AICPA

July 13, 2020

Mr. John Moriarty
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Notice of Proposed Rulemaking Regarding the Taxable Year of Income Inclusion under an Accrual Method of Accounting [REG-104870-18] and Notice of Proposed Rulemaking Regarding Advance Payments for Goods, Services, and Other Items [REG-104554-18]

Dear Mr. Moriarty:

The American Institute of CPAs (AICPA) commends the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) to issue timely guidance related to section 451(b) and (c).[1] Section 451(b) and (c) were added to the Internal Revenue Code (IRC or "Code") as part of Public Law 115-97, commonly referred to as the Tax Cuts and Jobs Act (the TCJA or the "Act").[2]

On September 9, 2019, the IRS and Treasury issued notices of proposed rulemaking [REG-104870-18] and [REG-104554-18] ("the proposed regulations"). This letter is in response to the proposed regulations.

As a preface to our comments, we commend Treasury and the IRS for their responsive efforts to rapidly changing economic conditions as a result of the 2020 coronavirus pandemic. In response to comments made by Treasury Secretary Steven Mnuchin that American companies would have ample liquidity throughout the crisis period, we believe that preserving the principles of realization for the taxation of revenue to circumstances when a company has either earned, received, or has the right to receive income would provide, in effect, a liquidity boost for companies during this crisis. As we will discuss, the financial accounting changes to revenue recognition in conjunction with the TCJA changes to tax accounting revenue recognition may require companies to pay tax on income not yet earned or received, income that may never be received, or income that is a greater amount than the appropriate amount of income to be recognized under a completed transaction. Companies are facing unprecedented challenges

[1] All references to "section" or "§" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "regulations" are to U.S. Treasury regulations promulgated thereunder, unless otherwise specified.
[2] Public Law 115-97, 131 Stat. 2054.

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during this period. Our overall recommendations in these comments may provide a modicum of relief during these uncertain times while remaining within the intent of these provisions.

The AICPA is pleased to submit our comments regarding section 451(b) and (c), Prop. Reg. § 1.451-3 and Prop. Reg. § 1.451-8. Specifically, we recommend that Treasury and the IRS provide guidance on the following issues related to new section 451(b) and (c):

I. Provide criteria for taxpayers to determine when realization occurs
   1. Realization for the sale of goods
   2. Realization for the use of property

II. Provide an administrative safe harbor allowing taxpayers with certain applicable financial statements to adopt a "book percentage of completion method" of accounting

III. Eliminate the presumption rule with respect to contingent payments in proposed regulation § 1.451-3

IV. Provide that "net revenue" is the appropriate amount of recognition under the applicable financial statement income inclusion rule

V. Provide guidance addressing implications for taxpayers with alternating applicable financial statement and non-applicable financial statement years

VI. Expand the specified good rule with respect to advance payments in proposed regulation § 1.451-8

VII. Clarify when a taxpayer's obligation with respect to advance payments is satisfied

VIII. Clarify the applicable financial statement write-down rule

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We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact Connie Cunningham, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (310) 557-8544, or CCCunningham@bdo.com; Elizabeth Young, Senior Manager — AICPA Tax Policy & Advocacy, at (202) 434-9247, or elizabeth.young@aicpa-cima.com; or me at (612) 397-3071 or chris.hesse@CLAconnect.com.

Sincerely,

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable David J. Kautter, Assistant Secretary for Tax Policy, Department of the Treasury
The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service
The Honorable Michael J. Desmond, Chief Counsel, Internal Revenue Service
Ms. Wendy Friese, Tax Policy Advisor, Office of Tax Legislative Counsel, Department of the Treasury

AMERICAN INSTITUTE OF CPAs

Notice of Proposed Rulemaking Regarding the Taxable Year of Income Inclusion under an Accrual Method of Accounting [REG-104870-18] and Notice of Proposed Rulemaking Regarding Advance Payments for Goods, Services, and Other Items [REG-104554-18]

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BACKGROUND

The TCJA amended the general revenue recognition rule under section 451. This rule requires an accrual method taxpayer to recognize revenue when all the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy.[3] Prior to the TJCA, an accrual method taxpayer recognized income at the earlier of: (i) the occurrence of the required performance under the contract; (ii) the date payment is due; or (iii) the date payment is received ("all events test").[4] As amended by the TCJA, section 451(b) provides that for a taxpayer that computes income under an accrual method of accounting, the all events test is met no later than when any item of gross income (or a portion thereof) is taken into account as revenue in an applicable financial statement (AFS) of the taxpayer, or such other financial statement as the Secretary may prescribe (AFS Income Inclusion Rule). The AFS Income Inclusion Rule does not apply to income recognized under a special method of accounting.[5]

The TCJA also amended section 451 by inserting new section 451(c), which provides an accrual method taxpayer with an AFS a one-year deferral method of accounting for advance payments for goods, services, or other such items as may be identified by the Secretary. This deferral method is an exception to the general revenue recognition rules. Accordingly, section 451(c)(1)(A) also provides a "full inclusion" method of accounting for advance payments for which the deferral method is not elected.

In addition to the TCJA, many companies were required to adopt financial accounting revenue recognition changes under Accounting Standard Codification 606 (ASC 606) or International Financial Reporting Standards 15 (IFRS 15) (the "New Standards").[6] The effective dates of these standards were generally the same period as the effective date of amended section 451 for public entities and the year subsequent to the effective date of section 451 for nonpublic entities. Under the New Standards, revenue is recognized when transfer of control of the underlying asset occurs as compared to the prior generally realized or realizable and earned standard. This recognition model does not depend on whether a taxpayer has an unconditional right to payment, but rather requires recognition when an item of revenue is probable not to reverse in a subsequent

[3] Treasury Reg. § 1.451-1(a).

[4] *See* Rev. Rul. 2004-52, 2004-1 C.B. 973; Rev. Rul. 2003-10, 2003-1 C.B. 288; Rev. Rul. 84-31, 1984-1 C.B. 127.

[5] *See e.g.,* section 451(b); sections 451(d)-(k); section 453; section 455; section 456; section 458; section 460; section 467.

[6] *See* Financial Accounting Standards Board (FASB) Update No. 2019-04 and International Accounting Standards Board (IASB) IFRS 15 (2014). FASB ASC 606 is generally effective for public entities in their first reporting period after December 15, 2017 and nonpublic entities for their first annual reporting period after December 15, 2018.

reporting period. Due to this new criterion, the amount of revenue reported for financial accounting purposes may include increases in consideration which historically were not fixed and determinable (e.g., performance bonuses, renewal revenue, and revenue for which the company has not yet billed or earned). The New Standards have required many companies to accelerate the recognition of revenue as compared to prior financial reporting.

The new transfer of control model also requires more companies to move to a percentage of completion method or "over time" recognition of revenue. The New Standards require recognition over time when: (i) the customer simultaneously receives and consumes the benefits; (ii) the customer controls the asset as it is created or enhanced; or (iii) the entity's performance does not create an asset with an alternative use and the entity has an enforceable right to payment.

The AFS Income Inclusion Rule combined with the expanded universe of taxpayers subject to financial revenue recognition under the New Standards may result in many taxpayers changing their tax accounting methods for revenue recognition to comply with financial reporting changes under ASC 606. The New Standards require revenue recognition for both goods and services under a "transfer of control" model, which, generally speaking, accelerates revenue recognition as compared to legacy generally accepted accounting principles (GAAP) or IFRS. Generally, the sale of a good for tax purposes has been considered completed at a point in time – the time at which benefits and burdens of ownership transfer. The preamble to the proposed regulations under section 451(b) clarifies that the AFS Income Inclusion Rule applies to both unbilled receivables for services and unbilled receivables for the sale of goods. However, the amendments to section 451 do not change the long-standing general requirement of realization for tax purposes prior to recognition.[7] Realization requires a taxpayer to have gross income under general principles of tax law (e.g., section 61) and generally only occurs when a taxpayer takes the last step to obtain the economic gain accrued to it.[8]

Proposed Reg. § 1.451-3(c)(6)(ii) clarifies that section 451(b) does not require revenue to be accelerated if the amount is contingent on the occurrence or the nonoccurrence of a future event. The proposed regulations also state that an amount included in the AFS transaction price that is actually or constructively received, or an amount for which the taxpayer has an enforceable right to payment for performance completed to date, is not treated as contingent.

Additionally, section 451(b) only changes the timing of income recognition, and does not provide for complete book/tax conformity. Under the proposed regulations, the transaction price used to determine the amount of gross income for tax purposes does not include any amounts for items subject to the provisions of section 461 (including allowances, adjustments, rebates, chargebacks, refunds, rewards, and amounts included in the cost of goods sold), and amounts collected for third parties, which may now be contemplated as part of the transaction price under the New Standards.

