simplicity purposes, this SALT Buzz initially describes the CAT considerations assuming revenue is recognized consistently.

Recognition

Under the Standard, some companies may no longer recognize certain types of revenue, such as instances where amounts are received as a conduit for another party. In some of these situations, the Department has argued in the past that the taxpayer's gross receipts included the amounts received for another party, citing to the fact that the revenue was recognized for financial accounting purposes. With the implementation of the Standard, the company may argue that it no longer has CAT gross receipts related to that revenue. The company may also argue that it is entitled to a refund for the restated prior periods.

Alternatively, the new Standard may require that a company recognize certain types of revenue for financial accounting purposes. Because the Department argues that the CAT gross receipts are based on the financial accounting method for recognizing revenue in certain situations, companies should consider whether such revenue may be considered CAT gross receipts under the Standard.

Transition Considerations

The Standard allows companies to apply a full retrospective approach or a modified retrospective approach to implement the changes. Under a full retrospective approach, a company would restate its prior period financial statements in compliance with the Standard. Thus, a company's revenue would be restated for each comparative year provided in its financial statements (typically two to three years) under the Standard. Under a modified retrospective approach, the Standard would be applied to contracts not completed as of the effective date and the company would record a cumulative catch-up adjustment for prior periods. Thus, a company's current year revenue would be stated consistent with the Standard, but not prior periods.

To the extent a company has a change in how it recognizes revenue for financial accounting purposes, it may be unclear whether the company's CAT gross receipts are changed by the Standard. There is no specific published guidance currently. There is also no statutory provision in the CAT statute specifically incorporating changes in revenue recognition for financial accounting or federal income tax purposes, even after the completion of an audit by the Internal Revenue Service.

Tax return preparers often use trial balance information to calculate the CAT gross receipts each quarter. In the year the Standard is implemented, the company's tax return preparers should be aware of the changes to ensure the CAT gross receipts are properly calculated. For example, if a company starts to defer revenue under the Standard that it previously recognized, the company could pay CAT on receipts that were already taxed. Assume company A recognized revenue on certain contracts immediately in prior years resulting in $100 of revenue in 2016 and $200 in 2017, but under the Standard had to recognize the revenue ratably over three years. Assuming the company applied the full retrospective approach, the company would have $99 of revenue in 2018 that was already recognized ($33 in 2016 and $66 from 2017). Such a company may consider whether filing amended CAT returns for prior years is also necessary. Although the recognition of revenue may be a timing consideration, filing amended CAT returns may avoid a "whipsaw" situation where an auditor includes gross receipts in the current period (the $99 in the example above) after the statute of limitations has expired on the earlier years (e.g., 2016 and 2017) where the gross receipts were already recognized.

Where a company accelerates revenue under the Standard, it is unclear whether the revenue from prior periods would be immediately recognized as CAT gross receipts or ignored for CAT purposes. For example, assuming the same revenue in the previous example above, company B recognized revenue ratably over a three year period and switches to recognizing all the revenue in the current period resulting in an increase in revenue in 2016 of $66 and $134 in 2017. Because the CAT chapter does not appear to specifically adopt changes in accounting method for prior years, it is unclear whether that additional revenue would be CAT gross receipts. The answer may also change if the company applies the modified retrospective approach and recognizes the cumulative change in prior years in the current period. In such a situation, the Department may argue that the cumulative change recognized in the current period meets the definition of a CAT gross receipt.

Federal Income Tax Accounting Method Changes

The federal income tax impact provides another wrinkle in understanding the impact of the changes in the Standard. R.C. 5751.01(F)(4) provides that the CAT adopts the method of accounting the taxpayer uses for federal income tax purposes, including any changes in method. The Department's position is that R.C. 5751.01(F)(4) only adopts the taxpayer's use of the cash versus accrual method of accounting. If a taxpayer adopts a change in its accounting method for federal income tax purposes that does not correspond with the revenue recognition method applied in future years under ASC 606, a question may exist which accounting method should be followed for CAT purposes. The Department argues that the CAT does not adopt the federal income tax treatment in many situations. A question may also exist whether the cumulative change in a company's method of accounting for federal income tax purposes would qualify as a CAT gross receipt. A company's tax return preparers should be aware of the changes in the federal methods of accounting so that they can accurately evaluate the impact on the company's CAT liability.

Trial Balance Changes

Even in situations where a company's recognition of revenue does not change for financial accounting purposes under the Standard or for federal income tax purposes, the company may have changes in its trial balance that may impact CAT gross receipts. The Department frequently argues that amounts recorded as "revenue" on the trial balance are includible in CAT gross receipts, even though there is an offsetting "contra-revenue" account. In many of these situations, the companies do not recognize revenue (or a sale) for financial accounting or federal income tax purposes due to the offsetting accounts. Because the CAT is measured by gross receipts, the Department argues that the "revenue" is taxable gross receipts. Unless a statutory exclusion applies, the Department argues that a contra-revenue account is a cost of doing business that is not deductible. Likewise, on audit the Department frequently includes contra-expense accounts, such as shipping reimbursements, in CAT gross receipts. Financial accounting personnel should communicate to tax return preparers the changes in the trial balance, particularly to revenue, contra-revenue, and contra-expense accounts to avoid errors in the calculation of the current year CAT liability and also to evaluate any exposures or opportunities.

If you would like to discuss how ASC 606 might impact you, please contact Debora (Dardinger) McGraw or any of our other tax professionals.

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