AICPA

September 13, 2017

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

Re: Revenue Recognition Standards Notice 2017-17

Dear Mr. Dinwiddie:

The American Institute of CPAs (AICPA) is pleased to submit comments as requested by the Internal Revenue Service (IRS) in Notice 2017-17, regarding the effect on taxpayers' methods of accounting of the new financial accounting revenue recognition standards, titled "Revenue from Contracts with Customers," announced by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB).

Our letter includes responses to the requested comments on issues of conformity between the new standards and the Internal Revenue Code (IRC) and related regulations, and the requested comments on procedures for accounting method changes. These comments were developed by the AICPA Tax Methods and Periods Technical Resource Panel and approved by the Tax Executive Committee.

The AICPA is the world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

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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 me at (408) 924-3508 or annette.nellen@sjsu.edu; Jennifer Kennedy, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (703) 918-6951, or jennifer.kennedy@pwc.com; or Ogochukwu Eke-Okoro, Lead Manager – AICPA Tax Policy & Advocacy, at (202) 434-9231, or ogo.eke-okoro@aicpa-cima.com.

Sincerely,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: Mr. Christopher Call, Attorney-Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Tom Moffit, Acting Deputy Associate Chief Counsel, Income Tax & Accounting, Internal Revenue Service

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Comments on Notice 2017-17

Developed by the AICPA Tax Methods and Periods Technical Resource Panel
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Comments on Notice 2017-17

I. Overview

In 2014, The FASB and IASB published a joint revenue recognition standard titled Revenue from Contracts with Customers (Topic 606 and International Financial Reporting Standards (IFRS) 15, hereafter "the new standard"). The new standard provides a framework to address revenue recognition issues for all contracts with customers regardless of industry-specific or transaction-specific fact patterns for both United States (U.S.) Generally Accepted Accounting Principles (GAAP) and IFRS, with certain limited exceptions. The new standard will affect the financial reporting practices of almost every company. When a change in the recognition of revenue is required, the change often will result in recognizing revenue sooner than is required under the current standard, though certain cases could result in later recognition of revenue compared to the current standard.

Although U.S. tax law contains specific rules with respect to the recognition of revenue for tax purposes, there are certain instances in which revenue recognition for tax purposes depends on revenue recognition for financial accounting purposes (e.g., for advance payments). In these instances, the new standard could have a significant impact on a company's cash tax position. In other instances, financial accounting changes as a result of the new standard could affect book-tax differences and deferred taxes related to revenue recognition.

After a one-year delay, the new standard generally is effective for annual reporting periods beginning after December 15, 2017 (public companies) and December 15, 2018 (nonpublic companies) for GAAP, and is effective beginning on or after January 1, 2018 for IFRS, with early adoption permitted. Companies must apply the new standards either (1) retroactively to each prior reporting period presented in the financial statements or (2) retroactively with the cumulative effect of initially applying the standard recognized at the date of initial application.

II. Legal Background

A. Highlights of the New Standard

To increase consistency in the recognition and presentation of revenue, the new standard employs a single, principles-based model for recognizing revenue that is applied to all contracts with customers to transfer goods, services, or nonfinancial assets, except contracts within the scope of other standards (such as leases, insurance contracts, certain financial instruments, guarantees, and nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers). The new standard supersedes the industry-specific standards that currently exist under GAAP, including standards for the software and construction industries.

Under the new standard, companies recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects entitlement in exchange for those goods or services. To achieve this core principle, a company must apply the following five steps:

1. Identify the contracts with the customer;
2. Identify the performance obligations in the contract;
3. Determine the transaction price;
4. Allocate the transaction price to the performance obligations in the contract; and
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

The new standard provides guidance, in the form of additional rules and numerous examples, on the application of the five steps.

Step 1 - Identify the Contracts with the Customer

The new standard provides that a contract modification is treated as a separate contract if the modification provides for the delivery of additional performance obligations at a price that reflects the stand-alone selling price for those additional obligations.

Step 2 – Identify the Performance Obligation in the Contract

The new standard provides that a performance obligation is a promise to transfer to the customer either a good or service (or a bundle of goods or services) that is distinct, or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. A good or service (or bundle of goods or services) is distinct where both of the following criteria are met:

1. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct); and
2. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

Many companies will identify additional performance obligations in their contracts which will result in either an acceleration or deferral of revenue compared to the current rules.

Step 3 – Determine the Transaction Price

The new standard explains that the transaction price is the amount of consideration that an entity is entitled to in exchange for transferring promised goods or services to a customer. The consideration promised in a contract with a customer may include fixed amounts and/or variable amounts (such as rebates, discounts, bonuses and volume discounts that are expected). In contrast, GAAP currently requires recognition of revenue when it is fixed and determinable. Note that the new standard contains a limited exception for variable consideration related to sales- or usage-based royalties from licenses of intellectual property which are not included in the transaction price until the customer's subsequent sales or usage occur.

Step 4 – Allocate the Transaction Price to the Performance Obligations in the Contract

The new standard requires the allocation of revenue among performance obligations based on relative stand-alone selling prices without regard to objective evidence of value or stated contract prices. Thus, companies no longer are required to establish vendor-specific objective evidence or third-party evidence of each deliverable to recognize revenue. Companies are also no longer subject to the "contingent revenue cap" where the amount of consideration allocated to a delivered item was limited to the consideration received that was not contingent upon future deliverables.

Step 5 – Recognize Revenue when (or as) the Entity Satisfies a Performance Obligation

The new standard explains that a performance obligation is satisfied when (or as) the customer obtains control of the good or the service. For each performance obligation, the company must determine whether the obligation is satisfied over time or at a point in time based on the criteria provided. Specifically, an entity generally satisfies a performance obligation over time if:

1. The customer simultaneously receives and consumes benefits provided by the entity's performance as entity performs;
2. The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
3. 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.

If performance occurs over time, revenue is recognized by applying a method of measuring progress toward completion of the performance obligation, such as "output methods" and "input methods" (including the percentage of completion (POC) method). In contrast, if a performance obligation is satisfied at a point in time, then revenue is recognized when control is transferred to the customer based on the presence of certain "indicators," which are a present right to payment, legal title, physical possession, risk and reward of ownership, and customer acceptance.

For licenses, special rules are provided for both GAAP (where a license of "symbolic" intellectual property (IP) (e.g., trademarks, logos, franchise rights) is transferred over time and a license of "functional" IP (e.g., software, completed media content, drug formulas) is transferred at a point in time) and for IFRS (where a license providing right to "access" IP is transferred over time and a right to "use" IP is transferred at a point in time.)

In certain cases, recognition of revenue will change from an over time model to a point in time model (e.g., production of large deliverables, license of drug formulas, etc.).

B. Overview of Tax Revenue Recognition Principles

Under general tax principles, a taxpayer must recognize revenue when it has a fixed right to receive the revenue (which generally occurs the *earlier* of when it is due, paid or earned) and the amount is determinable with reasonable accuracy.[1]

Amounts that are due or paid before they are earned (known as advance payments) are eligible for deferred recognition for tax purposes under specific provisions, such as

[1] Treas. Reg. § 1.451-1(a), Rev. Rul. 80-308, and Rev. Proc. 84-31.

Treas. Reg. § 1.451-5[2] for goods and integral services[3] and Rev. Proc. 2004-34 for goods, services, use of certain intellectual property, and other eligible payments.[4] Generally these advance payment provisions allow limited tax deferral that cannot exceed the financial accounting deferral.[5]

Revenue generated from the sale of goods generally is earned when the benefits and burdens of ownership of the good passes to the customer, which could occur upon shipment, delivery, acceptance, or title passage.[6] Revenue generated from the provision of services generally is earned when performance of the required services (or divisible services) is complete.[7] Revenue generated from the license of property is earned over the license term. And revenue related to long-term contracts generally is recognized using a POC method[8] or, if specific criteria are met, the completed contract method.[9]

Other relevant general tax principles that are implicated by the new standard include the fact that a taxpayer generally is bound by the form of its contract in defining the contract, determining deliverables under the contract, and determining the contract prices for each deliverable.[10] There are limited exceptions to this general rule provided for long-term contracts subject to section 460.[11]

III. Requested Comments on Issues of Conformity Between the New Standards and the Code and Regulations

A. Question #1 - To What Extent Would Using the New Standards for Federal Income Tax Purposes Result in Acceleration or Deferral of Income Under Section 451 or Other Income Provisions of the Code?

As outlined above, U.S. tax law contains specific rules with respect to the recognition of revenue for tax purposes that often do not align with the recognition of revenue for financial accounting under the new standard. As a result, the new standard often will result in new or modified book-tax differences as opposed to the acceleration or deferral of income under section 451. However, there are certain instances in which the recognition of revenue for tax purposes depends on the recognition of revenue for financial accounting purposes (e.g., for advance payments). If advance payments are affected, then changes in the recognition of revenue under the new standard could accelerate or defer income under section 451.