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[7] H.R. Rep. No. 115-466, p. 428 n.872 (2017) (and reiterated by the Joint Committee on Taxation, General Explanation of Public Law 115-97 (JCS-1-18) at 166), "The provision does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred."

[8] *Helvering v. Horst*, 311 U.S. 112 (1940), "Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him."

Section 451(c) codifies the one-year deferral provisions under Rev. Proc. 2004-34 for advance payments for AFS taxpayers. Proposed Reg. § 1.451-8 expands the one-year deferral provisions to non-AFS taxpayers and provides AFS taxpayers with a new exclusion from the definition of an advance payment – the specified good exclusion. A specified good is a good for which:

- During the taxable year a payment is received, the taxpayer does not have on hand (or available to it in such year through its normal source of supply) goods of a substantially similar kind and in a sufficient quantity to satisfy the contract to transfer the good to the customer; and
- All the revenue from the sale of the good is recognized in the taxpayer's AFS in the year of delivery.

Also, a specified good must have a contractually provided delivery date that is more than one year after the year of receipt and that specifies the month and year of delivery listed in the written contract to the transaction.

SPECIFIC COMMENTS

I. Provide criteria for taxpayers to determine when realization occurs

1. Realization for the sale of goods

Overview

The preamble to the proposed regulations, citing the conference report[9] accompanying the Act, reinforces the intent that the revenue acceleration provision provided by section 451(b) does not require the recognition of income before an income tax realization event has occurred.[10] The preamble to the proposed regulations and the conference report acknowledge that, despite revisions to the timing rules, a taxpayer might continue to have amounts reported as revenue in its AFS that remain unrealized for tax purposes.

The requirement that income must be realized in order to be considered taxable income is a fundamental part of the income tax system. Treasury Reg. § 1.61-1(a) explicitly states that gross income includes income *realized* in any form, whether in money, property, or services. This definition encompasses all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[11] In *Eisner v Macomber*,[12] the Supreme Court determined a taxpayer did not have income from a particular transaction because no such income had been realized as a result of that transaction, providing further support that realization is a requirement for the income tax to be imposed, with a few exceptions enacted by Congress.

The Code does not define realization; the concept of a realization event has emerged in a piecemeal manner through case law and administrative guidance and has at times been used interchangeably with the all events test. In the majority of these cases, it appears that this lack

[9] H.R. Rep. No. 115-466, (2017).
[10] *Id.* at 428 n.872 (2017).
[11] *Commissioner v. Glenshaw Glass Co*., 348 U.S. 426, 431 (1955).
[12] 252 U.S. 189 (1920).

of distinction did not cause a difference in the time for recognizing gross income. However, interpretation of post-TCJA section 451(b) and particularly, the proposed regulations thereunder could, without further distinction, cause recognition of gross income prior to realization.

Also, the proposed regulations provide the definition which outlines the transaction price that is taken into account as revenue under section 451(b). The transaction price is the gross amount of consideration as determined by the taxpayer's AFS in exchange for the provision of goods, services, or other property.[13] The gross transaction price is reduced by amounts collected on behalf of third parties (for example, some sales taxes) that are not otherwise income to the taxpayer.[14] Future contingent events may affect the gross transaction price. Specifically, Prop. Reg. § 1.451-3(c)(6)(ii) provides that the transaction price does not include:

> Increases in consideration to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event (for example, bonuses contingent on performance and insurance contract commissions contingent on renewal) for the period in which the amount is contingent. Amounts included in the transaction price for AFS purposes are presumed to not be contingent on the occurrence or nonoccurrence of a future event, unless, upon examination of all the facts and circumstances existing at the end of the taxable year, it can be established to the satisfaction of the Commissioner that the amount is contingent on the occurrence or nonoccurrence of a future event. An amount included in the transaction price for AFS purposes that is actually or constructively received, that is due and payable, or for which the taxpayer has an enforceable right to payment for performance completed to date, however, will not be treated as contingent on the occurrence or nonoccurrence of a future event.

Finally, as described in the background, the transaction price does not include reductions for amounts subject to section 461.[15]

Recommendation

The AICPA recommends that Treasury and the IRS issue final regulations that provide criteria to assist taxpayers in determining when realization occurs for the sale of goods.

Analysis

With respect to the sale of property, section 1001 generally requires a realization event in the case of a sale, exchange, or other disposition of property where gain or loss from the sale or other disposition of property is the excess of the "amount realized therefrom" over the adjusted basis of the property. For determining whether there has a been a realization event for a sale of property, courts often cite *Lucas v. North Tex. Lumber Co.*[16] In this case, the Supreme Court held that gain on a sale of property was not includible in an accrual basis taxpayer's gross income

[13] Proposed Reg. § 1.451-3(c)(6).
[14] Proposed Reg. § 1.451-3(c)(6)(i).
[15] Proposed Reg. § 1.451-3(c)(6)(iii).
[16] 281 U.S. 11 (1930).

when the buyer gave notice of its exercise of an option to purchase (thereby creating an executory contract of sale), but only when the documents transferring title and possession were executed. The Supreme Court opinion relied on determining when the seller acquired an unconditional right to receive payment under the contract. Similarly, in *Commissioner v. Union Pac. R. R. Co.*,[17] the Second Circuit wrote:

> A closed transaction for tax purposes results from a contract of sale which is absolute and unconditional on the part of the seller to deliver to the buyer a deed upon payment of the consideration and by which the purchaser secures immediate possession and exercises all the rights of ownership. The delivery of a deed may be postponed and payment of part of the purchase price may be deferred by installment payments; but for taxing purposes it is enough if the vendor obtains under the contract the unqualified right to recover the consideration.

In *Hallmark Cards, Inc. v. Commissioner*,[18] the Second Circuit summarized some of the key factors taken from prior case law as follows:

> At what point in time a sale takes place is to be determined from the totality of the circumstances. While no single factor is controlling, passage of title is perhaps the most significant factor to be considered, although the transfer of possession is also significant. *Commissioner v. Segall*, 114 F.2d 706, 709-710 (6th Cir. 1940), cert. denied 313 U.S. 562 (1941). The objective is to determine at what point in time the seller acquired an unconditional right to receive payment under the contract. *Lucas v. North Texas Lumber Co.*, 281 U.S. 11, 13 (1930).

Therefore, for realization to occur, there must be an unconditional right to receive payment. Generally, for sales of property, the unconditional right to receive payment only occurs when the benefits and burdens of ownership of the property are transferred in a closed transaction. Thus, the transfer of tax ownership of property generally simultaneously results in the required realization event, as well as the event that fixes the taxpayer's right to income under the prior all events test.

Recommendation

The AICPA recommends that Treasury and the IRS remove the phrase "[i]ncreases in" at the beginning of Prop. Reg. § 1.451-3(c)(6)(ii) to broaden the scope of the provision to all contingent revenue and not only "increases in" consideration that may be contingent.

Analysis

The AICPA is cognizant of the challenges of issuing guidance on the realization concept. The proposed regulations attempt to provide more certainty through exceptions to the AFS Income Inclusion Rule. One such exception is for transactions characterized in a different manner for

[17] 86 F.2d 637, 639 (2d Cir. 1936).
[18] 90 T.C. 26 (1988).

tax purposes as compared to a taxpayer's AFS. Additional guidance with respect to these transactions would be helpful to taxpayers.[19] Another exception to the AFS Income Inclusion Rule is the exception for contingencies to the term "transaction price." For contingencies, revisions to one of the exceptions provided by the proposed regulations would help harmonize the occurrence of a realization event for the sale of goods with the all events test provided by section 451(b), which now includes the AFS revenue acceleration provision.[20]

The inclusion of the phrase "[i]ncreases in," presently provided by Prop. Reg. § 1.451-3(c)(6)(ii), may lead to confusion where the taxpayer's right to income is otherwise contingent upon the occurrence or nonoccurrence of a future event. For example, in the case of an insurance broker, the proposed regulations provide an example demonstrating that the broker's right to receive a commission is contingent on the occurrence of a future event – the renewal of the insurance policy – irrespective of whether the income is an "increase in" other consideration.[21] As the commission is included in the original contract price, it may not be perceived as an "increase" in consideration.

Certain language provided in the preamble to the proposed regulations may lead some taxpayers to conclude that the contingent revenue exception is limited in application to only certain types of variable consideration (i.e., only certain amounts that increase the fixed consideration). However, the preamble language can also be read to apply to other types of consideration that are contingent upon the occurrence or nonoccurrence of a future event. In particular, the preamble provides: "[v]ariable consideration may also include promised consideration that taxpayers are not yet entitled to under the contract because it is contingent on the occurrence or nonoccurrence of a future event." This confusion can be avoided if the preamble to the proposed regulations indicates that the contingent revenue exception applies to all consideration that is contingent upon the occurrence or nonoccurrence of a future event.

