Tax Accounting Methods

Moderator/Panelist
Frank Angeleri, KPMG LLP, Philadelphia, PA

Panelists
Carol Conjura, KPMG LLP, Washington, DC
George A. Manousos, PwC, Washington, DC
Ellen McElroy, Eversheds Sutherland (US) LLP, Washington DC
Chair:

Frank Angeleri, KPMG
267.256.1600
fangeleri@kpmg.com

Speakers:

Carol Conjura, KPMG
202.533.3040
cconjura@kpmg.com

George Manousos, PwC
202.302.0942
george.manousos@pwc.com

Ellen McElroy, Eversheds Sutherland (US)
202.383.0948
ellenmcelroy@eversheds-sutherland.com
Agenda

- Revenue Recognition
- Bonus Depreciation
- Accounting Methods “Reverse” Planning: Accelerate Income/Defer Deductions
Revenue Recognition
Revenue Recognition and Deferral of Advance Payments

• Sec. 451(b) requires accrual-method taxpayers to recognize an item of income no later than the tax year in which it is recognized as revenue in the taxpayer’s financial statement.

• This type of book-tax difference was relatively uncommon outside of the defense industry prior to the new GAAP/IFRS revenue recognition standards (ASC 606 / IAS 15). However, taxpayers in many industries (e.g., software, pharmaceutical) are finding that the requirement to recognize unbilled revenue results in accelerated recognition.

• As a result of the changes to Sec. 451, as well as the required implementation of ASC 606 in 2018 for public companies (2019 for private companies), many taxpayers will be required to make changes in method of accounting with respect to revenue recognition in 2018 for tax purposes.
Proposed Sec. 451(b) Regulations

• Establishes “AFS Income Inclusion Rule” for any accrual method TP with an AFS when the timing of income inclusion for one or more items is determined under the All Events Test.

• Requires recognition of income at the earlier of: (i) when the all events test is met for an item of income; or (ii) when the taxpayer takes the income into account on its applicable financial statement.

• No separate rules established for foreign taxpayers even though the Preamble notes that rule could create mismatching between the CFC’s taxable income for US Federal and foreign tax purposes, which means that certain TPs may lose foreign taxes imposed on CFC income, especially when income is includible in gross income under sec. 951A, and thus ineligible to carry back or forward per sec. 904(c).
Proposed Sec. 451(b) Regulations

- Income recognition is required for the gross amount of consideration to which a TP expects to be entitled for AFS purposes in exchanges for goods, services, or other property (generally, the “transaction price”).

- “Revenue” for purposes of section 451(b), is clarified to include all items of income under section 61.

- Sec. 451(b) does not change how a transaction is characterized for U.S. federal income tax purposes. Although a transaction occurs for AFS purposes, it is not deemed to occur for U.S. Federal income tax purposes. For example, a rental agreement that is treated as a sale for AFS purposes but that is treated as a lease for U.S. federal income tax purposes, continues to be considered a lease.
Proposed Sec. 451(b) Regulations

- “Transaction price” does not include revenue that is contingent on a future event, transaction price is instead determined on a gross basis and does not include: (i) amounts collected on behalf of third parties; (ii) increases for contingent consideration; and (iii) reductions for amounts subject to section 461 (allowances, adjustments, rebates, chargebacks, refunds, rewards, and amounts included in the cost of goods sold).

- Proposed § 1.451–8(b)(7) defines “transaction price” by cross-reference to proposed § 1.451–3(c)(6), which contains a rebuttable presumption that an amount included in transaction price is not contingent.

- Taxpayers with multi-year contracts are required to apply a cumulative approach, reflecting amounts previously included under section 451 to determine income recognition for the current taxable year.

- A taxpayer that is a party to a contract with multiple performance obligations, defined as distinct contractual promises with a customer to transfer either a good or service (or a combination of both) or a series of goods, is required to allocate the transaction price to the obligations in a manner consistent with its AFS.
Revenue Recognition and Deferral of Advance Payments

• The deferral provisions of Rev. Proc. 2004-34 are codified into Sec. 451(c) as part of the TCJA. The Conference Report states that the intention was to repeal the longer deferral method that had been allowed in Reg. 1.451-5.