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[2] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.
[3] Treas. Reg. § 1.451-5(a)(1)(i).
[4] Rev. Proc. 2004-34, section 4.01(3).
[5] See, e.g., Treas. Reg. § 1.451-5(c)(1)(i), and section 5.02 of Rev. Proc. 2004-34.
[6] Treas. Reg. § 1.446-1(c)(1)(ii)(C).
[7] *Decision Inc. v. Commissioner,* 47 T.C. 58 (1966), Rev. Rul. 79-195, 1979-1 C.B. 177.
[8] Section 460(b).
[9] Treas. Reg. § 1.460-4(d).
[10] *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), *United States v. Fletcher*, 562 F.3d 839, 842 (7th Cir. 2009), *Commissioner v. National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134 (1974).
[11] Treas. Reg. § 1.460-1(e).

For example, under the new standard, revenue related to the license of software and pharmaceutical intellectual property is recognized upfront as opposed to over the license period, accelerating the recognition of revenue for financial accounting purposes. If this revenue is due or paid upfront and historically was deferred for tax purposes under Rev. Proc. 2004-34, then this revenue is accelerated for tax purposes under section 451.[12] Another example is when a new performance obligation is identified under the new standard, such as training provided after equipment is delivered, that would defer the recognition of revenue for financial accounting purposes. To the extent that the full contract price is due or paid when the equipment is delivered, and the taxpayer either uses or changes to the Deferral Method under Rev. Proc. 2004-34, this deferral of revenue under the new standard could result in the deferral of income under section 451.

Additional examples of deferral or acceleration of income are discussed in more detail in the responses to Questions 2 and 3 below.

B. Question #2 - What Industry and/or Transaction-Specific Issues Might Arise as a Result of the New Standards that May Need to be Addressed in Future Guidance?

Overview

There are many changes to the financial accounting rules that will affect tax accounting methods. In general, to the extent the financial accounting change implicates an advance payment (i.e., an amount due or paid in advance of being earned) which is deferred for tax purposes, then the change likely will affect the taxpayer's recognition of that advance payment for tax purposes and require an accounting method change. In these circumstances, taxpayers would benefit from IRS confirmation stating that taxpayers can follow the book deferral to the extent allowable under Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5. Taxpayers would also benefit from automatic method change procedures with normal section 481(a) adjustment spread periods to change their tax accounting methods to follow the new book recognition of advance payments.

In contrast, to the extent that the financial accounting change implicates an unbilled receivable (i.e., revenue recognized for financial accounting that is neither due nor paid), then the change likely will affect the calculation of a book-tax difference. In these circumstances, a safe harbor election or simplifying assumption is needed to alleviate the additional compliance burdens that will arise as a result of the new financial accounting rules. Note that even though in many cases the new standard will accelerate the recognition of revenue for financial accounting purposes, many (but not all) taxpayers will prefer to follow their financial accounting method in the interest of simplification.

The in-depth analysis of revenue streams and revenue recognition methods required to implement the new standard may highlight use of improper revenue recognition methods for

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[12] This conclusion assumes that the taxpayer has an applicable financial statement (AFS) and is recognizing revenue consistent with its AFS as required under Rev. Proc. 2004-34 for taxpayers that have an AFS. Taxpayers using the Deferral Method under Rev. Proc. 2004-34 that do not have an AFS will continue to recognize revenue when earned and thus are not affected by any changes in their financial statement reporting. For ease of discussion, this comment letter assumes that the taxpayer will have an AFS and is recognizing revenue under the Deferral Method under Rev. Proc. 2004-34 consistent with its AFS.

tax purposes. In these instances, the IRS should provide automatic consent for accounting method changes under section 451 and/or under section 460 with generally applicable terms and conditions as provided for under Rev. Proc. 2015-13 (e.g., audit protection, 4-year spread of positive section 481(a) adjustment) to encourage voluntary compliance with proper tax accounting principles. Because these changes often will not result directly from the financial accounting implementation of the new standard, the AICPA recommends that automatic method change procedures are not dependent on whether the tax method change is necessitated by a financial accounting change, as discussed in more detail in section III of our letter.

Below are several examples of specific issues that are expected to arise as a result of the new financial accounting standard, as well as our recommendations for the IRS.

Issue 1: Identification of Contract with Customer

a) *Contract Modifications*

Recommendation

The AICPA recommends that the IRS issue guidance that allows for tax purposes, similar rules and simplifying assumptions as the new standard, when determining if contract modifications are separate contracts.

Analysis

Under the new standard, contract modifications generally are treated as a separate contract when the modification provides for an additional performance obligation(s) at a price that reflects stand-alone selling prices of the additional obligation. For tax purposes, a taxpayer generally is not allowed to treat contract modifications as a separate contract.

In light of the fact that the rules under the new standard generally will not significantly change when revenue is recognized, the IRS should allow similar rules for tax purposes. For example, with respect to contract modifications, because the new standard requires separate contract treatment only when the contract modification provides for additional performance obligation(s) at a price that reflects the stand-alone selling price(s), treating that modification as a separate contract for tax purposes as well is not distortive. Under the new standard, contract modifications generally are treated as a separate contract when the modification provides for an additional performance obligation(s) at a price that reflects stand-alone selling prices of the additional obligation. For tax purposes, a taxpayer generally is not allowed to treat contract modifications as a separate contract.

b) *Practical Expedient*

Recommendations

The AICPA recommends that the IRS allow, for federal tax purposes, a practical expedient similar to the one provided in the new standard.

Analysis

For tax purposes, outside of special rules allowing the application of rules on a group or pool basis, a taxpayer generally is required to analyze each contract separately.[13] A practical expedient is provided under the new standard that allows for the application of the new standard to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying the guidance to the portfolio would not differ materially from applying the guidance to the individual contracts (or performance obligations) within that portfolio. Allowing a similar practical expedient for tax purposes will not materially affect the timing of when revenue is recognized.

Issue 2: Identification of Performance Obligations in General

a) *Discounts Treated as Separate Performance Obligations*

Recommendation

The AICPA recommends that the IRS provide guidance confirming the treatment of discounts treated as separate performance obligations (which creates an advance payment that is eligible for deferral under Rev. Proc. 2004-34) and ensure that any future revisions to the advance payment guidance does not change this result.

Analysis

Under the new standard, certain discounts (e.g., the right to purchase free or discounted goods) are considered separate performance obligations, likely delaying recognition of revenue. For example, where a customer purchases an item today that earns them the right to purchase another good at a discount in the future, the right to purchase goods at a discount is considered a separate performance obligation. In this instance, a portion of the revenue earned from the current transaction is allocated to the subsequent transaction and deferred for financial accounting purposes. The transaction creates an advance payment that is eligible for deferral under Rev. Proc. 2004-34 until the year following the year of receipt.

b) *Customer Loyalty Programs*

Recommendations

The AICPA recommends that the IRS provide guidance confirming the treatment of customer loyalty programs as an advance payment for financial accounting purposes within the meaning of Rev. Proc. 2004-34. We also recommend that the IRS ensure that any future revisions to the advance payment guidance does not disturb this treatment.

Analysis

Customer loyalty programs may create separate performance obligations that defer a portion of revenue earned from the current transaction until the loyalty awards are redeemed. These

[13] Treas. Reg. § 1.263(a)-4(h).

programs create an advance payment for financial accounting purposes within the meaning of Rev. Proc. 2004-34 that is eligible for deferral like any other advance payment. See separate discussion of customer loyalty programs in section III(B), issue 3 of our letter.

c) Services Performed by a Retailer for a Vendor

Recommendation

The AICPA recommends that the IRS provide guidance confirming the treatment of services performed by a retailer for a vendor that is deferred for financial accounting purposes is an advance payment within the meaning of Rev. Proc. 2004-34 that is eligible for deferral. We also recommend that the IRS ensure that any future revisions to the advance payment guidance do not affect this treatment.

Analysis

Certain services provided by retailers to vendors (e.g., cooperative advertising where a retailer issues an advertisement that contains the vendor's products) may represent a promised service in the contract and a separate performance obligation. In these instances, revenue is allocated from the saleable product to the separate performance obligation and recognized as the services are provided.

The effect of treating services performed by a retailer for a vendor as a separate performance obligation depends on when the services are provided compared to when control of the good is transferred, as well as the billing practices of the vendor. That is, if the services are provided before the related goods are transferred, and billing occurs upon transfer of goods, then the transaction may give rise to an unbilled receivable that likely is reversed for tax purposes if the services are not specifically provided for in the contract. However, if the goods are transferred before the services are provided, and billing occurs upon transfer of goods, then the transaction likely will give rise to an advance payment that is eligible for deferral under Rev. Proc. 2004-34.

d) Customer Premises Equipment – Not Separately Stated in Contract

Recommendations

With respect to customer premises equipment (CPEs), the AICPA recommends that the IRS provide guidance confirming that a taxpayer is required to follow the form of its contract and should not recognize unbilled revenue allocated to the CPEs that are not separately stated as a deliverable in the contract and recognized for financial accounting purposes. In contrast, revenue billed or paid is recognized for tax purposes because such amounts are advance payments that generally are recognized to the extent recognized for financial accounting purposes.