2. Realization for the use of property

Overview

Taxpayers enter into a variety of property-related transactions during the ordinary course of business. For some companies, these transactions may be straightforward – e.g., fixed, non-escalating rental payments for the use of property. For others, payments for the use of property may require escalating payments over the period of the lease term. In addition, payments for the use of property are not limited to the use of tangible property, but also extend to intangible property – licenses, trademarks, know-how, and similar transactions.

It is clear that the AFS Income Inclusion Rule does not apply to special methods of accounting.[22] As such, taxpayers who enter into agreements that are considered section 467 rental agreements

[19] Proposed Reg. § 1.451-3(e). The AFS Income Inclusion Rule does not change the characterization of a transaction to conform to the characterization of the transaction in the taxpayer's AFS.
[20] Proposed Reg. § 1.451-3(c)(6)(ii) (the contingent revenue exception).
[21] Proposed Reg. § 1.451-3(m)(10).
[22] Section 451(b)(2).

are not subject to the AFS Income Inclusion rule. However, that exception only applies to a subset of lease transactions into which a taxpayer may enter.[23]

For example, a taxpayer may enter into a lease agreement where payments for the use of property do not exceed $250,000, do not escalate over the rental period, or any escalations are tied to an index that exempts the lease from section 467. In addition, a taxpayer may also enter into an agreement to license an intangible asset such as a product or process that requires royalties to be paid throughout the agreement for the use of the intellectual property.

Similar to our comments expressing that realization is a threshold for recognizing revenue from the sale of goods, realization is also a threshold for recognizing revenue from the use of property. As we discuss below, for the use of property, such as the rental of a building or equipment, financial accounting requires a company to recognize rental income over a systematic and rational basis – typically a straight-line recognition of income over the entirety of the rental period. The AICPA notes this financial accounting requirement has been in place long before the revenue recognition changes under ASC 606.

ASC 606 does, however, change the accounting for licenses of intellectual property. Included in the ambit of ASC 606 are licenses for software and technology, motion pictures, music, other media and entertainment, franchises, patents, trademarks, and copyrights.[24] Under ASC 606, financial accounting uses the same criteria that is used for the sale of goods or services to determine when to recognize revenue. This model may require point in time recognition or recognition over time depending on transfer of control versus a benefits and burdens of ownership test. Accordingly, a company may recognize revenue in its AFS under ASC 606 for certain license transactions, even when benefits and burdens of ownership do not transfer, the company has not received payments, and the company is not entitled to bill for payment (for example, a license of intellectual property for a period of ten years in which the company is entitled to invoice for each annual period of use). When these are true leases or licenses for tax purposes, realization does not occur at the same time it does for the sale of property. The license or lease contract will condition the taxpayer's right to be paid on the continued availability and use of the property for the specific period of time that gives rise to that right. This ultimately differentiates realization in the case of a sale from realization in the case of a lease or license.

<u>Recommendation</u>

The AICPA recommends that Treasury and the IRS issue final regulations providing that realization with respect to leased or licensed property occurs over the term of the lease or license based on the terms of the contract. Thus, the final section 451(b) regulations should provide that the AFS Income Inclusion Rule does not apply to accelerate income from non-section 467 rental agreements or to licenses of intangible property where payment has not been received, the

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[23] Summarized briefly, a section 467 rental agreement is one in which there is at least one amount allocable to the use of property during a calendar year which is to be paid after the close of the calendar year; the total amount of lease payments due under the agreement is $250,000 or more; and the lease either has increasing or decreasing rents or prepaid or deferred rents.

[24] ASC 606-10-55-54.

amount has not been earned through the provision of the licensed property, and the taxpayer does not yet have the right to bill.

Alternatively, the AICPA recommends that the final regulations provide that rents under a non-section 467 rental agreement, royalties under licenses of intangible property, or license fees over an agreement that spans multiple taxable years for which the New Standards recognize revenue upfront are contingent payments that are not properly included in income until the year the amounts are due and payable under the terms of a lease or license. The final regulations should clearly include rents due under a non-section 467 rental agreement or royalties due under a license of intangible property as contingent consideration that is not included in transaction price unless and until earned through performance.

Analysis

Under ASC 842-30-25-11, a lessor is required to recognize rent payments as income in profit or loss over the term of the rental agreement on a straight-line basis unless another systematic and rational basis is more representative of the pattern that a benefit is expected to be derived from the use of the underlying tangible property, subject to ASC 842-30-25-12. Fluctuation in market rent (i.e., escalating rent payments) is not a "systematic and rational basis" to diverge from using the straight-line basis to recognize revenue from non-section 467 rental agreements for financial reporting purposes. These changes are expected to occur over the term of a rental agreement and are unrelated to the expected usage of an "underlying asset" (i.e., tangible property).[25] Thus, for financial reporting purposes, a lessor is required to recognize revenue from a non-section 467 rental agreement with escalating rent payments (e.g., rent holidays or scheduled rent increases) on a straight-line basis ratably over the term of the non-section 467 rental agreement.[26] As a result, the amount of revenue recognized in a taxpayer's AFS is greater than the rent payments allocated to rental periods in the earlier years of the non-section 467 rental agreement.

Additionally, under ASC 606, a company applies a five-step process: (1) identify a contract with a customer; (2) identify the performance obligation(s); (3) determine the transaction price; (4) allocate the transaction price to the performance obligation(s); and (5) recognize revenue when (or as) the company satisfies a performance obligation. Specifically, ASC 606-10-25-23 requires a company to recognize revenue when (or as) a company satisfies a performance obligation under a contract by transferring control of a promised good or service (e.g., an asset) to a customer.[27] Upon contract execution, a company determines whether it satisfies a performance obligation over time or at a point in time.[28] A performance obligation contained in a license for intangible property is generally satisfied at a point in time for financial reporting purposes if the license is characterized as a functional license as opposed to a symbolic license.[29] Specifically, ASC 606-

[25] *See* ASC 842-30-25-11.

[26] *Id*.

[27] Under ASC 606-10-25-25, in relevant part, control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. Control also includes the ability to prevent other [companies] from directing the use of, and obtaining the benefits from, an asset.

[28] ASC 606-10-25-24.

[29] ASC 606-10-25-30.

10-55 provides a company's implementation of ASC 606 for licensing of intellectual property that includes, but is not limited to, the following: software; motion pictures, music, and other forms of media and entertainment; franchises; and patents, trademarks, and copyrights.[30] A company transfers a license for intellectual property at a *point in time* if the language in the contract provides the customer with a right to use the company's intellectual property as it exists at the point in time the license is granted, pursuant to ASC 606-10-55-58. Therefore, a company is required to recognize revenue for financial reporting purposes from a license of intangible property to a customer when the company transfers the right to use its intangible property to the customer.[31]

Applying ASC 606 to a typical term software license arrangement results in the identification of at least two performance obligations: (1) the right to use the software (i.e., the license); and (2) customer support (e.g., software maintenance during the term). The license agreement provides for an amount payable periodically (e.g., annually) throughout the term of the agreement. Under ASC 606, the consideration due under the license agreement is allocated between the performance obligations, with the consideration allocated to the license recognized in the year the license is first made available to the customer, and the consideration allocated to the maintenance recognized ratably over the term.

As explained in more detail below, tax accounting for leases and licenses should not follow financial accounting treatment when the revenue recognized for financial accounting purposes has not been realized or is contingent on the future provision of property. For tax purposes, revenue is recognized on the basis of clearly realized accessions to wealth.[32] For example, in *Helvering v. Horst*,[33] the Supreme Court stated, "[a]dmittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining 'realization' of income as the taxable event rather than the acquisition of the right to receive it." In the context of a lease or license, the realization principle requires property to be provided to the lessee/licensee in order for income to be realized by the lessor/licensor. Thus, for tax purposes, escalating rent payments historically have been recognized as revenue in accordance with the rent allocation schedule in a non-section 467 rental agreement as this treatment reflects when the rent accrues to the lessor.[34] While not authoritative, the IRS has concluded that a taxpayer does not have a fixed and unconditional right to receive income during a rent holiday period.[35]

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[30] ASC 606-10-55-54.

[31] *See* ASC 606-10-55-58C.

[32] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429 – 30 (1955).

[33] 311 U.S. 112, 115 (1940).

[34] *See generally Piccadilly Cafeterias, Inc. v. U.S.*, 35. Fed. Cl. 330 (Ct. Cl. 1996) (finding that a payment schedule that had escalating annual rent payments was an allocation schedule under section 467).

