‘Sledgehammer’ Income Recognition Provision May Fuel Uncertainty

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An attempt to narrow the scope of the income recognition provision in the Tax Cuts and Jobs Act using a footnote in the legislative history may not pass muster in a legal challenge.

The TCJA (P.L. 115-97) includes a provision — section 451(b) — that requires a taxpayer on the accrual method of accounting to include almost all items of income in a tax year if those items make it onto their relevant financial statements.

Leslie J. Schneider of Ivins, Phillips & Barker Chtd. helped draft the conference committee report footnote concerning the scope of section 451(b). At the March 9 Federal Bar Association Section on Taxation conference in Washington, Schneider shared his understanding of how that provision came to be enacted in the TCJA and why only time will tell how it will be interpreted.

In 2008 the IRS began issuing technical memoranda — starting with TAM 200803017 — and other decisions that allowed accounting method changes for government contractors seeking to delay recognizing income for result-oriented services until those results had been achieved, Schneider said. Despite those taxpayers taking deductions as expenses arose during the course of those contracts and reporting revenue on financial reports over time, the IRS held that the all-events test did not require recognition of income until contract completion, he noted.

“I guess someone in the government thought that wasn’t a fair answer and must have passed on to the Hill what they thought was an abuse in that favorable ruling,” Schneider said.

In an unrelated development around the same time, the Tax Court released its decision in *Capital One Financial Corp. v. Commissioner*, 133 T.C. 136 (2009), Schneider said. In *Capital One*, the Tax Court ruled that in a typical four-party credit card transaction the interchange fee is not a fee for any service other than the lending of money, so that it may be treated as interest and original issue discount and could be deferred using the accrual method under section 1272(a)(6).

A Proposal and a Footnote

Schneider said the two issues do not even involve the same principles because the IRS advice on government contracts involved the all-events test and the *Capital One* case involved fees treated as a service for one purpose and as interest for another. Even so, someone tried to fix both together, he said.

“Instead of maybe writing a very specific rule to cover one and a very specific rule to cover the other, they swatted a fly with a sledgehammer and wrote a conformity test,” he said. That provision was included in the 2014 proposed tax reform bill drafted by former House Ways and Means Committee Chair Dave Camp.

Schneider said the section 451 proposal did not attract much attention because there was little prospect of Camp’s bill being enacted under President Obama. During consideration of the TCJA after President Trump’s election, drafters started looking at the Camp draft for revenue-raising provisions.

Once the TCJA was under consideration by the conference committee, taxpayers started to notice the section 451(b) proposal and ask about just how broad it would be, Schneider said. In between the release of Camp's draft and the consideration of the TCJA, the Financial Accounting Standards Board had updated Accounting Standards Codification Topic 606, "Revenue From Contracts With Customers," which provides for revenue acceleration on a wide range of transactions.

When practitioners spoke to the Joint Committee on Taxation about situations unrelated to the all-events test in which financial accounting recognizes income sooner than tax accounting, "to our surprise they said 'No, no, we never intended this provision to apply to those kind of transactions,'" Schneider related. Further, the JCT personnel said the provision is not meant to cover situations without a realization event, he said.

Practitioners were therefore asked to, and did, help write a footnote for the legislative history to point out that section 451(b) was meant to address the application of the all-events test, Schneider said. However, the legislative history still needed separate statements to include the result in *Capital One* and general market discount issues, he added.

Because the rule has been written far more broadly than intended, the government is boxed in by having to create a host of exceptions, Schneider said. Congress now expects the IRS and Treasury to create even more exceptions to keep the effect of the rule focused on the narrow issues it was meant to address, he said.

"The problem is, we will all be gone, and years later a judge will read the statutory provision and it sounds awfully broad, without any limitations," Schneider said, "We all know that judges don't care about what the people meant when they wrote it 20 years earlier; it's 'What do the words say?'" This will make the eventual regulations especially important, he added.

DOCUMENT ATTRIBUTES

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