In addition, in interest of simplification, the AICPA recommends that the IRS provide a safe harbor that allows taxpayers to follow the financial accounting treatment of CPEs as separate performance obligations to which revenue is allocated based on relative stand-alone selling prices. Given that the CPEs almost always are delivered at the beginning of a service contract, revenue is accelerated for financial accounting purposes under the new standard. The safe harbor would alleviate compliance burdens with respect to tracking a book/tax difference for CPEs for those taxpayers who prefer to follow financial accounting. The AICPA also recommends that the IRS provide similar safe harbors for other transactions where revenue is allocated to a performance obligation that is not separately stated in the contract. See additional discussion in section III(B), issue 5 of our letter.

<u>*Analysis*</u>

Certain equipment (e.g., CPEs) such as modems and cable boxes in the telecommunications industry are treated as separate performance obligations even though not separately stated as a deliverable in the contract. In this instance, revenue is allocated from the related telecommunication service to the CPEs, and recognized when control of the CPE is transferred to the customer.

e) *Shipping and Handling Activities*

<u>*Recommendation*</u>

With respect to shipping and handling activities, the AICPA recommends that the IRS provide a safe harbor, similar to the financial accounting practical expedient that allows taxpayers to elect to not treat, as a separate performance obligation, shipping and handling activities that occur after the customer obtains control of the related good.

<u>*Analysis*</u>

Shipping and handling activities that are performed before the customer obtains control of the good are not considered separate performance obligations and are considered to fulfill the entity's promise to transfer the good. If shipping and handling activities are performed after the customer obtains control of the goods, then the activities are considered separate performance obligations. However, a company can elect to account for shipping and handling as activities to fulfill the promise to transfer the good.

Practically, these activities occur after the related good is transferred, and thus revenue is accelerated under such a safe harbor. Moreover, because shipping and handling activities often are not separately stated in the contract, following the practical expedient likely would result in following the form of the contract.

<u>**Issue 3: Identification of Performance Obligations with Respect to Customer Loyalty Program**</u>

<u>*Recommendation*</u>

The AICPA recommends that the IRS adopt, for federal income tax purposes, the new financial accounting treatment of the obligation to redeem award points under a customer loyalty program.

Analysis

One of the types of transactions that will undergo significant changes in financial accounting treatment, when the new standard becomes effective, is the treatment of a company's liability to redeem award points pursuant to a customer loyalty program. Many companies that provide goods and services to customers build customer affinity by offering customers awards pursuant to a customer loyalty program. These programs originated decades ago with programs promoting the use of trading stamps to encourage customers to remain loyal to a particular group of stores. However, more recently, these programs have expanded with the advent of frequent flyer loyalty programs sponsored by airlines and similar programs offered by hotel chains and restaurant chains, as well as retail stores.

Under these programs, a customer typically joins a program sponsored by the company and each time that the customer purchases goods or services from the plan sponsor, the customer is awarded loyalty points. The customer typically accumulates the award points and then eventually redeems the award points for no additional cost merchandise or services that are provided by the program sponsor. In some cases, the merchandise is provided by the plan sponsor itself. In other cases, the merchandise is provided by a third party.

One variation in the terms of a typical customer loyalty program is that in a few programs, customers are awarded cash refunds in exchange for making frequent purchases. Another variation in program terms is that some programs permit a customer to redeem award points to reduce the retail cost of additional merchandise purchased from the program sponsor, in lieu of waiting until the customer accumulates enough award points to acquire merchandise at no additional charge. Alternatively, some programs offer customers the opportunity to purchase additional award points in order to redeem outstanding award points for merchandise or services costing a greater amount than the redemption value of the customer's accumulated award points.

Regardless of the form of customer loyalty program, prior to the issuance of the new standard, companies typically accounted for such a program as a liability to redeem award points and a promotional expense. Thus, when a customer initially purchases goods or services in a transaction in which award points are earned, the merchant typically records the full sales price of the goods or services as current revenue. As an offset to such revenue inclusion, the merchant typically records an offsetting expense based on the merchant's best estimate of the likely cost of redeeming the award points issued in the transaction.

Some companies have followed a similar approach for federal income tax purposes.[14] However, the IRS has resisted such treatment, arguing that the offsetting expense of redeeming award points is not deductible in the taxable year in which the award points are issued to a customer, but instead is deferred until the taxable year that the award points are redeemed by a customer. The situation has resulted in considerable controversy between the IRS and taxpayers as to the proper tax treatment of redeeming award points.

Under the new standard, in most (but not all) customer loyalty arrangements, the accounting treatment of the initial sale of merchandise and services on which award points are earned, and

[14] See, e.g., *Giant Eagle, Inc.*, 822 F.3d 666 (2016), and *Gold Coast Hotel and Casino*, 158 F.3d 484 (1998).

the treatment of the offsetting obligation to redeem the award points, are modified. Instead of recognizing the entire amount of revenue earned upon the initial sale of merchandise or services, the new standard would require companies to treat a portion of the revenue earned from the sale as being allocable to the deferred performance obligation to provide merchandise or services at no charge (or at a reduced charge) in the future, when award points are redeemed. The amount allocated to the current sale of merchandise or services is recognized at the time the merchandise or services are provided to the customer, but the amount allocated to the deferred performance obligation to provide merchandise or services in the future for no additional cost (or for a reduced amount) is deferred until the award points are redeemed and the merchandise or services are provided in redemption of the award points.

The new standard cautions that this treatment is not appropriate for all customer loyalty programs. The new standard notes that where three parties are involved in a customer loyalty program, a different approach is likely required. This cautionary note in the new standard is interpreted by the accounting profession as illustrated by the following examples:

1. Fact pattern: In a two-party arrangement, a customer earns award points from a company by purchasing merchandise or services from that company and the award points are redeemable for merchandise or services provided to the customer at either no additional charge or at a reduced charge.

   In this arrangement, a portion of the sales price paid for the merchandise or services is allocated to the value of the award points issued to the customer and that revenue is deferred until the award points are redeemed. This interpretation applies irrespective of whether the company is engaged in the trade or business of providing the types of merchandise or services that are obtained in redemption of award points.

   For example, if an airline sells a ticket to a customer and issues award points to the customer, the airline should allocate the revenue from the sale of the airline ticket between the value of the airline ticket and the value of the award points. This approach recognizes the amount allocated to the airline ticket purchased by the customer as current revenue, and defers the amount of revenue allocated to the award points until the award points are redeemed for a ticket at no additional cost or some other type of award.

2. Fact pattern: In a three-party arrangement, a merchant sells award points to an unrelated third party, which then issues those award points to customers of the third party. The revenue from the sale of the award points is deferred until the award points are redeemed by the purchaser's customers.

   For example, a hotel chain sells award points to a financial institution and the financial institution provides credit cards and issues award points to customers. The customers use the financial institution's credit card to purchase merchandise or services which enables them to redeem the award points for free hotel stays at the merchant's hotel chain. The hotel chain must defer the revenue derived from the sale of the award points to the financial institution until the financial institution's credit card holders redeem their award points for hotel stays. The purchaser of the award points (i.e., the financial institution) is not viewed as earning any deferred revenue from the issuance of the award points.

The IRS should adopt, for federal income tax purposes, the new financial accounting treatment of the obligation to redeem award points under a customer loyalty program. The treatment proposed under the new standard is the proper treatment of the transaction for federal income tax purposes. In an arm's length relationship between a retailer and its customers, it is not economically realistic to view the merchant as selling the customer one item of merchandise or services for its full retail price, while providing the customer with a second item of merchandise gratuitously. In this type of situation, the courts have uniformly treated the merchant as selling each item of property for an amount based on an allocation of the lump-sum sales price among the items of property and/or services purchased by the buyer in proportion to their relative fair market values.[15]

In the case of a customer loyalty program, the award points issued in exchange for the purchase of merchandise or services has a value to the purchaser as well as a cost to the seller. Since the parties have an arm's length commercial relationship, it is not appropriate for tax purposes to view the award points as a gift to the purchaser of the merchandise or services.

Depending on the nature of the arrangement and whether merchandise or services are involved, it is appropriate to defer the revenue allocated to the award points, either under the authority of Treas. Reg. § 1.451-5 or Rev. Proc. 2004-34. The deferred revenue is recognized when the award points are redeemed, limited by the following:

1. If revenue is deferred using the application of Rev. Proc. 2004-34, the deferral period may not extend beyond the end of the taxable year immediately subsequent to the taxable year in which the revenue was received; and
2. If the revenue is deferred using the application of Treas. Reg. § 1.451-5, the deferral period may not extend beyond the end of the second taxable year immediately subsequent to the taxable year in which the revenue is received. This limitation is due to the limitation on the deferral of substantial advance payments contained in Treas. Reg. § 1.451-5(c).