[35] TAM 9406003 (1993) (concluding that for a lease not subject to section 467, "Whether an amount should be recognized for tax purposes under an accrual method of accounting presents a mixed question of law and fact to be determined in each instance. Here it appears that the taxpayer should recognize for tax purposes the rental payment due to it under a lease's provisions. During rent holiday periods, the taxpayer either does not have a fixed and unconditional right to payment or only has a fixed and unconditional right to the payment specified in the lease. Further, the lease's provisions provide the particular facts necessary for determining the payment with reasonable accuracy.").

Section 61(a) provides that gross income is all income from whatever source derived,[36] including (but not limited to) rent.[37] Treasury Reg. § 1.61-8(a) provides that, "[g]ross income includes rentals received or accrued for the occupancy of real estate or the use of personal property." In plain language "accrued" means "to come into existence as a claim that is legally enforceable."[38] For Federal income tax purposes, revenue generally accrues when all events have occurred that fix a taxpayer's right to revenue and the amount of this revenue can be determined with reasonable accuracy.[39]

For purposes of a non-section 467 rental agreement or a license of intangible property, a lessor/licensor has a fixed right to receive rent or a license fee when a lessee/licensee has incurred a concurrent fixed obligation to make the payment.[40] The IRS has acknowledged that the fixing event that gives rise to a taxpayer's right to revenue is that another taxpayer has a fixed and determinable liability.[41] All the events must occur that fix the fact of a liability before an expense is deductible pursuant to section 461(h)(4) and Treas. Reg. § 1.461-1(a)(2)(i). Further, the fact of a lessor's or lessee's liability is fixed upon the occurrence of the rent payment coming due or the use of the property, respectively.[42] The mere execution of a non-section 467 rental agreement and binding legal obligations thereunder, without more, does not fix the fact of the lessor's or lessee's liability for the entire obligation under the non-section 467 rental agreement.[43] Since a non-section 467 rental agreement contains mutually exclusive promises – the lessor is required to provide the property and the lessee is required to make rental payments for each period of use – the fixing of the associated liabilities are contingent on performance or tendered performance and not the mere execution of the non-section 467 rental agreement.[44]

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[36] *See also* Treas. Reg. § 1.61-1(a).
[37] Section 61(a)(5).
[38] The American Heritage Dictionary of the English Language (5th Ed. 2020).
[39] Section 451(c). *See also* Treas. Reg. § 1.451-1(a) (application of the AFS Income Inclusion Rule under section 451(b) is limited to the timing of an item of income that is otherwise properly includible in gross income under section 61).
[40] *See Capital Investments of Hawaii, Inc. v. Commissioner*, T.C. Memo. 1982-80, FN 9 (reasoning of decisions analyzing section 451 is applicable to an analysis under section 461). *See generally*, *Schneer v. Commissioner*, 97 T.C. 643, 650 (1991) (right to receive revenue cannot be fixed before the obligor has an obligation to pay).
[41] *See generally* Rev. Rul. 98-39, 1998-2 C.B. 198 ("Generally, in a transaction where one taxpayer is accruing a liability to pay another taxpayer, the last event necessary to establish the fact of the liability under the all events test of [Treas. Reg.] § 1.461-1(a)(2)(i) [(general rule for tax year of deduction)] is the same event that fixes the right to receive income under the all events test of Treas. Reg. § 1.451-1(a) [(general rule for tax year of inclusion)].").
[42] *See* Rev. Rul. 2007-3, 2007-1 C.B. 350; Rev. Rul. 80-230, 1980-2 C.B. 169; Rev. Rul. 79-410, 1979-2 C.B. 213; *Ill. Power Co. v. Commissioner*, 87 T.C. 1417, 1443 – 47 (Dec. 23, 1986) (actual payment is not required to fix the liability as long as the event fixing the liability (i.e., performance under the rental agreement) has occurred).
[43] *See Spencer, White & Prentis v. Commissioner*, 144 F.2d 45, 47 (2d Cir. 1944) ("It is well settled that deductions may only be taken for the year in which the taxpayer's liability to pay becomes definite and certain, even though the transactions (such as the contract in the present case) which occasioned the liability, may have taken place in an earlier year.").
[44] *Levin v. Commissioner*, 219 F.2d 588, 589 (3d Cir. 1955) (taxpayers that entered into a contract in year 1 for the provision of services in years 1 and 2 were not entitled to deduct the entire amount of the contract price in year 1 because the taxpayers had not incurred the entire amount of the liability in year 1). *See also Gulf Oil Corp. v. Commissioner*, 914 F.2 396, 409 (3d Cir. 1990) ("Unconditional liability under an executory contract is not created until at least one party performed."); Rev. Rul. 2007-3, 2007-1 C.B. 350 (fact of the liability is not established for an expense stemming from a bilateral contractual arrangement, that is, mutual promises, prior to the performance of the contracted for services by the oblige).

Rent payments are generally not includible in a taxpayer's gross income until the rental period to which they relate.[45] For purposes of a non-section 467 rental agreement or a license of intangible property, all events that fix the right to receive revenue occur as the property is provided under the agreement. Similarly, license fees (including any royalties) related to future license periods are contingent on the provision of property in the future and thus, should not accrue in a tax year earlier than when the property is provided.

The following example illustrates the disparate treatment of a license between financial accounting under ASC 606 and tax accounting:

> *Example 1*
>
> On January 1, 20XX, A, a calendar year accrual method corporation with an AFS entered into a three-year term software license that also includes three years of software maintenance and customer support. The agreement provides for annual payments of $300 per year due January 1st beginning January 1, 20XX. Under ASC 606, A identified two performance obligations: (1) the license; and (2) maintenance and support. A allocated the total $900 consideration in the amount of $600 to the license and $300 to the maintenance and support. On its AFS for 20XX, A reported $700 of revenue with respect to the agreement – $600 for the license and $100 for the 20XX maintenance and support.
>
> For tax purposes, the revenue is not realized until the earlier of when the taxpayer provides the right to use the property, when the amount is received, or when the taxpayer has the right to invoice. Accordingly, the taxpayer should recognize revenue of $300 in 20XX, $300 of revenue in 20X1, and $300 of revenue in 20X2.

II. Provide an administrative safe harbor allowing taxpayers with certain applicable financial statements to adopt a "book percentage of completion" method of accounting

Overview

ASC 606 requires additional companies to recognize revenue on an "over time" or percentage of completion (PCM) method of accounting. For many service providers, the use of PCM, coupled with the AFS Income Inclusion Rule of section 451, generally increases financial accounting and tax accounting conformity. However, when ASC 606 requires certain taxpayers in a manufacturing trade or business to recognize revenue over time, disparate treatment between financial accounting and tax accounting for the recognition of costs incurred creates significant income acceleration for tax with no directly related costs.[46] In addition, tracking book-tax differences related to costs previously deducted for book and capitalized for tax creates significant complexities and administrative burden.

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[45] *Consolidated Foods Corp.*, 66 T.C. at 443 (1976) (holding that a rental agreement obligation should not be regarded as under a "total commitment" theory and that a taxpayer satisfied the all events test for its rent liability "as each basic rent payment became due.").

[46] This mismatch occurs when the taxpayer cannot recognize costs over time, because revenue does not relate to a section 460 long-term contact.

Recommendation

The AICPA recommends that Treasury and the IRS issue final regulations that include an administrative safe harbor method of accounting allowing taxpayers with a certified audited financial statement prepared in accordance with GAAP or IFRS to follow their book method of "over time" PCM accounting in instances where contracts are recognized over time under ASC 606, but are not long-term contracts under section 460.[47]

Analysis

The AICPA supports the following recommendations provided by Ivins Phillip & Barker:[48]

- The frequency of transactions now required to be reported under PCM for financial accounting purposes;
- The disparity in the treatment of transactions between financial accounting and tax accounting;
- The requirement to maintain a separate inventory costing method;
- The requirement to maintain product-by-product tracking of the costs of work-in-progress; and
- The ability to mitigate difficulties in accounting for progress payments.

In addition, the optional book PCM safe harbor provides a number of overall benefits as follows:

- Increase in voluntary and correct compliance;
- Decrease IRS examination burden;
- Obviate the need for a cost of goods sold offset; and
- Provide an equitable system of accounting across a broad spectrum of taxpayers.

Treasury and the IRS received comments on the significant administrative burden taxpayers encounter when they are required to recognize revenue and costs over time for financial accounting purposes and must recognize revenue over time and their costs of goods sold when the ownership of the property is transferred for tax purposes. The AICPA echoes the concerns stated in the comment letters previously received and released by Treasury and the IRS and add our support for the addition of an optional book PCM safe harbor method of accounting. In addition to the referenced comments, we ask Treasury and the IRS to consider the voluntary compliance framework of our taxation system and the breadth of the effect of ASC 606 to a large population of taxpayers.

