Unintended Results Eyed for Revenue Recognition Guidance

by Nathan J. Richman

Revenue recognition changes in the 2017 tax law and new financial accounting standards may raise even more unexpected consequences than previously noted.

The Tax Cuts and Jobs Act (P.L. 115-97) addressed two unrelated, narrow issues arising from the "sledgehammer" of the requirement under section 451(b) that a taxpayer on the accrual method of accounting include almost all items of income in a tax year if those items are included on their relevant financial statements.

At the same time, taxpayers are dealing with the transition to the new financial accounting standards for revenue recognition in the Financial Accounting Standards Board's recent updates to ASC Topic 606, "Revenue From Contracts With Customers."

So far, the only guidance on the two revenue recognition changes issued this year has been a revenue procedure with the accounting method change for early adopters of ASC 606 and a notice clarifying the lack of effect of section 451(b) on market discount on bonds. However, the wide breadth of section 451(b) was noticed quickly enough that footnote 872 of the conference committee report clarifies that the new rule "does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred."

> ***Additional unintended consequences include the possible mismatch between financial reporting and tax reporting rules regarding identification of a principal or agent in a transaction, Schneider said.***

Leslie J. Schneider of Ivins, Phillips & Barker Chtd. told *Tax Notes* that practitioners studying ASC 606 have been finding more book-tax divergences than the drafters of section 451(b) had contemplated. In light of those, comments on legislative intent from the Joint Committee on Taxation and Treasury will be interesting, he added.

Additional unintended consequences include the possible mismatch between financial reporting and tax reporting rules regarding identification of a principal or agent in a transaction, Schneider said. "For example, there has been a lot of case law dealing with the question of, if I arrange with a third party to produce goods for a customer and they ship the goods directly to the customer, am I just earning a commission on the transaction or do I have the full revenue and cost of goods sold even though all I am doing is paying the third party to make the product?" he said.

The tax and financial accounting answers to that question may be different, Schneider said. "People are very worried about how that would apply under 451(b)," he said. A previously clear tax answer regarding who is the principal may have been upended, requiring recognition of much more gain, he said.

Even in areas unchanged by ASC 606, section 451(b) has made previously unconsidered financial accounting rules relevant to tax law, Schneider noted.

Cost of Goods Sold

Jane Rohrs of Deloitte Tax LLP said there are many open questions for the government to answer about revenue recognition.

According to Schneider, the biggest question for the IRS and Treasury on section 451(b) is whether the acceleration of revenue recognition will be accompanied by an acceleration of the offset for costs of goods sold. Financial statements include both the revenue and cost of goods sold, reporting the net proceeds from a sale, he noted.

"So therefore, was it intended that you only recognize the net amount for tax purposes, even though you haven't sold the goods from a tax point of view?" Schneider asked. For most taxpayers, having to recognize only the revenue without the cost offset would be a disaster, he said.

Schneider and his firm sent the IRS and Treasury a letter in June arguing for allowing acceleration of cost of goods sold under section 451(b).

Book-Tax Conformity

Schneider said there is another large divergence between book accounting and tax accounting regarding the percentage of completion method. ASC 606 requires the use of the method for a category of contracts, and not all those contracts are long-term contracts, a prerequisite for use of the method under the tax law, he said.

"There is a whole question about somebody who doesn't use that method for tax purposes because it isn't a long-term contract — how do you fit together the tax rules with those financial accounting rules under this new 451(b)? How do those rules work in concert with each other?" Schneider asked. He added that he is drafting a comment letter asking the IRS and Treasury to allow the book percentage of completion method to be used for tax purposes, allowing conformity even for contracts that aren't long-term under section 460.

Many companies would appreciate being allowed to just follow book for tax purposes, and many other problems could be avoided with that solution, Schneider said.

Rohrs said she hopes for a safe harbor allowing taxpayers to elect to use the percentage of completion method for tax purposes when they are using it for financial accounting purposes.

Christian Wood of RSM US LLP said that he, too, hopes for guidance on estimated expenses, but that the comments he has heard from IRS and Treasury officials sound like they generally dislike the idea.

Wood said there have been several safe harbor requests for specific situations in which a taxpayer could follow book treatment for tax purposes. The government is waiting for comments but seems to have received few so far, he said.

There are situations when using book would accelerate income 90 percent of the time, and those are obvious candidates for safe harbors, Wood said. Generally, the financial reporting rules have a bias against recognizing income, while the tax rules have the opposite bias, he said.

So far, the IRS and Treasury have been reluctant to issue safe harbors when the tension between book treatment and tax treatment has moved in the opposite direction from normal, Wood added.

Realization Issues

Commissions and other forms of variable consideration also raise interesting questions under section 451(b), Rohrs said. In particular, contingent consideration must be accelerated under ASC 606, even though it isn't fixed yet, she said.

The questions collide with the realization footnote from the conference committee report, Rohrs added.

Moreover, footnote 872 explicitly states that section 451(b) isn't meant to change a lease into a sale or vice versa, Rohrs noted. "We'd also like to see some guidance saying that is also the case for sale versus license," she said.

Rohrs contrasted what Treasury and the IRS can do with footnote 872 with the difficulties the government faces in trying to find a regulatory solution for qualified improvement property (QIP).

A drafting glitch in the TCJA left QIP ineligible for bonus depreciation despite Congress's intent to allow it. Proposed bonus depreciation regulations (REG-104397-18) released August 3 address the issue for only a short period by allowing bonus depreciation on QIP acquired and placed in service between September 27, 2017, and December 31, 2017.

Unlike for QIP, there is a statutory ambiguity on which the IRS and Treasury can hang proposed regulations following footnote 872, Rohrs said.

Wood said the issue addressed by footnote 872 involves the difference between the section 61 rules on whether the taxpayer has income and the section 451 rules on when that income is recognized. "Before, there really wasn't much difference between the two, so most of the guidance and case law tends to focus on 451 and gets to an answer without having to distinguish between the two," he said.

Other Questions

Taxpayers and practitioners also want answers on how to treat functional intellectual property for tax purposes after the changes to ASC 606, Wood said. For example, a contract may license a piece of software for 10 years with annual renewals and payments made at the end of each year. Before the changes to ASC 606, the licensor would recognize income each year for the payment received in that year, he said.

If there is no continuing obligation after the software has been turned over, the new ASC 606 rules would accelerate the whole 10 years' worth of income into the first year, despite the annual cash flow, according to Wood. If the tax treatment has to follow the book treatment, the licensor could owe taxes on the whole contract before it receives any of the proceeds, he said.

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Section 451(b) doesn't apply to special methods of accounting, so taxpayers and practitioners are looking for guidance on those, Wood said. "What is a special method of accounting? Is it a special method of accounting if it is only permitted under the code? Is it any special method of accounting that is permitted under regs? Published guidance? Is it anything that applies equally both to cash and accrual taxpayers?" he asked.

And more clarity is needed concerning section 467 rental issues, Rohrs said. She said she hopes the government will agree with the interpretation that those issues fall outside section 451(b).

What, When, How

In addition to regulations under section 451(b) and ASC 606, the JCT blue book is expected to have some further explanation, Schneider said.

The blue book has been pending for several months.

Schneider said he expects guidance on section 451(b) and ASC 606 to come out together and by the end of the year. Advance payments guidance under the other section 451 addition from the TCJA, section 451(c), may come separately, he said.

Rohrs said she has heard that section 451(b) guidance may be coming sooner than by the end of the year.

Wood said that the section 451(b) and ASC 606 guidance might not come out together. "There's some crossover, but there are some issues that are discrete within each," he said. The section 451(b) guidance will likely come out separately and first, he said. ■