Issue 4: Determination of Transaction Price

Recommendations

The AICPA recommends that the IRS clarify whether contingent consideration that is due or paid but not earned under the tax law is recognized for tax purposes if it is recognized for financial accounting purposes. If recognized, the AICPA recommends that the IRS provide procedures allowing the eligibility of a method change for automatic consent with normal terms and conditions (in particular, a 4-year spread of the section 481(a) adjustment). The AICPA also recommends that the IRS clarify the definition of advance payment under Rev. Proc. 2004-34 to make it clear whether contingent consideration is included within the scope of the guidance.

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[15] See, e.g., *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945); *First Pennsylvania Banking & Trust Co. v. Commissioner,* 56 T.C. 677 (1971).

Analysis

To the extent that it is probable (GAAP) or highly probable (IFRS) that a significant reversal of such revenue will not occur in future periods, variable consideration is required in the transaction price. Taxpayers must base the estimate of variable consideration on the expected value or most likely amount approach (whichever is more predictive). In contrast, under current GAAP and IFRS, variable consideration is recognized only when fixed and determinable.

Volume rebates are also considered variable consideration that are reflected in the transaction price to the extent that they will probably achieve the relevant threshold. In contrast, under current GAAP, volume rebates generally are not taken into account until the relevant threshold is met.

For example, in the pharmaceutical and life sciences industry, common arrangements with variable consideration include licensing arrangements with milestone payments, and distributor arrangements with rebates, price protection, or other incentives. Technology companies often enter into arrangements with variable amounts, such as performance bonuses for timely completion of deliverables, service level guarantees with penalties, and refund rights, due to their focus on customer adoption of cutting-edge products. In the entertainment and media industry, variable consideration may include performance bonuses for advertising, audience shortfalls for television, volume discounts on usage rates, tiered promotional pricing on voice and data access, and price protection on digital video disc sales.

To the extent that the contingent revenue is due or paid but not earned, under tax law the amount is considered an advance payment that is recognized for tax purposes as well because advance payments currently are not deferred for tax purposes if not deferred for financial accounting purposes. However, this conclusion is not entirely clear because current guidance (i.e., Rev. Proc. 2004-34) defines an advance payment as an amount that is recognized in whole or in part in a subsequent taxable year for financial accounting purposes, and it is likely not known whether any amount of the contingent revenue will be recognized in a subsequent taxable year for financial accounting purposes. Moreover, the current definition in Rev. Proc. 2004-34 also reaches the result that contingent revenue recognized for financial accounting purposes entirely in the year of receipt is not considered an advance payment under the guidance because no amount may be recognized in a subsequent tax year. But, contingent revenue that is recognized in part in the year of receipt and in part in a subsequent year, due solely to a true up of estimated amounts, is considered an advance payment.

To the extent contingent revenue is not due or paid (i.e., creates an unbilled receivable or “contract asset” for financial accounting purposes), the IRS should confirm that it is appropriate for taxpayers to reverse the financial accounting recognition of that revenue until the earlier of when it is due, paid or earned under the tax law.

It is expected that recognition of contingent revenue for financial accounting purposes will increase the prevalence of “unbilled receivables” that are recognized the earlier of when the revenue is due, paid or earned under the tax law. This fact will likely put more pressure on the meaning of “due” in the “due, paid or earned” standard, which generally is an undefined term in the tax law.

Thus, we recommend that the IRS issue guidance to clarify when an amount is due for this purpose. For example, a taxpayer sends an invoice with normal commercial payment terms where the customer has 30 days to submit payment. It is unclear if the amount is due as of the invoice date or 30 days later. With respect to this fact pattern, the AICPA notes that in some cases, taxpayers for valid business reasons send invoices with non-standard payment terms, such as the customer has six months or a year to pay. In these instances, it is the AICPA's recommendation that the amount is due based on an invoice date when the invoice contains normal commercial terms (e.g., payment due in 30 days) and based on contractual terms when payment is due under the contractual terms six months or a year after providing the invoice.

Issue 5: Allocation of Transaction Price

Recommendations

The AICPA recommends that the IRS provide a book conformity safe harbor that allows taxpayers to follow the financial accounting allocation of the transaction price in a contract.

Given that the allocation of the transaction price under the new standard is based on the underlying economics of the transaction, and an allocation theoretically already is required if the contract does not explicitly provide prices for each deliverable, the AICPA recommends that the IRS allow the book conformity safe harbor in all circumstances. At a minimum, the AICPA recommends that the IRS allow the book conformity safe harbor in circumstances where revenue is accelerated with regard to the tax law (similar to the book conformity rule allowed under the tangible property regulations).[16]

Analysis

Under the new standard, the transaction price is allocated to each performance obligation in a contract based on the relative stand-alone selling prices (RSSPs) of each performance obligation as opposed to the contract prices, if any. Examples of circumstances where this allocation is relevant are widespread. In the retail and consumer products industry, for example, an extended warranty that is distinct from the product is a separate performance obligation, and revenue is allocated to that performance obligation based on the RSSP rather than based on the stated contract price, if any.

In the technology industry, consideration is allocated to each performance obligation (e.g., software licenses and maintenance services) based on RSSP regardless of whether there is vendor specific objective evidence (VSOE) of the selling prices of each performance obligation and regardless of stated contract prices. For pharmaceuticals and life sciences industries, consideration may be allocated to no cost products or discounted equipment such as medical devices based on the RSSP if they are separate performance obligations from the related goods and maintenance services. In aerospace and defense industries, consideration may be allocated to no cost products or discounted equipment such as wheels and brakes based on the RSSP if they are separate performance obligations from the related maintenance services. The entertainment and media industries generally must allocate consideration to no cost products or discounted equipment such as advertising spots, handsets or

[16] See, e.g., Treas. Reg. § 1.263(a)-1(f)(1).

telecommunications equipment based on the RSSP price if they are separate performance obligations from the related telecommunications services.

If taxpayers are bound to follow the form of their contract, then they must allocate the transaction price to each deliverable stated in the contract based on stated contract prices as opposed to allocating the transaction price to each identified performance obligation based on the RSSPs. Such a rule, theoretically, would require taxpayers to restate contract prices on a deliverable-by-deliverable and transaction-by-transaction basis, which is a significant, and in some cases, impossible undertaking. In instances where a contract contains multiple deliverables for a single price, a taxpayer is generally required to allocate the total transaction price for tax purposes based on relative fair market values, as noted in the discussion above in section III(B), issue 3 of our letter. Thus, the tax law currently could treat similarly situated taxpayers differently if a taxpayer is required to strictly follow the form of the contract.

In many instances, the combination of the new standard's requirements to identify performance obligations that are not stated in the contract and to allocate the transaction price based on RSSP will result in an acceleration of revenue because the transaction price is allocated away from ongoing services to an upfront deliverable. Taxpayers will have a significant compliance burden if they are required to allocate revenue from a single transaction differently for book and tax purposes. To alleviate this burden, the IRS should provide a book conformity safe harbor that allows taxpayers the option to follow the financial accounting allocation of the transaction price in a contract.

Issue 6: Transfer of Control

a) *Sell-Through Arrangements*

Recommendation

The AICPA recommends that the IRS provide an automatic method change with normal terms and conditions, including a 4-year spread period of a section 481(a) adjustment, for taxpayers that must change the treatment of their sell-through arrangements.

Analysis

Current financial accounting rules defer the recognition of revenue under certain sell-through arrangements with distributors until the product is sold by the distributor to the end customer. This approach is used, for example, because the distributor is thinly capitalized, does not have a high-grade credit rating, or can return the unsold product, rotate older stock, or receive price concessions, or because the entity cannot reasonably estimate returns or concessions. Under the new standard, revenue is recognized when goods are transferred to the distributor as opposed to when the distributor sells the goods to the end customer.

Taxpayers that currently follow the book deferral of sell-through arrangements under Rev. Proc. 2004-34 will need a method change to recognize revenue when the goods are sold to the distributor. In this instance, taxpayers are uncertain whether they are within the scope of the current automatic provision under Rev. Proc. 2004-34 because the transaction no longer will give rise to an advance payment within the meaning of Rev. Proc. 2004-34. That is, following the implementation of the new standard, no portion of the revenue from a sell-through arrangement is recognized in a subsequent year in the taxpayer's AFS.

b) Technology Industry

<u>*Recommendations*</u>

The AICPA recommends that the IRS issue guidance confirming that licenses of intellectual property are earned for tax purposes over the license period. Currently, this general tax principle is not addressed clearly in regulations or rulings.

Also, there is the potential for significant distortion if the section 481(a) is recognized in one year and there is a need for relief to pay additional taxes due. Therefore, the AICPA recommends that the IRS revise the terms and conditions applicable to changes in the recognition of advance payments deferred under Rev. Proc. 2004-34 to apply the general terms and conditions under Rev. Proc. 2015-13 which are applicable to most accounting method changes.