Many nonpublic entities did not complete their adoption of ASC 606 until well into 2019 or even into early 2020. These entities are not required to file quarterly financial statements and, accordingly, were not required to present revenue under ASC 606 until their first annual reporting period after December 15, 2018. Other recently issued financial accounting standards

[47] The AICPA believes that reliance on the certified financial statements as defined in section 451(b)(3)(A) and (B) would provide appropriate protection to the government with respect to abuse of the safe harbor.
[48] *See* Comments on Proposed Regulations Section 451(b) and Section 451(c) Reg-104870-18 & Reg-104554-18, Ivins Phillips Barker, Ctd., (November 8, 2019).

(e.g., ASC Topic 842 – Leases), as well as the continued release of the TCJA interpretive guidance and coronavirus relief provisions have strained resources for these taxpayers – many of which do not have in-house tax departments.

These entities generally receive audited financial statements as a requirement of their debt holders and are thus subject to the AFS Income Inclusion Rule. Comments previously received by Treasury and the IRS indicate that large taxpayers, even with their greater resources, face difficulty in tracking and unwinding costs incurred and expensed to the income statement under the over-time GAAP requirements. The requirement for taxpayers to perform complex procedures to determine the proper capitalization under sections 471 and 263A of expenditures deducted for financial accounting purposes creates added complexity and cost for a significant number of taxpayers. The optional book PCM safe harbor would provide relief for companies subject to the over-time/non-section 460 contract issue.

Also, the optional book PCM safe harbor would encourage voluntary compliance and reduce the examination burden of the IRS. Companies desire to comply with the TCJA changes to revenue recognition, but many of these companies are finding difficulties with developing systems and processes necessary to comply. If the intent of the AFS Income Inclusion Rule is to generally increase financial accounting and tax accounting conformity, the optional book PCM method provides an administrative avenue to further this goal.

III. Eliminate the presumption rule with respect to contingent payments in proposed regulation § 1.451-3

Overview

The proposed regulations under section 451(b) contain a presumption rule as follows: "amounts included in the transaction price for AFS purposes are presumed to not be contingent on the occurrence or nonoccurrence of a future event, unless, upon examination of all the facts and circumstances existing at the end of the taxable year, it can be established to the satisfaction of the IRS Commissioner ("Commissioner") that the amount is contingent on the occurrence or nonoccurrence of a future event."

Recommendation

The AICPA recommends that the final regulations remove the presumption rule in Prop. Reg. § 1.451-3 and that Treasury and the IRS provide additional guidance on contingent future income.

Analysis

The preamble to the proposed regulations provides that the intent of the provision is to reduce the compliance burden and prevent abuse and undue administrative burden. However, the presumption rule creates confusion as to what is considered contingent future income and what must be demonstrated in order to satisfy the Commissioner. The proposed regulations provide two examples where future income is contingent: bonuses contingent upon performance and insurance contract commissions contingent upon renewal. However, the proposed regulations do not provide any factors or additional analysis that would assist taxpayers with determining whether an item of future income is contingent.

The presumption rule creates additional uncertainty for taxpayers. Generally, the burden of proof is on the taxpayer to prove that the Commissioner's determination is in error.[49] The presumption rule under Prop. Reg. § 1.451-3(c)(6)(ii) increases the burden of proof of the taxpayer that an amount is contingent or that an amount treated as contingent on a future occurrence clearly reflects income.

The examples provided highlight clear circumstances where potential future income is contingent. A bonus for which a taxpayer has no unconditional right to receive payment (as it is not fixed until earned through successful performance) or a commission for which an agent does not have an unconditional right to receive payment (as it is not fixed until the execution of the renewal agreement) are relatively straightforward situations. However, in certain situations, such as when there is no unconditional right to receive income until milestones are met, income is in dispute, or retainages are withheld until approval and acceptance, the determination of whether an amount is contingent or has not yet been realized is uncertain. Accordingly, Treasury and the IRS should provide factors and additional examples demonstrating where income would be considered contingent and remove the presumption rule altogether.

IV. Provide that "net revenue" is the appropriate amount of recognition under the applicable financial statement income inclusion rule

Overview

The operative rule of section 451(b) requires accrual method taxpayers with an AFS to recognize an item of gross income (or portion thereof) no later than when such item (or portion thereof) is taken into account as revenue in the taxpayer's AFS.

Recommendation

The AICPA recommends that Treasury and the IRS provide final regulations that state that the appropriate amount of gross income recognized under the AFS Income Inclusion Rule is the net amount recognized in the AFS.

Analysis

The acceleration of gross income under section 451(b) has the potential to overstate the amount of income that should be subject to taxation in a given year if the final regulations do not provide for a net income effect as the operative rule. In addition to the distortion, subjecting a gross amount of revenue to taxation in one year could leave a hanging offset in a subsequent year due to the general inability to carry back losses under the TCJA, apart from the exceptions provided for under the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act").[50]

[49] *Welch v. Helvering*, 290 U.S. 111, 115 (1933).
[50] Public Law No. 113-136.

This distortion arises in situations when a taxpayer is not entitled to offset the gross revenue recognized in its AFS with the amount of cost of goods sold recognized in its AFS or with reductions to revenue in its AFS for amounts that it will never collect. If the amount of gross income accelerated under the AFS Income Inclusion Rule is gross revenue, a taxpayer will be subject to taxation of more income than recognized in its AFS.

Prior to the TCJA, a fixed right to receive income arises at the earliest of when income is received, becomes due, or is earned by the taxpayer.[51] Post TCJA, the all events test with respect to any item of gross income (or portion thereof) is met no later than when such item (or portion thereof) is taken into account as revenue in: (1) an AFS of the taxpayer; or (2) such other financial statement as the Secretary may specify. Accordingly, under the AFS Income Inclusion Rule, a taxpayer may recognize revenue earlier than received, due, or earned.

Proposed Reg. § 1.451-3(c)(4) defines "revenue" as all transaction price amounts includible in gross income under section 61. The proposed regulations define "transaction price" as the gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes in exchange for transferring promised goods, services, or other property, but does not include:

- Amounts collected on behalf of third parties that are otherwise not income to the taxpayer;
- Increases in consideration to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event (e.g., bonuses contingent on performance and insurance contract commissions contingent on renewal) for the period in which the amount is contingent; or
- Reductions for amounts subject to section 461, including allowances, adjustments, rebates, chargebacks, refunds, rewards, and amounts included in cost of goods sold.

These definitions in the proposed regulations may require taxpayers to recognize a gross amount of revenue even if the taxpayer's AFS reduces the gross revenue, either by allowances, adjustments, rebates, chargebacks, refunds, or rewards, or for costs of goods sold. In an AFS, revenue is typically reduced for contra-revenue items (such as the above-mentioned items, other than cost of goods sold) and presented at a net amount to reflect the actual consideration the company expects to receive from the transaction. The proposed regulations deny cost offsets to accelerated revenue as those items are governed under section 461 (or sections 471 and 263A). However, the appropriate amount of revenue accelerated under the AFS Income Inclusion Rule should be the net amount accelerated in the AFS.

Subjecting only the net amount to the AFS Income Inclusion Rule, whether the reduction in revenue is attributable to contra-revenue items or cost of goods sold incurred, does not accelerate the timing of a deduction under section 461; rather, it is a necessary adjustment to clearly reflect the amount of income to be recognized under the AFS Income Inclusion Rule. As indicated by several courts and expressed most clearly in *Sullenger v. Commissioner,* "[t]he cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory."[52]

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[51] *E.g., Schlude v. Commissioner*, 372 U.S. 128 (1963); Rev. Rul. 74-607, 1974-2 C.B. 149 (1974).
[52] 11 T.C. 1076 at 1077 (1948).

