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Federal Income Tax Implications of New FASB Reporting Rules

I. Background

A. In the past few years there have been several new pronouncements dealing with financial reporting for a variety of different types of transactions.

1. In May of 2014, the FASB issued Accounting Standards Update Topic 606 ("Topic 606"), relating to financial reporting for revenue recognition in connection with contracts with customers. This pronouncement is effective in 2018 for public companies and in 2019 for privately-held companies.

2. In February of 2016, the FASB issued Accounting Standards Update Topic 842 ("Topic 842"), relating to financial reporting for leases. This pronouncement is effective in 2018 for public companies and in 2020 for privately-held companies.

3. In March of 2017, the FASB issued Accounting Standards Update Topic 715 ("Topic 715"), dealing with financial reporting for retirement benefits. This pronouncement is effective in 2018 for public companies and in 2019 for privately-held companies.

B. Following the promulgation of the foregoing three new financial reporting pronouncements, Congress enacted new revenue recognition rules for tax purposes as part of the Tax Cut and Jobs Act of 2017.

1. In new section 451(b) of the Internal Revenue Code ("Code"), except for certain limited exceptions, taxpayers may not include revenue in gross income at a later time for tax purposes than that revenue is included in the taxpayer's gross income in the taxpayer's applicable financial statements. This provision is effective for taxable years beginning after December 31, 2017.

2. In new section 451(c) of the Code, advance payments for the performance of services, or for the sale of goods, may be deferred from gross income for tax purposes, but for no longer than one taxable year following the year of receipt of the advance payment, provided the advance payment is deferred for that same time period or longer in the taxpayer's applicable financial statements.

3. As a result, the special deferral rules for advance payments for services previously covered by Rev. Proc. 2004-34, 2004 C.B. 991, are codified and the special deferral rules for advance payments for the sale of goods in Treas. Reg. § 1.451-5 are repealed. This provision is effective in 2018.

3. The enactment of these new Code provisions will require many taxpayers to file requests to change their methods of accounting for tax purposes in a variety of situations.

C. Combination of effects of financial accounting pronouncements and new tax rules

1. The combination of new financial reporting rules, coupled with new tax reporting rules, has far-reaching ramifications for both tax and financial accounting.

2. In addition, the vaguely worded statutory rules are causing considerable confusion concerning their scope and intended effect.

3. This presentation will analyze these new rules and offer possible solutions to the problems caused by the interaction of the new financial reporting and new tax accounting rules.

II. Scope and Effect of New Section 451(b)

A. Basic rules

1. A taxpayer may not report revenue for tax purposes later than the revenue is reported for financial reporting purposes.

2. There is an exception for revenue that is reported for tax purposes under a special method of accounting. For example, if a taxpayer is required to report income using the percentage-of-completion method under section 460, the taxpayer will not be required to use a different method that accelerates revenue recognition for tax purposes because the taxpayer reports that revenue in an earlier period in its financial statements.

3. However, apart from this exception and a special exception for mortgage servicing contracts, the revenue recognition rule is very broadly worded.

B. Intended scope of provisions

1. Notwithstanding the broad wording of section 451(b), this provision was originally targeted at two very specific situations.

2. The first situation involved something called “unbilled receivables.”

a. Unbilled receivables arise a situation where an accrual-basis taxpayer contracts to provide services that are result-oriented, such a research contract calling for test results or a contract that requires the preparation of a report, in contrast to contracts calling for training or janitorial services that are repetitive and severable in nature.

b. In TAM 200803017, and in accounting method change consent letters issued after this TAM, the IRS ruled that a taxpayer need not report revenue for tax purposes from a result-oriented service contract until the services are completed, notwithstanding that for financial reporting purposes revenue is reported as the services are performed. This conclusion is based on an interpretation of the "all-events test," which applies for tax purposes, but not for financial reporting purposes.

c. This is one of the situations that is specifically targeted for reversal by section 451(b).

3. The second situation involves the treatment of interchange fees arising in credit card transactions. In *Capital One Financial Corp. v. Commissioner*, 133 T.C. 136 (2009), the Tax Court held that an interchange fee in a credit card charge transaction was basically a fee for lending money and, therefore, for tax purposes could be treated as interest income that is reported by the lender over the average life of the related credit card receivables using the OID principles in section 1272(a)(6). In contrast, for financial reporting purposes, interchange fees are regarded as a fee for services and, therefore, is deemed earned at the inception of the credit card charge transaction.

4. Congress was apparently targeting for reversal these two disparate types of transactions. Since the principles at issue in each type of transaction are different, Congress borrowed provisions from Chairman Camp's prior tax reform proposal and imposed on taxpayers a financial conformity test for revenue recognition.