<u>*Analysis*</u>

In the technology industry, under the new standard, licenses of software generally are recognized upfront at the point when the license is granted as opposed to over the term of the license agreement as generally recognized under the old standard. Maintenance services are likely recognized over the term of the license agreement.

The new standard is expected to significantly accelerate the recognition of software license revenue. To the extent this acceleration does not implicate an advance payment (i.e., the amount is not due or paid), then presumably the taxpayer should continue to recognize the license revenue over the term of the license for tax purposes.

To the extent the acceleration of license revenue under the new standard implicates an advance payment, then taxpayers likely must follow the financial accounting recognition of that license revenue because advance payments generally are not deferred for tax purposes longer than deferred for financial accounting purposes. Current guidance requires a method change when financial accounting changes the recognition of advance payments that are deferred under Rev. Proc. 2004-34. However, this change is implemented on a cutoff basis. In many advance payment situations, implementing a method change on a cutoff basis effectively equates to a one-year spread of a section 481(a) adjustment where the taxpayer is required to recognize income under the new accounting method fully in the year of change.

c) Pharmaceutical and Life Science Companies

<u>*Recommendations*</u>

To the extent that the acceleration of revenue implicates an unbilled receivable because the license revenue is neither due nor paid, the AICPA recommends that the IRS allow companies to continue to recognize the license revenue over the license term for tax purposes.

The AICPA also recommends that the IRS provide an automatic method change with normal terms and conditions (e.g., 4-year spread of positive 481(a) adjustment) for taxpayers that are required to change their method of accounting for license revenue.

<u>*Analysis*</u>

Pharmaceutical and life science companies that license intellectual property such as drug patents and formulas generally will recognize the license revenue upfront when the intellectual property right is granted as opposed to over the term of the license agreement. Similar to the above discussion with respect to software licenses, the recognition of revenue attributable to licenses of intellectual property by pharmaceutical and life sciences companies is expected to significantly accelerate.

To the extent the acceleration of revenue implicates an advance payment because the license revenue has been billed or paid, companies will likely need to follow the financial accounting recognition of the license revenue for tax purposes.

d) Entertainment and Media Companies

<u>*Recommendation*</u>

The AICPA recommends that the IRS provide an automatic method change with normal terms and conditions (e.g. 4-year spread of positive 481(a) adjustment) to recognize license revenue the earlier of when it is due, paid or earned (i.e., over the license term).

<u>*Analysis*</u>

Entertainment and media companies that license entertainment content (e.g., films and syndicated television series) likely will recognize the license revenue upfront when the content is made available to the customer, which generally is consistent with current financial accounting rules. Entertainment and media companies that currently follow the financial recognition of unbilled license revenue upfront likely will need to change their method to recognize the revenue the earlier of when it is due, paid or earned in accordance with section 451.

e) Percentage of Completion Method

<u>*Recommendations*</u>

In the interest of simplification, the AICPA recommends that the IRS allow book-tax conformity when a taxpayer is required to use the POC method for financial accounting purposes, but is not permitted to use the POC method for tax purposes under section 460 (e.g., for government production contracts for items that are not unique and do not take more than 12 months to produce).

The AICPA also recommends that the IRS allow book-tax conformity when a taxpayer is required to use the POC method for book and tax purposes, but uses a different measurement to determine contract completion.

Both of these proposed rules of convenience are important to smaller taxpayers that will have more difficulty maintaining two different revenue recognition methods for their contracts.

Analysis

In the aerospace and defense industry, many contracts currently accounted for at a point in time (e.g., using a units-of-delivery method) are recognized over time (e.g., using the POC) under the new standard because control is transferred during the production period. For example, government contracts typically require progress payments and an unconditional obligation to pay in exchange for the customer controlling any work in process, factors which will cause the transfer of control over time for these contracts.

In many instances, taxpayers would like to follow their book method of accounting for contracts even when use of the POC method would accelerate the recognition of revenue.

C. Question #3 - To What Extent do the New Standards Deviate from the Requirements of Section 451? In What Situations Should the IRS Allow Taxpayers Who Adopt the New Standards to Follow Their Book Method of Accounting for Tax Purposes (for Example, Where Income is Always Accelerated)?

Recommendation

The AICPA recommends that the IRS permit taxpayers to follow financial accounting under certain safe harbors in the interest of simplification as suggested in more detail in section III(B), Question 2 above.

Analysis

Recognition of revenue under the new standard often will not align with the general tax principles outlined above. However, to the extent that revenue recognized under the new standard implicates an advance payment (i.e., the amount recognized for financial accounting is due or paid), then that recognition generally is followed for tax purposes because advance payments generally are not deferred for tax purposes if the advance payments are recognized for financial accounting purposes. In many cases the new standard will accelerate the recognition of advance payments for financial accounting purposes, resulting in an acceleration of advance payments for tax purposes. Some of these specific examples are discussed in more detail in the response to section III(B), Question 2 above.

In contrast, if revenue recognized under the new standard implicates an unbilled receivable (i.e., revenue recognized for financial accounting that is neither due nor paid), then taxpayers will need to consider when that revenue is earned under general tax principles with regard to when earned under the new standard. In general, the rule on when revenue is earned under the new standard differs most significantly from the general tax principles is with respect to the timing of the recognition of non-divisible service revenue (which is recognized over time for financial accounting and when services are complete for tax purposes) and license revenue (which is recognized upfront for financial accounting and over the license period for tax purposes).

Significant differences also arise under the new standard with respect to the use of the POC method for financial accounting purposes for contracts that are not subject to Section 460 and thus not eligible for the POC method for tax purposes. In addition, the requirement to recognize contingent revenue under the new standard differs significantly from general tax principles that require recognition of unbilled revenue only when fixed and determinable (which was the old financial accounting standard).

Finally, the financial accounting requirement to recognize revenue based on relative stand-alone selling prices of each performance obligation as opposed to stated contract prices also will create significant compliance burdens.

D. Question #4 To What Extent do the Rules Regarding Allocation of Stand-alone Sales Price and Transaction Price in the New Standards Affect Taxpayers' Ability to Satisfy Their Tax Obligations?

Under the new standard, the transaction price is allocated to each performance obligation in a contract based on the RSSPs of each performance obligation as opposed to the stated contract prices, if any. The requirement to allocate revenue from a single transaction differently for book and tax purposes will create significant compliance burdens on taxpayers.

Specific examples of how the different allocation requirements will affect the ability of taxpayers in certain industries to satisfy their tax obligation are explained in more detail in response to section III(B), Question 2, issue 5 above.

3. Requested Comments on Procedures for Method Changes

A. Question #1 - Is the Exception for Small Businesses in Paragraph 5.02(2) of the Proposed Revenue Procedure Appropriate?

Recommendation

The AICPA recommends that the IRS provide taxpayers, which fall into the small business exception, the option to implement a change in method of accounting based on a certain cutoff (e.g. based on the gross receipts of a business) or with a section 481(a) adjustment. The AICPA recommends that the IRS define small business taxpayers as trades or businesses with gross receipts under $10 million (averaged over the prior three years) or assets under $10 million.

Analysis

Section 5.02(2) of the proposed revenue procedure allows certain small taxpayers to make a qualifying same-year method change on a cutoff basis. The new standard is implemented for financial accounting purposes with a cumulative adjustment made to the taxpayer's equity either in the year preceding the year of adoption (under modified retrospective approach) or in the first year presented in the financial statements (under full retrospective approach). This cumulative adjustment functions similar to a section 481(a) adjustment in that the taxpayer cumulatively catches up to the new method, and will not continue to account for revenue from existing contracts using the old method.

As a result, implementing a change in method of accounting for advance payments (where the taxpayer is required to follow the financial accounting change for tax purposes as discussed in III(B) of our letter) on a cutoff basis is burdensome for two reasons. First, the taxpayer is required to apply the old financial accounting law to recognize revenue from contracts entered into prior to the qualifying same-year method change. Second, the impact of revenue accelerated under the new standard generally would fall entirely in the year of change as opposed to being spread over four taxable years if the change is implemented with a positive section 481(a) adjustment. To avoid these implications if a cutoff method is required, taxpayers are forced to change to a full inclusion method in the year of adoption of the new standard, and then subsequently change back to a Deferral Method.

As written, it is ambiguous whether the exception for small businesses allows for the option of implementing the change in method of accounting on a cutoff basis or whether such taxpayers are required to implement the change on a cutoff basis. For the reasons explained above, it is expected that small business would prefer to implement any required changes with a section 481(a) adjustment.