The following example illustrates the taxation of gross revenue:

> <u>*Example 2*</u>
>
> B, an accrual method taxpayer that manufactures tooling enters into a contract to produce a tool for A for $250x (Contract #1). Contract #1 is not subject to section 460. The contract is not complete by B's year end. During 2019, B incurs total costs to produce the tool of $100x. B expects total costs for production to be $200x. In 2019, B does not recognize any amount of income for financial accounting or federal income tax purposes.
>
> B has adopted ASC 606 for its financial accounting and B determines that revenue from its contract with A should be recognized over time. Following section 451(b), B accelerates the recognition of $125x of revenue but is not allowed a deduction for the $100x of costs incurred until the sale is completed. If the acceleration and taxation of gross receipts is the operative rule for the sale of goods, B is taxed on $125x of revenue although B's total expected gross margin is $50x. In plain terms, at a 21% corporate tax rate, B incurs a tax liability of $26.25x, which is two and one-half times the tax liability of B's expected gross margin or $10.5x ($50x x 21%).
>
> During 2020, B enters into a similar contract (Contract #2). At the end of 2020, B accelerates $125x related to revenue for Contract #2. In addition, B includes the remaining $125x from Contract #1 into revenue. B is allowed a deduction for the $200x cost of goods sold from Contract #1. However, B is not allowed a deduction for costs incurred to fulfill Contract #2.
>
> This pattern of similar contracts and revenue recognition continues for B for a number of years. However, due to economic decline and the loss of need for B's products, B ceases operations. In its final year of operations, B does not enter into any new contracts. During its final year, B recognizes $125x of revenue for its last contract and $200x of costs of goods sold. Due to the inability to carry back losses for years after 2020, B cannot offset the previously accelerated $125x of gross receipts with the appropriate amount of cost of goods sold.

The final regulations should recognize the distortive effect of the AFS Income Inclusion Rule and interpret the rule to require only the net amount to be subject to taxation prior to when an item is received, due, or earned. Any additional amount subject to taxation prior to when the item is due, received, or earned is inconsistent with the tax policy objective of section 451(b) to match financial accounting and tax accounting recognition of revenue.

V. Provide guidance addressing implications for taxpayers with alternating applicable financial statement and non-applicable financial statement years

Overview

The preamble to the proposed regulations under section 451(b) provides that the AFS Income Inclusion Rule applies on a year-by-year basis. Therefore, an accrual method taxpayer with an AFS in one taxable year, but without an AFS in a subsequent taxable year, must apply the AFS Income Inclusion Rule in the taxable year that they have an AFS. The accrual method taxpayer would also disregard the AFS Income Inclusion Rule in the taxable year without an AFS. However, the proposed regulations do not address how the taxpayer is to account for the alternating methods of accounting.

There are many cases where a taxpayer has an AFS in a prior year, but will not have an AFS in a subsequent year, or vice versa, such as in the following situations:

- A taxpayer alternates the level of assurance from year to year; receiving a certified audited financial statement in one year and a reviewed financial statement in the subsequent year.
- A taxpayer undergoes an acquisition and the pre-transaction period or post-transaction period is audited, but the remainder of the short year is not included in an AFS.

Also, a taxpayer with an AFS in a prior year may not be certain at the time they file their tax return that an AFS will be filed for the current year. While this situation is encountered mainly with taxpayers with tax years that do not match the fiscal year of their AFS (which is addressed in the proposed regulations), the preparation of financial statements may be delayed beyond filing of the tax returns. This delay creates uncertainty with regard to tax return preparation.

Recommendations

The AICPA recommends that Treasury and the IRS issue final regulations providing that a change in method of accounting occurs, and is permitted on an automatic basis, when a taxpayer alternates between an AFS and non-AFS situation. The AICPA also recommends that the final regulations include a waiver of eligibility restrictions.

Additionally, the AICPA recommends that the IRS provide an optional safe harbor for alternating AFS taxpayers, or taxpayers without an issued AFS by the filing date of the return under which the taxpayers may maintain that their method of revenue recognition is no later than the recognition in its financial statement if: (a) the prior tax year had an AFS; and (b) the current year financial statement revenue recognition method applied is consistent with the method used in the prior year.

Analysis

A taxpayer may alternate between the situation where it has an AFS that covers the entire year or it has an AFS for only a portion of the year. The examples listed in the overview section are two of the more common scenarios where a taxpayer does not have an entire taxable year covered by an AFS. If the final regulations require such taxpayers to cease applying section 451(b), particularly on a cut-off method, a distortion in income for these taxpayers is a possibility.

The AFS Income Inclusion Rule generally accelerates revenue recognition for GAAP purposes, which then accelerates the timing of revenue recognition for tax purposes. A taxpayer that is not subject to the AFS Income Inclusion Rule due to alternating or short taxable years not covered by an AFS could encounter significant losses in those tax years and significant income in a subsequent year when section 451(b) applies. These losses are caused by the reversal of previously accelerated income that is no longer subject to the AFS Income Inclusion Rule. The income is accelerated when the AFS income inclusion applies in the subsequent year.

In the case of C corporation acquisitions, the alternating application creates especially unfavorable implications where significant net operating losses (NOLs) are generated because such losses generally cannot be carried back and are limited in the future. In the subsequent year, when the taxpayer is subject to the AFS Income Inclusion Rule, significant income is potentially recognized that is attributable to the predecessor (pre-sale owners). Additionally, the alternating application of the AFS Income Inclusion Rule, while permissible, creates an administrative burden for affected taxpayers. Additional analysis is required to determine revenue recognition absent the financial statement revenue acceleration. The alternating application and implications are illustrated in the following examples:

Example 3

In 20X1, A, an engineering services firm, enters into a multi-year contract with a customer for $100x. The contract is expected to be complete in 20X4. A does not receive advance payments for its services. During 20X1 and 20X3, A has an AFS. In 20X2 and 20X4, A does not have an AFS. For financial accounting purposes, A recognizes $25x of revenue per year. Under the contract, A does not earn the revenue until 20X4.

As A does not have an AFS in either 20X2 or 20X4, the cumulative rule for multi-year contracts in Prop. Reg. § 1.451-3(k) does not apply. Accordingly, A recognizes revenue as follows:

	20X1	**20X2**	**20X3**	**20X4**
Financial accounting	$25x	$25x	$25x	$25x
Tax accounting*	$25x	($25x)	$37.5x ($25x + $12.5x)	$75x ($100x - $37.5x +$12.5x)
Section 481(a) adjustment (20X2)		($25x)		
Section 481(a) adjustment (20X3)			$50x ($12.5x per year over four year spread period)	$12.5x (continues to 20X6)
Section 481(a) adjustment (20X4)				($37.5x)
Total tax revenue recognized	$25x	($25x)	$37.5x	$75x
*Tax accounting amounts include the current portion of any required § 481(a) adjustment.				

Example 4

> Taxpayer B is a manufacturer that produces goods under contract with a production period of less than 90 days. B typically generates net taxable income of $2 million per year. B recognizes income in its AFS as the goods are produced. For tax purposes, B is not subject to section 460. Before the application of section 451(b), B recognized revenue and calculated cost of goods sold when the goods were shipped. B has an AFS and recognized $5 million of tax revenue as of December 31, 20X1. On April 30, 20X2, the stock of B is acquired by X. B will join X's consolidated group, resulting in a short period ending April 30, 20X2. Due to the acquisition, an AFS is not filed for the short period ending April 30, 20X2. If B is required to cease applying section 451(b) to the short tax year ending April 30, 20X2, it will generate an NOL of $3 million ($2 million of net taxable income less $5 million § 481(a) adjustment). The NOL cannot be carried back. Additionally, the utilization of the NOL will be limited under section 382 to B, a member of X's consolidated group. Since B is part of the AFS for X's group, for the tax year ending December 31, 20X2, B will be required to accelerate $5 million of taxable income under section 451(b) and will recognize a section 481(a) adjustment equal to such amount. Depending on the section 382 limitation, B may not be able to use the NOL generated in April 30, 20X2 to reduce the income recognized post-acquisition.

In the example, the method of accounting either creates a loss or reduces overall taxable income as compared to the AFS Income Inclusion Rule. In addition, the mechanics of the section 481(a) adjustment(s) create an administrative burden for the taxpayer and the IRS in tracking the appropriate amount of revenue to recognize. Providing a safe harbor to continue recognizing revenue in accordance with section 451(b) would provide relief.

Also, without a safe harbor, a taxpayer would have to file Form 3115 each time it alternates between being subject or not to the AFS Income Inclusion Rule. This required accounting method change poses additional taxpayer burden. Without an exception to existing eligibility restrictions, the taxpayer may have to file a non-automatic method change. Inadvertent noncompliance can also impose substantial consequences to taxpayers making a good faith effort to comply.

VI. Expand the specified good rule with respect to advance payments in proposed regulation § 1.451-8

Overview

The proposed regulations under section 451(c) generally incorporate the language and rules for advance payments as described in Rev. Proc. 2004-34. Mirroring the exclusion items under section 451(c)(4)(B), the proposed regulations provide a list of specific items which are excluded from the definition of an "advance payment" and also include an exception for payments received in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery date for a specified good. [53]

Proposed Reg. § 1.451-8(b)(9) defines a specified good. Pursuant to the proposed regulations, a specified good is a good for which: (1) During the taxable year in which payment is received, the taxpayer does not have goods of a substantially similar kind and in sufficient quantity to satisfy the contract to transfer the good to the customer; and (2) all the revenue from the sale of the good is recognized in the taxpayer's AFS in the year of delivery.