• Amended Sec. 451(c) defines advance payments as payments for goods and services. In Notice 2018-35, IRS indicated that the intent of the changes made by the TCJA was to track Rev. Proc. 2004-34, and that taxpayers may continue to rely on Rev. Proc. 2004-34 in connection with amended Sec. 451(c) until further guidance is provided.

• Earlier this year, Treas. Reg. §1.451-5 (and its multi-year income deferral period) was withdrawn.

• The repeal is effective for tax years ending after July 15, 2019, so it appears taxpayers may continue to take advantage of the provision.
Proposed Sec. 451(c) Regulations

• An advance payment is defined as any payment;
  • (i) the full inclusion of which in gross income in the year of receipt, is a permissible method of accounting;
  • (ii) any portion of which is included in revenue for financial accounting purposes in a subsequent tax year;
  • (iii) for goods, services, and other items designated by the CIR.

- **Included** - services; the sale of goods; the use of intellectual property, (copyrights, patents, trademarks, and similar intangible rights); the occupancy or use of property if ancillary to the provision of services; the sale, lease, or license of computer software; guaranty or warranty contracts; subscriptions in tangible or intangible format; memberships in an organization; and an eligible gift card sale.

- **Excluded** - rent; insurance premiums; payments with respect to financial instruments; and, payments received in a tax year earlier than the tax year immediately preceding the tax year of the contractual delivery date for a specified good.
Proposed Sec. 451(c) Regulations

- Proposed regulations include a significant exclusion (the “Specified Goods Exception”) for certain qualifying payments. The exception excludes “certain payments, in a limited manner, that would otherwise constitute advance payments” when received in connection with commercially significant or high-value goods that take a significant amount of time to produce provided the TP receives an upfront payment but delivery of the finished goods does not occur for at least two tax years.

- Notwithstanding any financial statement write-down, any income deferred by a TP under the AFS (or non-AFS) deferral method must be included in income in subsequent taxable year.

- Presumption that an amount included in transaction price is not contingent may be rebutted by demonstrating to the satisfaction of Commissioner that an amount is contingent on the occurrence or nonoccurrence of future events.
Effect on Transactions

• Due diligence should focus on whether Target has implemented these changes for both financial accounting and tax accounting purposes.

• Must consider treatment of significant potential increases to transaction price (e.g., bonus payments) or reductions in same (e.g., allowances, adjustments, rebates, chargebacks, refunds, rewards, COGS).

• Should also evaluate whether transaction price is contingent consideration subject to the occurrence or non-occurrence of a future event.

• Consider whether performance obligations have been allocated properly among goods and services, or a bundle of both, and whether income has been apportioned to the proper period with any advance payment.

• The tax agreement should clearly address the treatment of any income deferrals, and related cost of sales.
Bonus Depreciation
Bonus Depreciation - Section 168(k)

• The Treasury and IRS released the final regulations (TD 9874) and the additional proposed regulations (REG-106808-19) under Section 168(k) on September 13, 2019.

• The final regulations adopted the August 2018 proposed regulations with certain modifications and clarifications.

• The additional proposed regulations contain new provisions that were not previously addressed in the August 2018 proposed regulations.

• Taxpayers may apply the final regulations and the additional proposed regulations to qualified property placed in service after September 27, 2017, in a taxable year ending on or after September 28, 2017 (provided that the taxpayers consistently apply all the rules therein).

• If final/proposed regulations now afford bonus depreciation for 2017/2018 tax years, then may be able to amend or file a 3115 to recoup missed bonus depreciation, depending on facts.
Bonus Depreciation - Section 168(k)

Highlights of the final regulations

- **Self-constructed property:**
  - Proposed regs focused strictly on WBC date.
  - Final regulations retain the historical rules and when construction begins.
    - 10% safe harbor is back, who owns property when, 461 method of accounting, etc.