5. Unfortunately, the apparent "fix" for this problem is broadly-worded and potentially applicable to a host of transactions aside from those specifically targeted.

6. In light of the vague wording of section 451(b), the Joint Committee on Taxation attempted to narrow the scope of section 451(b) by adding a footnote to the Conference Report indicating that this section was intended to apply only to transactions where the revenue recognition rules were

governed by the application of the "all-events" test and should not apply to a transaction in which revenue had not yet been realized.

7. As examples of transactions where the new rule was not intended to apply, the Conference Committee Report mentions a majority owner of a business reporting the revenue of a non-consolidated subsidiary on an equity basis for financial reporting purposes, but reporting revenue for tax purposes only when a dividend was paid to the owner, a taxpayer reporting on the mark-to-market method for financial reporting purposes, but not subject to section 475 for tax purposes, and to a taxpayer that properly treats a lease as a conditional sale for financial reporting purposes, but as a lease for tax purposes. In each of these types of transactions, the prior law controls the timing of revenue recognition for tax purposes, as section 451(b) is not applicable.

8. However, as discussed below, this murky history leaves plenty of room for uncertainty in the case of particular types of transactions that are covered by the various new financial reporting pronouncements.

III. Impact of Topic 606 – Accounting for Revenue

A. Core Principle

1. An entity should recognize revenue to depict **["Depict" seems like a strange word for this context.]** the transfer of the promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

2. To achieve this core principle, an entity must:

    a. Identify the contract with the customer

    b. Identify the performance obligations in the contract

    c. Determine the transaction price

    d. Recognize revenue when (or as) the entity satisfies a performance obligation.

3. In addition, certain costs to obtain or fulfill a contract with a customer must be capitalized.

B. Examples

1. Transactions with variable consideration

a. A taxpayer enters into a transaction with a customer for the sale of goods, where the sales price increases if certain levels of sales are not attained or where the customer's resale price for the goods exceeds a certain threshold.

b. In a transaction of that type, Topic 606 might require recognition of revenue for the contingent portion of the consideration based on the probable recovery by the seller.

c. For tax purposes, the variable sales price might not satisfy the all-events test.

d. However, under new section 451(b), revenue might be required to be recognized for tax purposes to match the timing of revenue recognition for financial reporting purposes. One could argue that this is an "all-events" test issue and not a realization issue.

2. Production and sale of unique or special-order merchandise that is not readily saleable to another customer.

a. A taxpayer might enter into a transaction to modify its standard product configuration to accommodate the specific needs of a particular customer.

b. If the customer were to cancel the contract prior to its completion, the taxpayer could not readily sell the customized product to another customer at a profit. In that case, Topic 606 might require the taxpayer to report the revenue from the contract on the percentage-of-completion method for financial reporting purposes.

c. The taxpayer's product might not be classified as a long-term contract within the meaning of section 460 and, accordingly, for tax purposes, revenue and cost of goods sold would be reported on an accrual shipments basis.

d. However, would new section 451(b) require the acceleration of revenue recognition for tax purposes to match the timing of revenue recognition in the taxpayer's financial statements?

e. If revenue is accelerated for tax purposes, the taxpayer is not likely to be entitled to an immediate deduction for the cost of producing the product because the taxpayer still holds the product in inventory. The treatment of the cost of the product would seem to be controlled by the economic performance rules that prevent a taxpayer from deducting the cost of producing a product until the product is provided to the customer.

f. This fact pattern implicates the scope of the supposed exception from section 451(b) for revenue that has not been realized. See Conf. Comm. Rep.

g. Thus, it could be argued that revenue recognition is not accelerated by reason of section 451(b).

h. However, even if revenue is not accelerated in the absence of the receipt of progress payments, many of these types of contracts provide for progress payments. If the taxpayer is entitled to progress payments as the taxpayer performs the work, it seems unlikely that the taxpayer could satisfy the financial conformity requirement in Rev. Proc. 2004-34 and new section 451(c) that is a condition precedent to deferral of the progress payments for tax purposes. Accordingly, a taxpayer receiving progress payments might have to report the progress payments as current revenue for tax purposes, but without receiving the benefit of an offsetting deduction for the cost of the work that is still held in inventory.