The burden on small businesses is reduced if they are allowed the option to implement any required method changes within a year of change that would allow the cumulative catch up adjustment computed for financial accounting purposes as the necessary section 481(a) adjustment for the tax method change. For example, a taxpayer that implements a change in the recognition of advance payments in 2018 using the full retrospective approach is required to compute a cumulative catch up adjustment for financial accounting purposes that is booked to equity in the first year presented in the financial statements, or as of January 1, 2016. Because that change is effective in 2018, and is reflected in 2016 and 2017 in the financial statements for presentation purposes only, the change is made in 2018 for tax purposes with a section 481(a) adjustment computed as of January 1, 2017. If instead a method change was allowed for 2017, then the section 481(a) adjustment required for tax purposes would align with the cumulative catch up adjustment computed for financial accounting purposes.

For this purpose, the IRS should define small business taxpayers as trades or businesses with gross receipts under $10 million (averaged over the prior three years) or assets under $10 million. This standard is the same small business taxpayer definition included in Rev. Proc. 2015-20 for purposes of adopting the tangible property regulations. There is precedence for this approach in that the IRS previously provided a safe harbor for taxpayers who changed their book method of recognizing advance payments in revenues and used their new book method in determining the amount of advance payments included in gross income under the Deferral Method without securing the consent of the Commissioner of the Internal Revenue Services ("Commissioner").

B. Question #2 - What Types of Changes in Methods of Accounting do Taxpayers Anticipate Requesting?

Taxpayers will need to make accounting method changes for general revenue recognition issues pursuant to section 451, as well as for advance payments accounted for in accordance with Rev. Proc. 2004-34.

a) *General Revenue Recognition*

<u>Recommendations</u>

The AICPA recommends that the IRS provide, for a limited period of time, automatic consent for taxpayers to change to a permissible method under sections 451 and 460, regardless of whether the change results from the implementation of the new standard.

If, the IRS does not provide a blanket automatic method change, then the AICPA recommends that new automatic consent method changes are provided for a taxpayer to defer advance payments for inventory goods under Treas. Reg. § 1.451-5 and to recognize unbilled receivables when earned. With respect to unbilled receivables, the AICPA recommends that an automatic change is provided to recognize income from the provision of services or from the license of property in the year that all the events have occurred that fix the right to receive the income and the amount of the income is determined with reasonable accuracy.

<u>Analysis</u>

Taxpayers will identify general revenue recognition issues during implementation of the new standard because they will thoroughly analyze their revenue recognition policies during the process of adopting the new standard.

Currently automatic accounting method changes for revenue recognition issues under Rev. Proc. 2017-30 are limited to method changes for the following items:

1. Accrual of interest on nonperforming loans;
2. Advance rentals;
3. State or local income or franchise tax refunds;
4. Capital cost reduction payments;
5. Credit card annual fees;
6. Credit card late fees;
7. Advance payments;
8. Credit card cash advance fees;
9. Retainages; and
10. Advance payments – change in AFS

Unless taxpayers are changing a method of recognizing revenue pursuant to section 451 for an item listed above, the method change is made using the non-automatic method change procedures. For example, a taxpayer that is following its book method and recognizing revenue from the provision of services using a POC method currently is required to file a non-automatic method change to recognize revenue from the provision of services the earlier of when it is due, paid, or earned in accordance with the tax law (generally when the services or divisible services are complete). Similarly, a taxpayer that follows its book method and recognizes revenue from licensing intellectual property upfront is required to file a non-automatic method change to recognize such revenue the earlier of when it is due, paid, or earned in accordance with the tax law (generally over the period the licensee has the right to use the property). In our experience, these method changes are routinely granted (and generally with "bare consent," where the IRS does not rule on the application of the law to the taxpayer's facts).

Additionally, a taxpayer required to make a change to, from or within the POC method under section 460 must request consent under the non-automatic method changes procedures. The POC method is often used for financial accounting purposes in circumstances where the method is not usable for tax purposes (such as for the provision of services or for the production of items that are not unique and do not take more than 12 months to produce). It is therefore expected that many taxpayers currently following their book POC method will need to change from that method to an accrual method under section 451. Moreover, even when taxpayers are using a POC method under section 460, they may need to make a change within that method if they are currently following their book POC method, including the book determination of percent complete.

Notice 2017-17 contains a proposed revenue procedure that generally provides automatic consent for a taxpayer to make a qualifying same-year method change. This change is defined as a change of method of accounting for recognizing income that is made for the same year as the year the taxpayer adopts the new standards and made as a result of, or directly related to, the adoption of those standards. No additional guidance is provided as to when a change is considered to result from, or directly relate to, the adoption of the new standard. Some taxpayers may argue that a change in the method of recognizing revenue for tax purposes that is identified as a result of the implementation of the new standard directly relates to the adoption of the new standard. This argument is supported by the fact that the only tax method change that is necessitated by the implementation of new standard relates to the change in the recognition of advance payments, which already is eligible for automatic consent under Rev. Proc. 2017-30.

For a limited period of time, the IRS should provide automatic consent for taxpayers to change to a permissible method under sections 451 and 460, regardless of whether the change results from the implementation of the new standard. Our concern is that it is difficult to interpret whether a change is made as a result of, or directly related to, the adoption of the new standard, as currently required by the proposed automatic consent. Moreover, this request is also consistent with the principle underlying the method change procedures to encourage voluntary compliance with proper tax accounting methods because, once taxpayers have reviewed their tax revenue recognition methods, they will have the ability to easily correct those methods. Finally, our recommendation recognizes that the IRS has limited resources and is likely not able to review the significant number of method changes that are anticipated, not as a direct result of implementation of the new standard but as an indirect result of identifying improper tax methods during the analysis. The fact that the IRS likely would issue bare consent on these method changes (and thus not provide ruling protection) is a compelling reason to allow an automatic method change, to a permissible method under sections 451 and 460. The IRS should limit these automatic changes to bare consent given that the IRS is not ruling on the specifics of the taxpayer's method.

As an alternative, the IRS could provide new automatic consent method changes for a taxpayer to change to defer advance payments for inventory goods under Treas. Reg. § 1.451-5 and to recognize unbilled receivables when earned. First, Treas. Reg. § 1.451-5(b)(1) permits a taxpayer to defer the recognition of certain advance payments related to the sale of goods by reporting the advance payments in the tax year in which they are properly accruable for tax purposes (*i.e.*, when shipped, delivered or accepted), but no later than the tax year in which they are taken into account for financial reporting purposes. Treasury Reg. § 1.451-5(c)(1)(i) provides that, if certain conditions are met, a taxpayer that receives advance payments with respect to inventory goods may defer the advance payments until the end of the second taxable year following the year in which substantial advance payments are received.

For unbilled receivables, the IRS should provide an automatic change to recognize income from the provision of services or from the license of property in the year that all the events have occurred that fix the right to receive the income and the amount of the income is determined with reasonable accuracy. Making this change an automatic change will simplify the administrative burden of the IRS and the compliance burden for taxpayers, and permit a taxpayer to become compliant with the tax accounting requirements in the same year that it is also changing to comply with the new financial accounting standards. Moreover, the IRS routinely grants these method changes under the non-automatic consent procedures.

b) Advance Payments – Change in AFS

<u>Recommendations</u>

Changes in the recognition of advance payments are the most prevalent method changes that are required for tax purposes as a result of the implementation of the new standard. To simplify and clarify this process, the AICPA recommends that the IRS continue to permit taxpayers to change a method of accounting under section 16.10 of Rev. Proc. 2017-30 by attaching a statement to their tax return for the year of change in lieu of filing a Form 3115, *Application for Change in Accounting Method*. The IRS should include a section 481(a) adjustment and back-year audit protection similar to other accounting method changes.

The AICPA also recommends that the IRS consider the allocation of RSSP in a taxpayer's AFS as objective criteria, so that taxpayers are eligible to use the Deferral Method for items that are deferred for financial accounting purposes.

The AICPA further recommends that the IRS clarify whether a change in the financial accounting recognition of advance payments that are deferred for tax purposes under other provisions, (e.g. Treas. Reg. § 1.451-5) is considered a change in method of accounting requiring consent. If so, the AICPA recommends that the IRS provide automatic consent with normal terms and conditions (e.g., 4-year spread and audit protection) for that change.

<u>Analysis</u>

Recognition of advance payments is significantly affected by the new standards. When the new standard becomes effective as required, many taxpayers will change the way they recognize revenue from advance payments, including for example advance payments for goods, services or licenses. Taxpayers using the Deferral Method under Rev. Proc. 2004-34 for advance payments that change the manner in which these advance payments are recognized in revenues in their AFS are required to change the recognition of advance payments for tax purposes as well. This requirement is because the Deferral Method follows the book recognition of an advance payment in the year of receipt. The IRS administers this change in the recognition of advance payments under the Deferral Method as a change in method of accounting requiring the consent of the Commissioner.[17]

Section 16.10 of Rev. Proc. 2017-30 currently provides an automatic method change for taxpayers requesting a change in their method of accounting for including advance payments in gross income under Rev. Proc. 2004-34 by reason of a change in recognizing advance payments in revenues in their AFS. In lieu of filing a Form 3115, the IRS has allowed a simplified procedure to effect this method change by attaching a statement to the taxpayer's return for the year of change. However, there are significant drawbacks to this accounting method change in that it is made on a cutoff basis, applying only to advance payments received on or after the beginning of the year of change, and without audit protection. Accordingly, a section 481(a) adjustment is neither required nor permitted.