The exclusion provides for a similar deferral to the former Treas. Reg. § 1.451-5 for goods. However, unlike the deferral provided in former Treas. Reg. § 1.451-5, the specified good exclusion does not include services that are to be performed as an integral part of the sale of the good.

Lastly, the preamble to the proposed regulations states that Treasury and the IRS believe an exclusion from the advance payment rules is appropriate for certain goods for which a taxpayer requires a customer to make an upfront payment and which require a considerable amount of time to produce. However, upon excluding payments received for specified goods from the definition of an advance payment, the proposed regulations did not provide an alternative rule for the proper timing of recognizing revenue for these items when included with an integral services component. Without this clarity, taxpayers face uncertainty as to when a payment received for a specified good is recognized under the all events test under section 451.

<u>Recommendation</u>

The AICPA recommends that the final regulations include integral services as items eligible for deferral as a specified good.

<u>Analysis</u>

The preamble to the proposed regulations notes that the specified goods rule came into existence as a result of comments expressing concern regarding the one-year deferral provisions for advance payments, combined with the revocation of Treas. Reg. § 1.451-5 with respect to taxpayers that accept "pre-delivery payments for the sale of high-value customer-configured equipment that will be delivered to customers at reasonably certain times" as well as for taxpayers that produce goods which are "commercially significant or of high-value." [54]

The specified goods exclusion does not presently include the provision of integral services to the specified good. Former Treas. Reg. § 1.451-5(a)(2)(i) recognized that with the sale of goods often comes the requirement to perform services integral to the provision of those goods. For example, a durable good may be sold with a training program provided over the subsequent two to three years. Under the training program, the customer would call upon the training services provided by the taxpayer, but a specified point in time of delivery of such services would not exist.

[53] Proposed Reg. § 1.451-8(b)(1)(ii)(H).
[54] 84 Fed. Reg. at 47177.

Recommendation

The AICPA recommends that the final regulations issued by Treasury and the IRS should not include the requirement provided for in the proposed regulations that contracts for specified goods contain a contractual delivery date. We recommend that the specified goods exclusion should apply if a taxpayer reasonably expects to deliver the goods two or more years later than the year of receipt.

Analysis

The proposed regulations require a specified good to have a contractual delivery date, defined as the month and year of delivery listed in the written contract to the transaction.[55] This specified date may preclude taxpayers from using the exclusion. Many customers that enter into contracts to purchase goods that are not kept in inventory are delivered more than two tax years after the contract date and do not contractually agree to a specific delivery date/month. Based upon how the rule is currently written, it is not clear what the delivery date and quantity requirements are within the contract in order for the taxpayer to fall under the specified goods rule.

For example, a taxpayer enters into an agreement with a customer and the customer orders a series of goods with a scheduled delivered period over four years. For financial accounting purposes, revenue is recognized as each good is delivered. The taxpayer does not carry the items in its finished goods inventory and is required to purchase significant amounts of materials to construct the goods. Due to a large order of customized units, the taxpayer requires an advance payment for a significant amount of the order. Under the agreement, the taxpayer must provide a minimum amount of each good monthly. Uncertainty exists on whether this minimum monthly or yearly delivery specification meets the requirements of a contractual delivery date for specified goods under Prop. Reg. § 1.451-8(b)(8).

A limitation of the specified goods exclusion is the requirement that all revenue from the sale of specified goods must be recognized in the taxpayer's AFS in the year of delivery. This defined delivery date and a taxpayer's adoption of ASC 606 excludes many otherwise-eligible taxpayers from the scope of specified goods when such taxpayers are required to recognize revenue over time in their AFS.

Recommendation

The AICPA recommends that the IRS and Treasury provide final regulations that state that revenue is recognized entirely upon delivery, regardless of whether amounts are recognized upon delivery for financial statement purposes. In addition, we recommend that the final regulations provide a rule that payments received for the sale of specified goods are recognized at delivery.

[55] Proposed Reg. § 1.451-8(b)(8).

Analysis

Under ASC 606, entities are required to recognize revenue when (or as) the performance obligations are satisfied by transferring a promised good or service to a customer. Such goods are considered transferred when (or as) the customer obtains control of the asset.[56] In evaluating the transfer of control, there are three criteria that indicate that control is transferred over time:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.[57]

If any one of these criteria is met, the entity recognizes revenue over time. Alternatively, if none of the criteria is met, control transfers to the customer at a point in time.[58] Thus, for a transaction to meet the requirement under Prop. Reg. § 1.451-8(b)(9)(ii) that all revenue from the sale of specified goods is recognized in the taxpayer's AFS in the year of delivery, an entity must first conclude that control transfers to the customer at a point in time after failing the criteria above.

The requirements for a transaction to meet the definition of a specified good under the proposed regulations and the conditions that would result in an entity recognizing revenue in its AFS in the year of delivery (at a point in time) appear to be contradictory. For example, for an entity to conclude that revenue should be recognized at a point in time, the entity would have to determine that its performance creates an asset with an alternative use and that it does not have right to payment for performance completed to date. An asset has an alternative use to an entity if the entity is not restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or is not limited practically from readily directing the asset in its completed state for another use.[59] A practical limitation on an entity's ability to direct the asset for another use exists if an entity would incur significant economic losses to direct the asset for another use.[60] An entity would likely incur significant economic loss to direct an asset for another use if the entity were contracted for the manufacture of highly customized goods, but would presumably not incur significant economic loss to direct the asset for another use for standard goods kept in inventory. However, by definition, a specified good is an item which the taxpayer does not have substantially similar goods in inventory (or available through normal supply channels).

In the preamble to Prop. Reg. § 1.451-8, the government indicated that the specified goods exclusion was provided in response to comments requesting such a rule for commercially significant goods, such as those sold to customers in the aerospace industry. However, the

[56] ASC 606-10-25-23.
[57] ASC 606-10-25-27.
[58] ASC 606-10-25-24.
[59] ASC 606-10-28-28.
[60] ASC 606-10-55-10.

specified goods exclusion should apply to a broader group than the very limited range of taxpayers who are permitted to take advantage of the specified goods rule as written.

Excluding specified goods from the definition of advance payments subject to section 451(c) without providing an alternative rule as to the treatment of such revenue creates uncertainty. As previously described, the general revenue recognition rules require a taxpayer to recognize income upon the earlier of when an item is paid, due, or earned. In the case of specified goods, payments are made at least two taxable years prior to the contractual delivery date. If a taxpayer enters into a contract for the manufacture of specified goods for which contractual delivery is required at least two years after receipt of payment, it is unclear when the taxpayer would recognize income under the all events test. Accordingly, the final regulations should provide additional clarity to taxpayers by providing a rule that advance payments received for the sale of specified goods are not subject to the all events test under section 451(b), but rather recognized entirely upon delivery for tax purposes, regardless of the financial reporting treatment.

VII. Clarify when a taxpayer's obligation with respect to advance payments is satisfied

Overview

The AFS deferral method in Prop. Reg. § 1.451-8 incorporates many provisions similar to the deferral method provided in Rev. Proc. 2004-34. However, the preamble, as well as a specific example in the proposed regulations, imply an accrual method taxpayer with an AFS must determine when an advance payment is earned, even if the item is still deferred in the taxpayer's AFS.

The legislative history to section 451(c)[61] indicates the statute is intended to generally codify the deferral method in Rev. Proc. 2004-34. Rev. Proc. 2004-34 was issued, in part, to reduce the administrative and tax compliance burdens on taxpayers and to minimize disputes between the IRS and taxpayers regarding advance payments.[62] As part of the administrative and tax compliance burden reduction, an AFS taxpayer historically took a position that "to the extent earned" provisions of Rev. Proc. 2004-34 did not apply unless the taxpayer entered into a transaction in which the taxpayer transferred substantially all assets and liabilities. In limited circumstances, obligations may be considered satisfied prior to when fully recognized in a taxpayer's AFS, but the determination of satisfied differed from the determination of earned.

Recommendation

The AICPA recommends that the Treasury and the IRS clarify the application of the AFS deferral method in the final regulations. Specifically, the final regulations should recognize that the deferral of an obligation in the taxpayer's AFS provides both the administrative simplicity desired in Rev. Proc. 2004-34 and assurance that the underlying obligation is not considered complete because revenue has not been recognized for AFS purposes.

[61] H. Rept. 115-466 (2017).
[62] Notice 2002-79, 2002-2 C.B. 964 (2002).