3. Same type of transactions as in 2., above, but contract is for services, instead of for the production and sale of goods.

a. In that case, under both Topic 606 and prior GAAP principles, the taxpayer would be required to report income from transaction on a percentage of completion basis for financial reporting purposes.

b. Thus, revenue and expenses would be recognized as the services are performed, not when the services are completed.

c. Section 451(b) was specifically intended to address this situation.

d. Accordingly, the result in TAM 200803017 would be overturned by section 451(b). Thus, accrual-basis taxpayers performing result-oriented service contracts must recognize revenue as the services are performed.

e. While the percentage-of-completion method is one way of measuring how much revenue would be earned for tax purposes, other measures such as physical measures of service performance might also be used for tax purposes, creating the potential for a Schedule M adjustment.

f. Since the cost of performing services is deductible by an accrual-basis taxpayer as the costs of services are incurred, this result does not producing the mismatching of revenue and expenses for tax purposes that occurs in the case of a contract for the production and sale of goods.

g. If this type of contract provides for progress payments, the financial conformity requirement in Rev. Proc. 2004-34 and new section 451(c) would not be satisfied if the taxpayer uses the percentage-of-completion method to report the revenue for financial reporting purposes.

h. Accordingly, progress payments would need to be recognized at the earlier of when due and payable or when received by the taxpayer.

4. Customer loyalty programs

a. Prior to the effective date of Topic 606, revenue from the sale of merchandise or services in which the customer was granted award points that could be redeemed at a later date for free or discounted merchandise or services was accounted for as follows.

b. When the merchandise or services was initially sold to the customer, the entire consideration was allocated to the merchandise or services and was deemed earned and recognized by the seller at that point in time.

c. However, an offsetting liability was established by the seller for the estimated future cost of redeeming the customer's award points that were issued in conjunction with the revenue-generating transaction, taking into account an allowance for breakage (i.e., the customer's failure to redeem the award points).

d. For tax purposes, the revenue was accounted for in the same manner as for financial reporting purposes; however, a controversy developed for tax purposes as to whether the estimated cost of redeeming the award points could be deducted at the time of the revenue-generating transaction or only at the later time when the award points were actually redeemed by a customer.

e. Under Topic 606, the foregoing type of transaction is split into two separate revenue-generating transactions. A portion of the initial sale price of the merchandise or services is allocated to the merchandise or services that are initially sold to the customer and a portion of the initial sales price is allocated to the merchandise or services that will be provided to the customer when the award points are redeemed.

f. The allocation of the initial sales price between these two transactions is based on the relative fair market values of the initial merchandise or services and the award points.

g. If that treatment for financial reporting purposes could be followed for tax purposes, the taxpayer would obtain a more favorable result if, under the prior treatment, it was held that the taxpayer is prevented from claiming a deduction for the expense of redeeming the award points until the award points are actually redeemed.

g. If the IRS is willing to treat a customer loyalty program in the same way for tax purposes that is now required for financial reporting purposes under Topic 606, a taxpayer would need to file an accounting method change request under Rev. Proc. 2004-34 and new section 451(c) in order to be entitled to defer a portion of the sales revenue as deferred revenue allocable to the award points.

h. Taxpayers following that approach should remember that prepaid revenue may be deferred under Rev. Proc. 2004-34 and new section 451(c) for only one year.

i. For this reason, taxpayers should make sure that their customer loyalty programs contain an ordering rule with respect to award point redemptions that treats award points as having been redeemed in the order in which they were earned.

j. That approach would maximize the amount that qualifies for the one-year deferral under Rev. Proc. 2004-34 and section 451(c).

IV. Impact of Topic 842 – Accounting for Leases

A. Core Principles

1. Prior rules

a. Leases were treated as off-balance sheet financing by a lessee and there was no required recognition of the asset and liability created by a lease.

2. New rules

   a. The right to use the leased assets must be shown as an asset in the lessee's balance sheet, and the obligation to pay rent must be shown as a liability in the lessee's balance sheet.

   b. For finance leases, a lessee must:

      i. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the balance sheet.

      ii. Recognize interest on the lease liability separately from the amortization of the right-of-use asset in the income statement.

      iii. Classify repayments of the principal portion of a lease liability within the financing section of the cash flow statement and classify payments of interest on the lease liability and variable lease payments within the operating section of the cash flow statement.

   c. For operating leases, a lessee must

      i. Recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in the balance sheet.

      ii. Recognize a single lease cost, calculated in a manner that allocates the cost of the lease over the lease term on a generally straight-line basis.

      iii. Classify all cash payments within the operating section of the cash flow statement.

   d. The financial accounting treatment of lessors remains essentially unchanged.

   e. Some changes have been made in the definition of a lease.

      i. At the inception of a contract, a determination should be made as to whether the transaction is a lease based on whether the contract conveys the right to control the use of property for a period of time in exchange for consideration.

ii. Control over the use of property is based on the fact that the customer has both the right to obtain substantially all of the economic benefits from the use of the property and the right to direct the use of the property.

iii. Previously, the emphasis in GAAP was on the question of whether the contract was more properly classified as a capital lease or as an operating lease.

iv. While an overall contract may be classified as a lease, a company is required to separate out lease components from non-lease components of that single contract and account for only the lease components in accordance with Topic 842.

