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Revenue Recognition under §§ 451(b) & (c)
and ASC 606



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Background

1. The Tax Cut and Jobs Act of 2017 (“TCJA”) contains two new revenue recognition provisions, Internal Revenue Code (“Code”), §§ 451(b) and 451(c).
2. § 451(b) provides that in the case of a taxpayer using the accrual method of accounting, the all-events test with respect to any item of gross income (or a portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in an applicable financial statement of the taxpayer, or such other financial statement as the Secretary may specify for purposes of this subsection.

3. § 451(c) provides that in the case of a taxpayer using the accrual method of accounting and that receives an advance payment during the taxable year, the taxpayer may report the advance payment in income in the year of receipt or in the immediate subsequent taxable year, provided the taxpayer elects deferral treatment and the advance payment is deferred in revenue to a future taxable year in the taxpayer's applicable financial statements.
4. At the time of its enactment, the only legislative guidance as to the scope and meaning of these provisions is the Conference Report. In that Conference Report, the main additional guidance that is provided is contained in footnote 872, page 428. That footnote provides that § 451(b) is not intended to revise the rules associated with the determination when an item of income is realized for federal income tax purposes and does not require the recognition of income in situations where a realization event has not yet occurred. The footnote provides examples of situations where a realization event has not yet occurred, including marking unsold property to market for financial reporting purposes and treating property as either a sale for financial reporting purposes, where the transaction is treated as a lease for tax purposes, or vice versa.

5. However, in the Blue Book issued by the staff of the Joint Committee on Taxation, there is an extremely detailed explanation of the scope of §§ 451(b) and (c) that goes far beyond what is contained in the official legislative history calling into question the validity of the Joint Committee explanation.
6. The Blue Book explains that in enacting §§ 451(b) and (c), Congress took into account the adoption of ASC 606, which dramatically revises the GAAP rules for determining when revenue should be recognized for financial reporting purposes.
7. One of the most significant changes in ASC 606 is that in certain situations a taxpayer is required to use a PCM-type of method (referred to as the “over-time” model in ASC 606) in recognizing revenue for financial reporting purposes, rather than the unit-of-delivery method, which is the method that is applicable for tax purposes, if the taxpayer is not subject to § 460.

8. The PCM method would be required for financial reporting purposes if control over the work-in-process transfers to the customer as the work is performed or if the goods that are produced are of a type that would have no alternative use to the producer and if the customer were to default on the contract, the producer has an enforceable right to payment. ASC 606, §§ 606-10-25-27 & -29.
9. The new rules in ASC 606, together with § 451(b), have the potential to drastically alter the revenue recognition rules for tax purposes.

Scope of § 451(b)

1. From its predecessor in the Camp tax reform legislative proposals, we know that § 451(b) was originally directed at transactions where a result-oriented contract for the performance of services is entered into and, at the end of a taxable year, the contract is only partially performed. One of the examples in the Blue Book addresses this situation and concludes that § 451(b) is applicable in that situation.
2. In the case of partially-completed, result-oriented, service contracts, the IRS had held in letter rulings that the all-events test is not satisfied until the contract is completed. TAM 9818004.
3. Is § 451(b) intended to be limited to partially-performed service contract?

Need for a Realization Event

1. As noted above, the legislative history of TCJA indicates that § 451(b) does not override the requirement in the tax law that there be a realization event before income is recognized under § 451(b).
2. This raises a series of questions as to what constitutes a realization event for this purpose.
3. The Blue Book contains a number of examples of when a realization event does or does not occur. Several of the examples involve services. Does the realization concept even apply to services?
4. If the realization concept is applicable to services, in the contingent revenue situation addressed in the Blue Book, where a taxpayer has fully performed the required services, but there is a contingency apart from the taxpayer's performance, has there been a realization event?
5. Has there been a realization event if under the over-time model in ASC 606, revenue is recognized for financial reporting purposes before the property is completed and delivered?

Cost Offset

1. In every situation where revenue is accelerated for financial reporting purposes under ASC 606 compared with the GAAP rules in effect before ASC 606, a corresponding acceleration of expenses occurs for financial reporting purposes.
2. For example, if revenue must be reported on an over-time model for financial reporting purposes under ASC 606, costs are deductible as revenue is recognized in order to match costs with revenues.
3. This principle is expressed in paragraph 340-40-25-8, which provides that the costs of performance must be deferred until the performance obligation is satisfied. While this principle is not new, it does make it clear that if ASC 606 accelerates the time when a performance obligation is deemed satisfied and the revenue related to such performance must be recognized, then the cost of that performance must be deducted at that same time.
4. This raises the issue of whether, for purposes of § 451(b), in the case of the sale of goods revenue accelerated on a PCM basis for financial reporting purposes is calculated net of the related cost of goods sold, or is just the gross revenue accelerated by § 451(b)?