We also request that the final regulations include examples of when an obligation with respect to advance payments is considered satisfied, such as when a taxpayer transfers substantially all its assets to another taxpayer. The AICPA also recommends clarifying Example 11 in Prop. Reg. § 1.451-8 to state the obligation with respect to the advance payment is satisfied (versus earned) to be consistent with the operative rule.

Analysis

The deferral method in Rev. Proc. 2004-34 provides specific requirements for when taxpayers must recognize revenue. For taxpayers with an AFS, the operative rule of the deferral method in Rev. Proc. 2004-34 is that the taxpayer is required to include:

- The advance payment in the year of receipt to the extent recognized in its AFS for such taxable year; and
- The remaining amount of the advance payment in gross income in the subsequent tax year, with certain exceptions.

Both Rev. Proc. 2004-34 and Prop. Reg. § 1.451-8(c)(2)(B) require a taxpayer to accelerate an advance payment into gross income when the taxpayer's obligation with respect to such advance payment is satisfied. The point at which an advance payment is satisfied requires a determination based on the facts and circumstances of the underlying agreement.

For taxpayers with an AFS, ASC 606 should be sufficient protection for when an advance payment is satisfied for purposes of section 451(c). ASC 606 requires companies to determine material and distinct performance obligations, allocate revenue based on an objective criterion to such performance obligations based on relative standalone selling price, and recognize revenue when each obligation is considered complete. Accordingly, deferral in a taxpayer's AFS should provide support that an obligation is not yet considered complete.

However, the preamble to the proposed regulations appears to disrupt many taxpayers' historical belief that they can follow AFS deferral without separate analysis of whether revenue is earned for tax purposes. Specifically, the preamble states:

> "Section 451(c) does not specifically address whether the deferral method may be used when an amount is earned in the taxable year but deferred for AFS purposes. The deferral method under section 451(c) is an exception to the requirement to include an amount in income when it is received. However, it is not an exception to the requirement to include an amount in income when it is earned under the all events test. Accordingly, consistent with Revenue Procedure 2004–34, these proposed regulations permit deferral of advance payments received to the extent, in the year of receipt, the amount is not included in revenue in the taxpayer's AFS and is not otherwise earned in the taxable year of receipt. The amounts not included in gross income in the year of receipt must be included in gross income in the next taxable year."

This language in the preamble is not provided for in the operative rule of the deferral method but is illustrated in Example 11 of Prop. Reg. § 1.451-8.

> Example 11 of Prop. Reg. § 1.451-8
>
> Travel agent services. On November 1, 2018, J, a travel agent, receives payment from a customer for an airline flight that will take place in April 2019. J purchases and delivers the airline ticket to the customer on November 14, 2018. J retains a portion of the customer's payment (the excess of the customer's payment over the cost of the airline ticket) as its commission. Because J is not required to provide any services after the ticket is delivered to the customer, J earns its commission when the airline ticket is delivered. The customer may cancel the flight and receive a refund from J only to the extent the airline itself provides refunds. In its AFS, J includes its commission in revenue for 2019. The commission is not an advance payment because the payment is not earned by J, in whole or in part, in a subsequent taxable year. Thus, J may not use the deferral method for this payment.

The example should clarify that a taxpayer's AFS analysis has concluded and that the performance obligation of arranging travel services is not complete until the year subsequent to the year of receipt. Inherent in the ASC 606 analysis is the requirement to determine when transfer of control of an obligation has occurred. If revenue is not recognized under ASC 606, it is very likely due to the fact that a taxpayer has a continuing obligation with respect to the advance payment.

The requirement that taxpayers must look to each agreement and each potential item within an agreement to determine the extent the item is earned creates additional uncertainty and compliance burdens for taxpayers and the IRS. Taxpayers historically have followed their AFS deferral under Rev. Proc. 2004-34 for one year and then included the remaining balance into gross income at the end of the subsequent taxable year, unless the taxpayer transferred its obligation to another taxpayer. This system of recognizing revenue to the extent recognized in the AFS as an equivalent to the "earned" standard is well understood and achieved the stated administrative objectives of Rev. Proc. 2004-34.

In addition, examples of when an obligation with respect to the advance payments is satisfied would assist taxpayers with applying the deferral method.

VIII. Clarify the applicable financial statement write-down rule

Overview

Under GAAP and IFRS, upon the acquisition of all the stock of a corporation in a purchase transaction, the amount of deferred revenue for advance payments received is typically written down on the balance sheet. The amount of the write-down is generally the difference between the unrecognized amount of the advance payment and the expected associated costs of fulfillment.

Proposed Reg. § 1.451-8(c)(3) provides a special rule for the application of the deferral method in the case of advance payments that are initially deferred in the financial statements and subsequently written down to a retained earnings account, or otherwise adjusted (advance payment adjustment rule). The IRS has previously issued advice on the appropriate treatment of an AFS write-down, and the proposed regulations mirror the conclusion in the advice.[63]

Recommendation

The AICPA recommends that the IRS and Treasury expand the special rule for the treatment of advance payments written down in the financial statements as a result of a stock acquisition to incorporate the short-period rule in Prop. Reg. § 1.451-8(c)(4). The following language is provided for inclusion in the final regulations:

> Notwithstanding section 451(c)(4)(A)(ii), if a taxpayer treats an advance payment as an item of deferred revenue in its AFS and writes-down or adjusts that item, or portion thereof, to an equity account (for example, retained earnings) or otherwise writes-down or adjusts that item of deferred revenue in a subsequent taxable year, revenue for that subsequent taxable year (or the appropriate year as determined under the rule for short periods in subparagraph (4) of this subsection) includes that item, or portion thereof, that is written down or adjusted.

Analysis

The advance payment adjustment rule requires taxpayers to include the amount of the AFS write-down (or applicable portion) into revenue in the subsequent tax year. The proposed regulations and previous advice, however do not address the interaction of the advance payment adjustment rule with the short taxable year rule. The short taxable year rule provides that if the year subsequent to the year of receipt is 92 days or less, a taxpayer using the deferral method must include the portion of the advance payment not recognized in the year of receipt to the extent included in revenue in an AFS in the short period. In plain language, for unrecognized advance payments, tax recognition during the short period equals AFS recognition.

One of the conditions of the use of the deferral method for a taxpayer with an AFS is that the advance payment (or portion thereof) must be reported in the taxpayer's AFS in a tax year subsequent to the year of receipt (the subsequent year AFS requirement). In the absence of a special rule, advance payments written down for financial accounting purposes, although meeting the subsequent year AFS requirement when tested at the time of receipt, would later fail to meet this requirement as a result of an intervening transaction (such as an acquisition of the stock of the taxpayer).

The transaction described in the overview does not involve any of the acceleration events in Prop. Reg. § 1.451-8(c)(2). Absent a special rule, it is unclear under the pre-TCJA guidance in Rev. Proc. 2004-34 whether the requirements for meeting the deferral method should be tested only at the time of receipt (in which case deferral method would be permitted notwithstanding

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[63] *See* CCA 201619009.

the intervening transaction), or whether the eligibility requirements for deferral must continue to be met at all times thereafter (in which case, the deferral method would not be allowed).

Treasury and the IRS have determined that a taxpayer should be entitled to apply the deferral method to advance payments that are written down in the AFS as described above. Specifically, the AFS adjustment rule in the proposed regulations provides:

> "[n]otwithstanding section 451(c)(4)(A)(ii), if a taxpayer treats an advance payment as an item of deferred revenue in its AFS and writes-down or adjusts that item, or portion thereof, to an equity account (for example, retained earnings) or otherwise writes-down or adjusts that item of deferred revenue in a subsequent taxable year, revenue for that subsequent taxable year includes that item, or portion thereof, that is written down or adjusted."[64]

The effect of the AFS adjustment rule as presently written is to permit, with one exception, the normal application of the deferral method in cases where some portion of the advance payment is earned by the taxpayer in a year subsequent to the year of receipt. The exception to the normal operation of the deferral method will arise in situations where the tax year following the write down is a short period of 92 days or less.

In the operation of the deferral method outside the context of the AFS adjustment rule, the proposed regulations provide another special rule that permits a taxpayer using the deferral method to defer advance payments one additional year if the year following the year of receipt is a short period of 92 days or less. However, by reason of the explicit requirement to include any written down advance payments in taxable income in the subsequent year only, the proposed regulations appear not to make the short period exception and thus the additional year of deferral available to written down advance payments. The policy underlying the short period rule is equally applicable to situations that may become subject to the AFS adjustment rule as a result of an intervening acquisition or other reasons that cause a write down of advance payments.

[64] The IRS indicated its view on this issue under prior law in CCA 201619009, which provides that the deferral method should be available to the seller and advance payments included in the buyer's income, notwithstanding a write down of the advance payments in the year following the year of receipt.