B. Tax Ramifications

1. The new financial accounting and disclosure rules do not change the tax law determination as to whether a transaction is treated as a conditional sales contract, as a financing, or as a lease.

a. Thus, the tax department should make sure that changes in treatment of leases for financial reporting purposes are not automatically followed for tax purposes.

2. However, depending on a taxpayer's implementation of Topic 842, a taxpayer may conclude that it has been improperly classifying a sale as either a lease or a financing, or vice-versa and the taxpayer may wish to change that tax classification. Such a reclassification is treated as a change in method of accounting for tax purposes.

3. The procedural rules for changing the classification of a lease turn on whether the change is intended to apply only to future leases and, therefore, may be made under the automatic consent procedures, or whether the change is intended to apply also to existing leases and, therefore, must be made under the advance consent procedures.

a. Section 6.03 of Rev. Proc. 2017-30, 2017-18 I.R.B. 1131, contains explicit rules for changing the classification of transactions from sales to leases or vice-versa, or from a lease to a financing transaction, or vice-versa.

b. This section provides that if a taxpayer is willing to change its treatment of only future leases entered into after the accounting method change to a proper method of accounting, this type of accounting method change may be made under the automatic consent procedures using a cut-off transition rule.

c. However, if a taxpayer uses the automatic consent procedures to make the change, the taxpayer does not receive audit protection with respect to its treatment of leases in prior years.

d. In contrast, if a taxpayer wishes to extend the scope of its accounting method change to also cover the treatment of existing leases entered into before the year of change, that request must be filed under the advance consent method change procedures, and the taxpayer must submit information corroborating that the counter-party or parties to the leases to be changed will account for the transactions in the same manner as proposed by the taxpayer.

e. Presumably, in that case there would be a section 481(a) adjustment and audit protection would be extended to the taxpayer.

C. Tax issues posed

1. Is section 451(b) applicable?

a. On its face, the statute provides that revenue may not be reported for tax purposes later than that revenue is reported in a taxpayer's applicable financial statements.

b. However, in a footnote in the Conference Report to TCJA, a timing difference due to a transaction that is classified as a lease for tax purposes, but as a sale for financial reporting purposes, is excluded from the scope of the revenue acceleration rules in section 451(b).

2. What is the scope of the item in the case of leasing transactions?

a. Another way of stating this issue is to ask what categories of lease transactions so resemble existing lease transactions that a taxpayer is bound to characterize future lease transactions of that same type in the same manner as previous lease transactions.

b. In other words, it seems clear that each individual lease is not eligible for its own separate characterization and method of accounting, but instead the same characterization and accounting method must be used for all lease transactions with the same or similar characteristics.

c. This gives rise to the issue of when new leases may be treated as sufficiently different from existing leases to be accounted for differently, without filing an accounting method change request.

3. What are the risks of an automatic method change filing?

a. A taxpayer would be turning itself in to the IRS and acknowledging that its present method of accounting for a certain category of leases is improper, but the taxpayer would not receive audit protection for that prior improper treatment or for the ongoing improper treatment with respect to existing leases, since only future leases would be covered by the accounting method change.

b. This makes the automatic consent approach very risky.

c. How would an examining agent react to such a Form 3115 filing that acknowledges that the taxpayer's existing treatment of leases is improper, but that treatment is not changed for existing leases?

4. How difficult is it to pursue the advance consent approach?

a. The taxpayer must obtain "buy-in" from the counterparty to the leasing transaction and those counter-parties would probably need to file their own Form 3115s in order to be consistent with the filing position of the taxpayer.

b. Very few, if any, of these types of filings have ever been made.

V. Impact of Topic 715 – Accounting for Retirement Benefits

A. Core Principles

1. Previous rules

a. Prior to the effective date (taxable years beginning after December 15, 2017) of Topic 715, the required GAAP financial statement treatment for employee pension expense and other post-retirement benefits ("OPEB") was to aggregate together a taxpayer's total liability for these expenses in a single line in the financial statements.

b. In addition, to the extent the pension expense and OPEB liability was allocable to employee services that were performed in connection with the production of property (either inventory or a fixed asset), the entire amount of pension and OPEB liability allocable to the labor incurred to produce the property was capitalized as part of the cost of the property produced.

c. As a result, most taxpayers followed that same inventory and fixed asset capitalization method for tax purposes.