5. The precise wording in the statute refers to income (implying gross income), rather than referring to revenue or gross receipts.
6. Treas. Reg. § 1.61-3(a) defines gross income as sales revenue minus cost of goods sold.
7. For goods produced by a taxpayer, economic performance under § 461(h) is satisfied as the costs are incurred, not when the goods are provided to the customer.
8. However, the inventoriable costs are not normally deductible until the goods are sold to the customer.
9. May the actual cost of goods sold incurred at the time the revenue is recognized under § 451(b) be accelerated to match the revenue?
10. May the total estimated cost of goods sold be taken into account in advance of the transfer of the goods to the customer for purposes of § 451(b)?
11. Is there a difference between overriding the economic performance requirement and simply measuring income net of cost of goods sold for purposes of § 451(b)?

12. The Blue Book makes it clear that the Joint Committee believes that § 451(b) [and § 451(c)] may accelerate revenue without taking into account the related costs of performance, even if economic performance with respect to the performance obligation is otherwise satisfied.
13. The Blue Book makes it clear that the Joint Committee believes that § 451(b) does not require the acceleration of an offsetting deduction for the cost of performance merely because revenue is accelerated under § 451(b).
14. Is the Blue Book correct in these conclusions?

Scope of § 451(c)

1. The principal question posed by the enactment of § 451(c) is whether Congress was focused solely on the disparity in the length of the deferral periods between Rev. Proc. 2004-34 and Treas. Reg. § 1.451-5 or whether § 451(c) was also intended to cover the acceleration of cost of goods sold in Treas. Reg. § 1.451-5(c).
2. In Announcement 2004-48, accompanying the publication of Rev. Proc. 2004-34, the IRS made clear that the absence of a cost offset rule for prepaid income from the sale of goods in Rev. Proc. 2004-34 was not based on a decision that such a cost offset was not warranted.

3. Instead, the Announcement indicated that the decision was based on a desire for simplification in Rev. Proc. 2004-34 and with the acknowledgement that if taxpayers desired a cost offset, they could use Treas. Reg. § 1.451-5, in lieu of Rev. Proc. 2004-34.
4. Is a cost offset for cost of goods sold permitted under § 451(c)?
5. The Blue Book makes clear that the Joint Committee believes that no cost offset was intended by Congress in enacting § 451(c).
6. Is the Joint Committee correct?

Relationship Between § § 451(b) & (c)

1. Does the resolution of the cost offset issue under § 451(b) affect the resolution of that issue under § 451(c)?
2. Since a lot of the pressure on § 451(c) is created by the over-time revenue model in ASC 606, how is the financial conformity requirement in § 451(c) applied when a taxpayer is using the over-time model in its financial statements?
3. If revenue is recognized under § 451(b), how does that affect the determination as to which subsequent payments satisfy the prior performance and which payments relate to future performance and are eligible for the limited deferral in § 451(c)?

4. This question also leads to the question whether the IRS would consider making § 460 treatment or the book over-time method in ASC 606 elective for taxpayers using the ASC 606 over time model in their financial statements, but where § 460 would otherwise be inapplicable.
 - a. If so, what would be the eligibility rules for such an election?
 - b. Would the tax method in those circumstances literally reflect the § 460 tax rules or would it conform to the ASC 606 method employed for financial reporting purposes?
 - c. How would Schedule M adjustments affect the tax method?
5. Is the IRS contemplating making prepaid income deferral available to taxpayers without an applicable financial statement?
 - a. Under what circumstances might such deferral rules be permitted?
 - b. Would a taxpayer without an applicable financial statement that is permitted to elect a deferral method under § 451(c) also be subject to § 451(b)?
6. Is the IRC contemplating expanding the scope of the types of prepayments that would be eligible for deferral under § 451(c)?

Procedural Considerations

1. Rev. Proc. 2018-60 provides automatic consent to make changes under § 451(b).
2. A new revenue procedure has not yet been issued in order for taxpayer's to comply with § 451(c), although the IRS has made it clear that such changes will qualify for automatic consent.
3. Uncertainties exist as to which of the various automatic revenue procedures apply where situations appear to overlap more than one revenue procedure.
4. Example One – Is a change in response to ASC 606 that no longer defers advance payments considered a method change under TCJA with a four-year spread or a change under Rev. Proc. 2004-34 requiring a cut-off transition adjustment?
5. Example Two – Same as example one, except amount of deferral is reduced, but not eliminated altogether.