  Example 6, Treas. Reg. § 1.168(k)-2(b)(5)(viii)(F): On August 15, 2017, EE, an accrual basis taxpayer, entered into a written binding contract with FF to manufacture an aircraft described in Section 168(k)(2)(C) for use in EE's trade or business. FF begins to manufacture the aircraft on October 1, 2017. The completed aircraft is delivered to EE on February 15, 2018, at which time EE incurred the total cost of the aircraft. EE places the aircraft in service on March 1, 2018. Pursuant to paragraphs (b)(5)(ii)(A) and (b)(5)(iv)(A) of this section, the aircraft is considered to be manufactured by EE. Because EE began manufacturing the aircraft after September 27, 2017, the aircraft qualifies for the 100-percent additional first year depreciation deduction, assuming all other requirements are met.
Bonus Depreciation - Section 168(k)

Highlights of the final regulations

• The final regulations confirm that the property primarily used in a trade or business in regulated public utilities and PIS after December 31, 2017, is not eligible for bonus depreciation.
  - The same rule applies in the case of self-constructed property used in regulated public utilities. Compare the example below to the one in the previous slide.

  - Example 11, Treas. Reg. § 1.168(k)-2(b)(5)(viii)(K): MM, a calendar year taxpayer, is engaged in a trade or business described in Section 163(j)(7)(A)(iv). In December 2018, MM began constructing a new electric generation power plant for its own use. MM placed in service this new power plant, including all component parts, in 2020. Even though MM began constructing the power plant after September 27, 2017, none of MM’s total expenditures of the power plant qualify for the additional first year depreciation deduction under this section because, pursuant to paragraph (b)(2)(ii)(F) of this section, the power plant is property that is primarily used in a trade or business described in section 163(j)(7)(A)(iv) and the power plant was placed in service in MM’s taxable year beginning after 2017.
Bonus Depreciation - Section 168(k)

Highlights of the final regulations

• The final regulations define the term “predecessor” of used property. The term includes:
  - a transferor of an asset to a transferee in a transaction to which Section 381(a) applies;
  - a transferor of an asset to a transferee in a transaction in which the transferee’s basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the hands of the transferor;
  - a partnership that is considered as continuing under Section 708(b)(2);
  - the decedent in the case of an asset acquired by an estate; or
  - a transferor of an asset to a trust.

• The final regulations provide a safe harbor rule for look-back period of five calendar years in determining whether a taxpayer had a prior depreciable interest.
Bonus Depreciation - Section 168(k)

Highlights of the final regulations

- The Treasury and IRS confirmed the legislative change for qualified improvement property (QIP), and therefore declined to consider commenters’ requests that (i) QIP placed in service after 2017 be treated as qualified property for bonus depreciation, and (ii) the IRS not challenge or audit taxpayers treating such property as 15-year property eligible for bonus depreciation.
  - Technical correction is required for the legislative glitch.
  - Position to claim bonus depreciation in advance of the technical correction?
BonuS Depreciation - Section 168(k)

Highlights of the additional proposed regulations

- Election under Prop. Reg. § 1.168(k)-2(c) is available to treat one or more components acquired or self-constructed after September 27, 2017, of certain larger self-constructed property as being eligible for bonus depreciation (similar to Rev. Proc. 2011-26).
  - However, the component election is not available for components of larger self-constructed property that is not eligible for the 100% bonus depreciation.
  - Election statement due by due date of extended federal income tax return.
  - For 2017 year, need 9100 relief to make election, although IRS relief may be forthcoming.
Accounting Methods “Reverse” Planning:

Accelerate Income/Defer Deductions
Reverse Planning: Value Proposition

It may be beneficial to accelerate income/defer deductions with accounting methods in the following situations:

- BEAT mitigation
- Section 163(j) taxable income/adjusted taxable income limit
- FTC utilization
- GILTI inclusion
Various capitalization/deferral techniques

1. Capitalization of research costs and/or software development under Section 174(b), Section 59(e), Rev. Proc. 2000-50
2. Capitalization of certain corporate functions that are mixed service costs under Section 263A
3. Capitalization of certain facilitative costs under Treas. Reg. 1.263(a)-4(e)(4)(iv)
4. Elect deferral of 404(a) accrued compensation for 401(k) match and profit sharing contributions
5. Timing of cash based deductions including –
   - Matching of related party interest expense
   - Deferring payments related to 461(h)/Treas. Reg. 1.461-4(g) liabilities
   - Defer payment of bonuses post March 15
   - State and local taxes
   - Defer payment related to recurring item exception and/or accelerate tax return filings
6. Defer accrued bonuses
   - Board resolution of bonuses in subsequent year
   - Fail all events test for bonuses by continued employment requirement
7. Depreciation elections – bonus depreciation, ADS, others Defer deduction related prepaids < 12 months
8. Defer deductions by allocating defined benefit pension plan contributions
9. Capitalize Section 266 costs
10. Capitalized repair/replacement costs/min cap policy

