Section 451 and Revenue Recognition

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Tax Accounting Committee
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**Moderator:**
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**Panelists:**
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Section 451(b)

- Section 451(b)(1)(A) provides that in the case of a taxpayer, the taxable income of which is computed under an accrual method of accounting, the all-events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in an applicable financial statement of the taxpayer or such other financial statement as the Secretary may specify for purposes of this subsection.
  - Does not apply to taxpayers without an applicable or specified financial statement or any item of gross income in connection with a mortgage servicing contract.
Section 451(c)

• Section 451(c) generally provides that an accrual method taxpayer, with an applicable financial statement (or financial statement specified by the Secretary), and that receives advance payments may report such advance payments in income in the year of receipt or recognize income to the extent recognized in its applicable (or specified) financial statement for the year of receipt and the remainder recognized in the immediate subsequent tax year.

• Applies to specified types of advance payments

• Notice 2018-35 provides that taxpayers may continue to rely on Rev. Proc. 2004-34 until section 451(c) guidance issued
Procedural Guidance

• Sections 16.07 and 16.10 of Rev. Proc. 2018-31
  • Automatic consent for certain advance payment changes
  • Changes under Section 16.10 made on a cut-off basis

  • Taxpayers implementing certain changes related to new financial accounting revenue recognition standards (ASC 606, IFRS 15)
  • Provides automatic consent for a taxpayer changing its method of accounting for—(1) identifying performance obligations; (2) allocating transaction price to such performance obligations; and/or (3) determining when performance obligations are satisfied
  • Does not apply to—(1) a change in the manner of identifying contracts or transaction price (e.g., variable consideration); (2) any section 460 related change; (3) any change that is eligible for automatic consent; or (4) a change to a method that does not comply with section 451
  • Change can be made with section 481(a) adjustment or on cut-off basis
Procedural Guidance (Cont.)

• Rev. Proc. 2018-60
  • Applies to accrual method taxpayers with an applicable financial statement to (1) change their method to comply with section 451(b) and/or (2) if not adopting ASC 606/IFRS 15, to allocate transaction price among performance obligations under section 451(b)(4)
  • Does not apply to a taxpayer (1) making a change that would fit under Rev. Proc. 2018-29; (2) changing to a special method of accounting not subject to section 451(b)(1)(A); or (3) that does not have an applicable financial statement
  • Change is made with a section 481(a) adjustment, which is determined separately for each change
Realization v. Recognition

• When does realization occur with respect goods manufactured by a taxpayer?
  • Does this change if the taxpayer is required to use over-time revenue recognition under ASC 606, but is not eligible for percentage of completion method under §460 for tax purposes?
  • Is the government considering a percentage of completion method safe harbor?
  • Consider Bluebook examples

• How does the realization concept apply in the context of services?
  • Is severability of services relevant
  • Consider Bluebook example of insurance commissions

• Bluebook provides that Treasury will provide rules determining realization – will the proposed regulations include such rules? If so, what principles will such rules follow?
Cost of Goods Sold Offset

- Are costs of goods sold properly accelerated to offset gross receipts in computing gross income?
  - Economic performance met, but goods not sold versus costs for which economic performance not met
  - Consider Bluebook discussion/examples
Section 451(b) and OID Provisions

• The reference to section 451(b)(1) in the exception in the special method of accounting rules for the OID provisions (any provision of part V of subchapter P except as provided in clause (ii) of paragraph (1)(B)), which includes the all events test, could be interpreted to apply the all events test to all OID and not just OID arising from credit card transactions.

• How does a taxpayer determine if a method under sections 1271 – 1288 is special method of accounting excepted from the rules under section 451(b)?
  – See e.g., Notice 2018-80 states that Treasury and the IRS intend to issue guidance that provides the market discount is not includible in income under 451(b)
Procedural Issues

• Is the government is considering permitting taxpayers to make all revenue recognition method changes under a single procedure and either on a cut-basis or with a section 481(a) adjustment (this includes changes impacting advance payments)?

• What is the intended scope of Rev. Proc. 2018-60 (e.g., does it apply only where a change is necessary to comply with section 451(b) requirement to follow financial accounting or is it intended to cover all changes involving the all-events test)?

• Automatic consent under Rev. Proc. 2018-60 does not require filing of Form 3115 with Ogden, UT address—how can taxpayers get audit protection earlier than filing the return with the Form 3115?

• Is the government considering waiving the no-back year audit protection for taxpayers under exam changing from impermissible methods to comply with section 451(b)?
Section 451(c)

• Will the proposed regulations include any rules different from those under Rev. Proc. 2004-34?

• Has the government considered providing a cost of goods sold offset for advance payments for the sale of goods similar to that provided in Reg. section 1.451-5?

• Will additional procedural guidance be issued for taxpayer’s already using the Deferral Method under Rev. Proc. 2004-34 to elect the deferral method under section 451(c)?
  – Can taxpayers without an applicable financial statement continue to rely on Rev. Proc. 2004-34?

• Does the government believe taxpayers can continue to rely on pre-section 451(c) case law (e.g., Artnell, Boise Cascade, Tampa Bay Devil Rays, etc.) to support deferral longer than one-year?
Guidance Update

• If proposed regulations are not out by the ABA, thoughts on timing of the issuance of the proposed regulations?
• Any procedural guidance anticipated to be issued in conjunction with the proposed regulations?
• Continued reliance on Notice 2018-35 if proposed section 451(c) regulations are issued?
Questions?