In the context of advance payments, failure to allow a section 481(a) adjustment is punitive in that it requires the taxpayer to apply the old financial accounting law to recognize revenue from contracts entered into prior to the year of change. In contrast, financial accounting generally will implement the new standard retroactively and apply new law to old contracts. Moreover, without a section 481(a) adjustment, the effect of any revenue accelerated under the new standard generally would fall entirely in the year of change as opposed to being spread over four taxable years if the change is implemented with a positive section 481(a) adjustment. To avoid these implications if a cutoff method is required, taxpayers could change to a full inclusion method in the year of adoption of the new standard in order to obtain a section 481(a) adjustment with a four-year spread, and then subsequently change back to the Deferral Method under the non-automatic procedures. However, this approach is inefficient and creates a disadvantage for unsophisticated taxpayers that are not privy to this alternative.

The AICPA is aware that the IRS is concerned that allowing a four-year spread of a section 481(a) adjustment related to accelerating revenue under the Deferral Method will create a windfall for taxpayers that would have had to recognize that revenue in the subsequent tax year by operation of the Deferral Method (where revenue deferred in the year of receipt is recognized in the subsequent taxable year). However, this conclusion does not consider the fact that new advance payments are received in the subsequent tax year and are also accelerated under the new standard. In this manner, the Deferral Method operates in the same manner as any other quickly turning receivable or payable where a four-year spread still is afforded to the taxpayer to prevent distortion and provide relief from the permanent acceleration of income when account balances remain consistent from year to year.

Another significant concern with respect to advance payments is the determination of whether a taxpayer is eligible to use the Deferral Method for allocable payments. Under Rev. Proc. 2004-34, a taxpayer only is eligible to use the Deferral Method for allocable payments if the allocation of the transaction price is based on objective criteria. Specifically, section 5.02(4) provides:

> A taxpayer that receives a payment that is partially attributable to an item or items described in section 4.01(3) of this revenue procedure may use the Deferral Method for the portion of the payment allocable to such item or items

[17] See, e.g., Section 16.10 of Rev. Proc. 2017-30.

> and, with respect to the remaining portion of the payment, may use any proper method of accounting (including the Deferral Method if the remaining portion of the advance payment is for an item or items described in section 4.01(3) of this revenue procedure with a different deferral period (based on the taxpayer's applicable financial statement or the earning of the payment, as applicable)), provided that the taxpayer's method for determining the portion of the payment allocable to such item or items is based on objective criteria.…
>
> A taxpayer's allocation method with respect to an allocable payment described in section 5.02(4)(a) of this revenue procedure will be deemed to be based on objective criteria if the allocation method is based on payments the taxpayer regularly receives for an item or items it regularly sells or provides separately.

There is no additional guidance with respect to what is considered objective criteria other than this example. In many instances, this fact pattern will not exist, and instead taxpayers will determine an allocation of RSSPs based on other factors. The suggest that the IRS consider an allocation of RSSP in a taxpayer's AFS as objective criteria so that taxpayers are eligible to use the Deferral Method for items that are deferred for financial accounting purposes. Such an approach will provide much needed simplification, allowing a taxpayer to follow its books for advance payments with limited deferral. Moreover, given that the new standard requires a thorough assessment of the RSSP of each item in a contract, and those allocations generally are reflective of the fair market value of each item, it is reasonable to use the allocation of transaction price in the AFS to satisfy the objective criteria standard.

C. Question #3 - Do Taxpayers Anticipate Requesting Changes in Methods of Accounting Prior to the Effective Dates of the New Standards?

<u>*Recommendation*</u>

The AICPA recommends that the IRS provide accounting method change guidance as soon as possible for those taxpayers that choose to early adopt for book purposes. Alternatively, if guidance is not issued in time for early adopters, the IRS should consider allowing taxpayers that previously filed non-automatic method changes to convert to the automatic procedure once it becomes available.

<u>*Analysis*</u>

The new standard is generally effective for annual reporting periods beginning after December 15, 2017. It is not anticipated that a significant number of taxpayers will adopt the new standards before the effective date. However, the new standard includes options for early adoption, thus, there is a possibility that some taxpayers may early adopt.

D. Question #4 - Which Procedures Should Taxpayers be Required to Use to Request Permission for a Qualifying Same-Year Method Change, the Automatic Method Change Procedures or the Advance Consent Procedures?

Recommendation

The AICPA generally agrees with the proposed revenue procedure provided by the IRS that provides automatic consent for accounting method changes that result from, or directly relate to, the adoption of the new standards. The IRS should not interpret this automatic change to limit application only to tax method changes necessitated by the adoption of the new standard. The IRS should instead allow all changes to a permissible method of recognizing revenue for tax purposes for a limited period of time.

Nonetheless, the AICPA recognizes that some taxpayers may want or need to obtain greater assurance as to the application of its proposed method of accounting with respect to the taxpayer's facts. As such, the AICPA suggests that any procedural guidance explicitly permit taxpayers to use the private letter ruling procedures or advance consent procedures to obtain an advance ruling or consent that a particular accounting method for recognizing revenue is a permissible method of accounting.

Analysis

Many taxpayers anticipate that implementation of the new standard will require a significant commitment of resources. Permitting taxpayers to file automatic method changes to comply with the tax effects of the new standard will reduce the administrative burden on both the IRS and taxpayers and encourage voluntary compliance with proper tax accounting methods. In addition, allowing automatic changes will relieve taxpayers of the burden of non-automatic filing fees ($0 for automatic vs. $9,500 minimum fee for nonautomatic) and allow taxpayers additional time to file required method changes (until extended due date for automatic vs by end of year for nonautomatic). This extension of time to file is particularly important in the transition year as it will allow additional time to assess the differences in revenue recognition for financial and tax reporting purposes to properly reflect tax revenue recognition methods in the year the new standard is implemented.

On the other hand, the primary downside of an automatic change is that a taxpayer is not afforded ruling protection that provides comfort that the proposed method of accounting is a proper application of the law to the facts. In many cases, taxpayers are satisfied that their proposed method is proper and will not need assurances from the government. In some instances, however, such as where significant system and data changes are needed to implement a proposed method, taxpayers prefer a ruling from the IRS that their proposed method is proper. Generally, if a change is eligible for automatic consent, the IRS will not entertain a non-automatic method change because the automatic change is the exclusive procedure for changes within its scope.

E. Question #5 – What Changes, Other Than Those Described in Section 5 of the Proposed Revenue Procedure, Do Taxpayers Expect will be Requested in the Year the Taxpayer Adopts the New Financial Standards, and Should They be Allowed as Automatic Changes?

Recommendation

The AICPA recommends that the IRS provide, for a limited period of time, automatic consent for taxpayers to change to a permissible method under sections 451 and 460, regardless of whether the change results from the implementation of the new standard.

Analysis

As previously discussed, section 5 of the proposed revenue procedure would provide automatic consent to make a "qualifying same-year method change that complies with income provision of the Code or the Regulations." Section 3 of the proposed revenue procedure defines a qualifying same-year method change as "a change of method of accounting for recognizing income that is made for the same year as the year the taxpayer adopts the new standards and made as a result of, or directly related to, the adoption of those standards."

As explained in more detail in section IV(B), Question 2 above, in addition to requesting method changes to change the method of recognizing revenue required as a result of, or directly relate to, adoption of the new standard, taxpayers also are likely to identify the use of impermissible methods when analyzing their current revenue recognition methods. Often the need to correct these impermissible methods will not result from adoption of the new standard. Moreover, it is not clear whether these changes are considered "directly related to" the adoption of the new standard.

F. Question #6 - What Related Accounting Method Changes Do Taxpayers Anticipate Requesting That May Appropriately be Made on a Single Form 3115?

Recommendation

For administrative ease, the AICPA recommends that any method changes related to adoption of the new standard are permitted on a single Form 3115, filed under the automatic consent procedures. As previously discussed above, we also recommend that generally revenue recognition method changes are permitted under the automatic consent provisions during the transition period.

Analysis

As discussed above, there are several areas where the new standards will affect a taxpayer's revenue recognition for tax purposes. Certain taxpayers will have accounting method changes for general revenue recognition under section 451. Currently a method change that is related to general revenue recognition is a non-automatic accounting method change requiring advance consent. In addition, it is anticipated that taxpayers will file changes under Rev. Proc. 2017-30, section 16.07 and section 16.10 for advance payments.

Currently, a Form 3115 is not required for an advance payment method change made under section 16.10 of Rev. Proc. 2017-30. A method change under Rev. Proc. 2017-30 section 16.10 is effected by attaching a statement detailing the method change to a timely filed return. Although we support the continued use of a statement to effect this method change, the IRS should provide taxpayers with the option of including the method change on a single Form 3115 with other revenue recognition method changes filed during the transition period.