2. New rules

a. Topic 715 notes that a company's pension and OPEB liability actually consists of a number of distinct components. These components are: (1) the service cost component (the portion directly attributable to the employee's current-year services; from a tax perspective, this component is usually referred to as current service cost); (2) interest on the employer's obligation to pay the benefits; (3) actual investment return on plan assets; (4) gain or loss on plan assets; (5) amortization of prior service cost or credit; and (6) amortization of transition asset or obligation existing at the time of the original establishment of the obligation.

b. Even though all of these components represent part of the total cost of an employee's services, nevertheless, Topic 715 concludes that for GAAP purposes, only the service cost component of the pension expense and OPEB liability with respect to a production employee is permitted to be capitalized to the cost of the property produced by that employee.

c. The balance of the pension expense and OPEB liability is required to be deducted as a period cost.

B. Tax ramifications

1. Basic inventory costing rules

a. For tax purposes, the starting point in every taxpayer's inventory costing calculations is the cost of the items of inventory that is determined under the taxpayer's GAAP method of accounting.

b. These costs are referred to in the UNICAP regulations as the taxpayer's section 471 cost of the inventory. Treas. Reg. § 1.263A-1(d)(2).

c. To determine the value of inventory for tax purposes, the taxpayer is then required to add to the section 471 cost of the ending inventory any additional section 263A costs that are required to be included in the cost of inventory for tax purposes. Treas. Reg. §§ 1.263A-1(d)(2) & (3).

d. In addition, a taxpayer must also make positive or negative adjustments to the cost of inventory for tax purposes for Schedule M adjustments relating to categories of costs that affect the cost of inventory. Schedule M adjustments are the differences between the amounts of particular categories of costs that are taken into account for financial accounting and tax purposes.

e. In the case of pension and OPEB expenses, the Schedule M adjustment ordinarily reflects the difference between the amount of the liability that is accrued for GAAP purposes and the amount that is actually contributed to the various benefit plans, which represents the amount that is permitted to be taken into account for tax purposes.

f. In the case of a taxpayer's liability for pension and OPEB expenses, the UNICAP regulations do not draw any distinction between the service cost component of the taxpayer's liability and the other components of that liability that are identified in Topic 715. Treas. Reg. § 1.263A-1(e)(3)(ii)(C); CCA 200946037. Thus, for tax purposes, the entire amount of the liability for these categories of retirement costs relating to production employees must be included in the cost of inventory or fixed assets produced by a taxpayer, to the extent that amount reflects actual payments to the benefit plans that would otherwise be deductible for tax purposes.

2. Effect of compliance with Topic 715

a. If a taxpayer's inventory or self-constructed assets will no longer include the total pension and OPEB liability that is accrued for GAAP purposes, but only the service cost component, a taxpayer will be required to include a new adjustment in its additional section 263A costs for tax purposes to take into account the amount of the difference resulting from the financial accounting change in the calculation of its absorption ratio under the simplified production method.

b. Alternatively, if the taxpayer uses a facts-and-circumstances allocation method for additional section 263A costs, the taxpayer's pool of additional section 263A costs will need to be enlarged to accommodate the components of employee pension and OPEB liability that are no longer included in the standard cost of inventory or fixed asset items for GAAP purposes.

c. In addition, because of the likelihood that there will be a Schedule M adjustment with respect to the difference between the aggregate book accrual and the tax deduction for pension and OPEB liability, that fact will also need to be taken into account in computing the amount of the adjustment to additional section 263A costs.

d. A change to treat a cost that was previously treated as a section 471 cost as instead being an additional section 263A cost is a change in method of accounting for tax purposes. Treas. Reg. § 1.263A-1(d)(2)(iii).

e. Accordingly, a taxpayer making this change will be required to file an accounting method change request for its 2018 taxable year in order to obtain the IRS's consent to make this type of accounting method change.

f. Unfortunately, section 12.02(1)(b)(iv) of Rev. Proc. 2017-30, 2017-18 I.R.B. 1131, 1179, provides that this type of cost reclassification from section 471 treatment to treatment as an additional section 263A cost does *not* qualify for the automatic consent procedures.

g. As a result, a taxpayer will be required to file a Form 3115 before the end of its 2018 taxable year to reflect the changes caused by the adoption of Topic 715, and the taxpayer will be required to pay the current filing fee for non-automatic accounting method changes in connection with this change.

h. All of the foregoing analysis regarding the cost of inventory is equally applicable in determining the cost of fixed assets constructed by a taxpayer's own employees.