Discussed in greater detail in the following slides
Capitalization of research costs and/or software development

- Section 59(e) capitalizes Sec. 174 costs over 10 year period
- Section 174(b) capitalizes Sec. 174 costs over a period of not less than 60 months (taxpayer can choose for longer period)
- Rev. Proc. 2000-50 applies to software development and may deduct over 36 or 60 month period
- Other considerations need to be taken into account including the total population of applicable costs, the start of the amortization period, the method of electing, the potential reversal of the election, and the scope of the election
### Executive Summary of Sec. 174(b), Sec. 59(e), and Rev. Proc. 2000-50

<table>
<thead>
<tr>
<th>IRC Section 174(b)</th>
<th>Project by Project</th>
<th>All Expenditures</th>
<th>Rev. Proc. 2000-50</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Population of Costs</td>
<td>All IRC §174 expenditures.</td>
<td>All IRC §174 expenditures.</td>
<td>Same</td>
</tr>
<tr>
<td>(2) Amortization Period</td>
<td>Deducted ratably over a 10-year period.</td>
<td>Period of not less than 60 months for each project.</td>
<td>Period of not less than 60 months for which amortization period chosen at time of election and repeats for follow-on years.</td>
</tr>
<tr>
<td>(a) Start of Amort. Period</td>
<td>Taxable year in which such expenditure was made.</td>
<td>Amortization begins in the month in which the taxpayer first realizes benefits from the expenditures and will have deemed to realize benefits when in the month where taxpayer first puts the process, formula, invention, or similar property to which the expenditures relate to an income-producing use.</td>
<td>Same</td>
</tr>
<tr>
<td>(3) Method of Election</td>
<td>An annual statement must be attached to the timely filed income tax return.</td>
<td>Form 3115 must be filed. The change is applied on a cut-off basis (no IRC §481(a) adjustment). An annual statement must be attached to the timely filed income tax return to identify the deferred expenditures</td>
<td>Same</td>
</tr>
<tr>
<td>(4) Reversal of Election</td>
<td>Revoked only with consent of the IRS Commissioner. For costs incurred in later years, the tax payer may decline to elect IRC §59(e).</td>
<td>A change in accounting method can be made to return to current expensing under IRC §174(a). The change is applied on a cut-off basis (no IRC §481(a) adjustment).</td>
<td>Same</td>
</tr>
<tr>
<td>(5) Scope of Election</td>
<td>Election can apply to all or a specified portion of IRC §174 expenditures.</td>
<td>Election can apply to one or more projects.</td>
<td>Election applies to all software development costs. Specific projects cannot be selected.</td>
</tr>
</tbody>
</table>

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**Comparison of 59(e), Sec. 174(b) and Rev Proc 2000-50**
Overview of applicable provisions of Section 263A

- Taxpayers subject to IRC § 263A must capitalize all direct and certain indirect costs properly allocable to property produced or property acquired for resale
  - “Produce” is broadly defined to include the following:
    - Construct, build, install, manufacture, develop, improve, create, raise, or grow.
    - Also includes property produced by another party pursuant to a contract with the taxpayer.
      - “Property” includes self-constructed assets that are produced by the taxpayer for use in its trade or business

- Types of costs subject to IRC § 263A:
  - Direct Costs – direct materials and labor costs
  - Indirect Costs – indirect labor costs, employee benefits, rent, taxes, etc.
  - Service Costs – subset of indirect costs
Overview of applicable provisions of Section 263A (continued)

- Service costs
  - Can be specifically identified with a service department or function; or
  - Directly benefits or are incurred by reason of a service department or function.
  - Example of service costs – personnel, accounting, security, finance, legal, etc.
  - **Mixed Service Costs** – relate to both production/resale and non-production/resale activities (i.e., capitalizable and deductible activities)