G. Questions #7 – If Multiple Changes are Requested on a Single Form 3115, Should the Taxpayer Report a Separate Section 481(a) Adjustment for Each Change and Should Those Adjustments be Netted and a Single Spread Period Applied?

Recommendation

The AICPA recommends that if multiple changes are requested on a single Form 3115, the taxpayer should report a separate section 481(a) adjustment (without netting the adjustments) for each change. The AICPA also recommends that the IRS issue guidance clarifying whether taxpayers should combine the section 481(a) adjustments and apply a single adjustment period to the net adjustment, or leave the section 481(a) adjustments for each item/revenue stream separate when multiple changes are reported on a single Form 3115.

Analysis

Similar to the method changes requested as a result of the final tangible property regulations, it is appropriate to have a separate section 481(a) adjustment for each item/method change rather than netting the adjustments.

H. Question #8 – What Alternative to Filing a Form 3115 Would Reduce the Burden of Compliance?

Recommendation

The AICPA recommends that the IRS permit taxpayers who qualify for the small business exception under paragraph 5.02(2) of the proposed revenue procedure to attach a statement to their tax return rather than filing Forms 3115.

Analysis

Our recommendation will reduce the administrative and compliance burden for small businesses to file Form 3115.

I. Question #9 - What Transition Procedures May be Helpful?

a) Generally Applicable Automatic Method Change

Recommendation

The AICPA recommends that during the transition period, all accounting method changes for advance payments or for income recognition under the rules of section 451 are permitted as automatic changes for reasons previously explained in this letter.

Alternatively, we suggest that the IRS permit certain additional tax accounting method changes as automatic changes, as described above.

Analysis

This recommendation includes both tax accounting method changes necessitated by the financial accounting revenue recognition standards and tax accounting method changes to correct improper methods under current tax accounting law. Making these changes under the automatic change procedures will enable taxpayers to change to proper methods as soon as possible.

Making the accounting method changes automatic during a transition period will provide the following benefits to taxpayers and the IRS:

1) Taxpayers will not incur the extra costs of preparing a non-automatic accounting method change, which generally requires the submission of more information than an automatic method change;
2) Taxpayers will not incur the expense of the user fee required for a non-automatic method change;
3) Taxpayers will have the later due date for filing the Form 3115 that is afforded to an automatic accounting method change (the timely filed, including extension, original federal income tax return implementing the requested automatic change for the requested year of change) instead of needing to file the Form 3115 during the year of change. During the year of change, a taxpayer is focused on determining how to properly implement the new financial accounting revenue recognition standards and is not able to determine what accounting method changes are needed for tax accounting purposes; and
4) By filing an automatic accounting method change, a taxpayer will have certainty as to how to complete its tax provision and federal income tax return for the year of change. The automatic method changes will prevent an influx of non-automatic accounting changes which will burden the IRS. If a non-automatic accounting method change is filed and a ruling letter is not received prior to the due date of the taxpayer's federal income tax return for the year of change, there is uncertainty in determining how to file that income tax return.

b) *Waiver of Eligibility Rules*

Recommendation

The AICPA recommends that, for a transition period, the IRS waive the eligibility rules in section 5.01(1) of Rev. Proc. 2015-13 (including the rules that the taxpayer has not requested a change for the same item during the past five taxable years, the taxpayer is not in its final year of trade or business, and the taxpayer does not engage in a liquidation or reorganization transaction to which section 381(a) applies) for the taxable year the taxpayer adopts the new standard, with appropriate rules for short tax years, acquisition issues, etc.

Analysis

This eligibility waiver will permit taxpayers that are trying to comply with proper tax accounting methods from the unnecessary requirement of having to file a non-automatic accounting method change. The IRS provided a similar waiver to assist taxpayers in complying with the substantial new rules under the tangible property regulations issued in 2013 and 2014.

c) *Waiver of Under Exam Rules*

Recommendation

The AICPA recommends that the IRS waive the exceptions in section 8.02(1) and section 7.03(3)(b) of Rev. Proc. 2015-13 so that a taxpayer under examination may file an accounting method change and obtain audit protection and, if the taxpayer under examination has a positive section 481(a) adjustment, allow it to utilize a four-year spread period.

Analysis

Our suggested waivers will make it easier for a taxpayer to change to a proper tax method if it determines it is using an improper method for tax accounting when it reviews its financial accounting methods, and to come into compliance with the tax accounting requirements in the same year that it is also changing to comply with the new financial accounting standards. If the IRS is concerned about the breadth of this waiver, the waiver could limit audit protection if the taxpayer's previous method of accounting is an issue under consideration at exam.

d) *Bare Consent Versus Ruling Protection*

Recommendation

The AICPA recommends that during the transition period, the accounting method change is not a ruling from the IRS that the proposed method is a proper method.

Analysis

Due to the expected volume of tax accounting method change requests, we understand the IRS may have concerns regarding whether a taxpayer's selected proposed method is proper and is not able to review all of the accounting method changes to confirm the proposed method is proper. To address this concern, during the transition period, we suggest that, although a taxpayer will receive audit protection for its automatic accounting method change, the accounting method change is not a ruling from the IRS that the proposed method is a proper method.

The IRS should provide a caveat, similar to section 10.01(2) of Rev. Proc. 2017-30, in which the consent granted for an automatic accounting method change for start-up expenditures under section 195 is not a determination that the taxpayer has properly characterized an item as a start-up expenditure and does not create any presumption that the proposed characterization of an item as a start-up expenditure is permissible under section 195(c)(1). The director will ascertain whether the taxpayer's characterization of an item as start-up expenditure is permissible. The IRS should apply a caveat similar to the one that is applied to automatic accounting method changes made during the transition period, and the director can determine the propriety of the proposed method of accounting.

However, a taxpayer that desires to obtain a ruling from the IRS that its proposed method of accounting is a proper method should have the ability to file either a private letter ruling request or a non-automatic accounting method change to obtain a ruling that its proposed method is proper. As we suggested with automatic changes, any non-automatic method changes should waive the eligibility rules in section 5.01(1)(d) and (f) of Rev. Proc. 2015-13 and waive the exceptions in section 8.02(1) and section 7.03(3)(b) of Rev. Proc. 2015-13 so that a taxpayer under examination may file an accounting method change and obtain audit protection and, if the taxpayer under examination and has a positive section 481(a) adjustment, it may obtain a four-year spread period.

e) *Extension of Time to File Non-Automatic Method Changes*

<u>*Recommendation*</u>

As an alternative to our suggestion to make all accounting method changes for advance payments or for income recognition under the rules of section 451 automatic changes, the AICPA suggests that the IRS allow a transition period during which time the filing of a non-automatic accounting method change is extended.

<u>*Analysis*</u>

Because taxpayers must perform significant work to comply with the new financial accounting revenue recognition standards, they may be unable to determine what accounting method changes are needed for tax purposes until after the year that they would like to make the change (the same year they are changing for financial accounting purposes). The IRS should provide an extension of time[18] that permits a taxpayer to file a non-automatic accounting method change for a change that it is no longer possible to file under the non-automatic change procedures.

[18] Similar to that provided in the transition rules under Rev. Proc. 2016-29, effective date, .02(2)(a)(ii).

The IRS should extend the due date until the extended due date of the federal income tax return for the tax year the new standard is implemented.[19]

J. Question #10 – What Additional Procedural Changes Would be Appropriate and Helpful?

Recommendation

The AICPA recommends that the IRS clarify the year of change for a change in the recognition of advance payments in a taxpayer's AFS for a taxpayer using the Deferral Method under Rev. Proc. 2004-34. Specifically, the IRS should require a taxpayer using the Deferral Method to change its tax method to reflect a change in the recognition of advance payments in its AFS for the year the new standard is implemented regardless of whether the financial accounting change is reflected in prior years for presentation purposes.

Analysis

The new revenue recognition standard is implemented for financial accounting purposes on either a full retrospective basis to each prior reporting period presented with a cumulative catch up to equity in the earliest year presented, or a modified retrospective basis with the cumulative effect of initially applying the standard recognized at the date of initial application.

The retroactive presentation of the new standard creates confusion as to when a change in the recognition of advance payments in a taxpayer's AFS by a taxpayer using the Deferral Method under Rev. Proc. 2004-34 is effected for tax purposes. For example, consider a taxpayer that adopts the new standard effective January 1, 2018, and presents both 2017 and 2018 financial data using its new revenue recognition methods in its 2018 AFS. Although it appears that the new method is not implemented in the AFS until 2018, and use of the new method in 2017 was included for presentation purposes only, some taxpayers are concerned that the presentation of the new method for 2017 in the AFS means that a tax method change for advance payments is required in 2017.

[19] Generally for annual reporting periods beginning after December 15, 2017 for public companies and for annual reporting periods beginning after December 15, 2018 for non-public companies (with early adoption permitted).