- Allocation of mixed service costs
  - Reg. § 1.263A-1(g)(4) provides that the Direct Reallocation Method is one method that can be used to allocate MSCs between production or resale and non-production or non-resale activities
  - Under the direct reallocation method, total costs of mixed service departments are allocated only to production/resale departments or costs centers
  - A change in method of accounting to the direct reallocation method is an automatic change that is implemented via a cumulative adjustment for prior years (IRC § 481(a))
    - The IRC § 481(a) adjustment must take into account any cumulative difference in income after 1986
    - Generally, a change to discontinue the direct reallocation method could not be made within the next 5 tax years; however, Rev. Proc. 2018-56 waives the 5 year scope limitation for changes made in 2018, 2019, or 2020
Two examples

- Example #1
  - *Service Providers* with significant NOLs or credit carryforwards
    - Defer BEAT expenses to later years to eliminate or reduce BEAT liability in the short term
    - Provides time to execute on planning opportunities to restructure contracts, etc.
    - Eliminate BEAT liability in future years when deferred costs can be recognized without triggering BEAT due to increased BEAT cushion

- Example #2
  - *Producers or Resellers* with COGS
    - Recharacterize BEAT expenses to COGS to consistently eliminate or reduce BEAT liability
Treas. Reg. §1.263(a)-4(e)(4)(iv) Election

— A taxpayer must capitalize amounts paid to create an intangible asset, including amounts paid to facilitate the creation of an intangible asset (see Treas. Reg. §1.263(a)-4(b)(ii))
  • Intangibles include endowment contracts, annuity contracts, or insurance contract that has or may have cash value (see Treas. Reg. §1.263(a)-4(d)(2)(i)(D))
  • An amount is paid to facilitate the acquisition or creation of an intangible if the amount is paid in the process of investigating or otherwise pursuing the transaction (see Treas. Reg. §1.263(a)-4(e)(1))

— Employee compensation, overhead, and de minimis costs are treated as amounts that do not facilitate the acquisition or creation of an intangible (see Treas. Reg. §1.263(a)-4(e)(4)(i))
  • However, taxpayers may elect to capitalize employee compensation, overhead and de minimis costs that would otherwise be facilitative (see Treas. Reg. §1.263(a)-4(e)(4)(iv))
Treas. Reg. §1.263(a)-4(e)(4)(iv) Election

— Facilitate = the amount paid in the process of investigating or otherwise pursuing a transaction based on all of the facts and circumstances (see Treas. Reg. §1.263(a)-4(e)(1)(i)).
  • In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative.
  • An amount paid to determine the value or price of a transaction is an amount paid in the process of investigating or otherwise pursuing the transaction.

— Employee compensation = compensation (including salary, bonuses and commissions) paid to an employee of the taxpayer. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder (see Treas. Reg. §1.263(a)-4(e)(4)(ii)(A)).

— Overhead = not clearly defined within the meaning of Treas. Reg. §1.263(a)-4 but interpret to reasonably include indirect costs that benefit or are incurred by reason of the performance of the facilitative activities of the taxpayer

— De minimis = amounts (other than employee compensation and overhead) paid in the process of investigating or otherwise pursuing a transaction if, in the aggregate, the amounts do not exceed $5,000 (see Treas. Reg. §1.263(a)-4(e)(4)(iii)(A)).
  • De minimis costs do not include commissions paid to facilitate the acquisition or creation of an intangible (see Treas. Reg. §1.263(a)-4(e)(4)(iii)(B)).
Amortization

• Pursuant to Treas. Reg. §1.167(a)-3(a), if an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance.
  • In accordance with Treas. Reg. § 1.167(a)-3(b)(1)(iii), intangible assets subject to capitalization under Treas. Reg. § 263(a)-4, will be amortized using the GAAP useful life as a reasonable proxy.

• Intangible assets for which the length of time can not be estimated with reasonable accuracy, will be treated as having a useful life equal to 15 years.
  • Safe harbor amortization for certain intangible assets (see Treas. Reg. §1.167(a)-3(b)(1)).
Questions?

Frank Angeleri, KPMG  
267.256.1600  
fangeleri@kpmg.com

Carol Conjura, KPMG  
202.533.3040  
cconjura@kpmg.com

Ellen McElroy, Eversheds Sutherland (US) LLP  
202.383.0948  
ellenmcelroy@eversheds-sutherland.com

George Manousos, PwC  
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