IRS Finalizes Changes Related to Revenue Recognition

As private companies and nonprofit organizations adopt the new guidance in Accounting Standards Codification (ASC) 606, *Revenue from Contracts with Customers*, they will need to consider the effect of adoption for financial reporting purposes and the associated effect on the computation of taxable income. ASC 606 may result in an entity recognizing revenue earlier than under current guidance. Since the ASC was issued in 2014, the tax laws were substantially updated with the 2017 *Tax Cuts and Jobs Act* (TCJA). The TCJA generally requires accrual method taxpayers to recognize revenue for federal income tax purposes no later than when such revenue is recognized for financial reporting purposes. The new guidance issued under ASC 606 and the TCJA may require taxpayers to accelerate the recognition income in a taxable year, resulting in an increase in related federal income tax liability.

On December 21, 2020, the U.S. Treasury Department and the IRS released the final regulations (Regulations) under Internal Revenue Code Section 451 implementing the amendments by the TCJA for determining the taxable year in which an amount must be reported as gross income on a taxpayer's return. The Regulations, *Taxable Year of Income Inclusion under an Accrual Method of Accounting and Advance Payments for Goods, Services, and Other Items* (RIN 1545-BO68 and RIN 1545-BO78), clarify the amendments by the TCJA of §451(b), which addresses the general requirement that accrual method taxpayers recognize gross income for tax purposes no later than the taxable year it is recognized on their applicable financial statements (AFS) (the AFS Inclusion Rule) and §451(c), which allow accrual method taxpayers to defer—for one year—tax reporting of certain advance payments of income to the extent the amounts are not reported as revenue on the taxpayer's AFS for the taxable year of receipt.

Section 451(b)

The Regulations do not define the term realization but attempt to clarify the extent the AFS Inclusion Rule requires the recognition of income items the tax law would otherwise not consider having been realized in the taxable year. This clarification allows AFS revenue to be reduced by amounts the taxpayer does not have an enforceable right to recover if the customer were to terminate the contract on the last day of the taxable year. The determination of whether the taxpayer has an enforceable right to recover AFS revenue is governed by the contract's terms and applicable federal, state, or international law, and includes amounts recoverable in equity and liquidated damages.

For contracts with multiple performance obligations, the Regulations clarify each performance obligation yields an item of gross income that must be accounted for separately. To determine the amount of gross income allocated to each performance obligation, the transaction price determined under the taxpayer's applicable accounting principles is allocated to each corresponding item of gross income in accordance with how the transaction price is allocated to each performance obligation for AFS purposes. The Regulations define transaction price as the total amount of consideration to which a taxpayer is—or expects to be—entitled from all of a contract's performance obligations. The transaction price is determined under the standards the taxpayer uses to prepare its AFS.

AFS include an audited financial statement filed with the SEC or used for a nontax business purpose such as reporting to owners, creditors, or other parties. Taxpayers who file financial statements with the federal government, a federal agency, state government, state agency, or self-regulatory organization are subject to §451(b).

Section 451(c)

The Regulations offer additional guidance to the TCJA amendments of §451(c) that allow taxpayers to defer—for one year—tax reporting of certain advance payments of income to the extent the amounts are not reported as revenue on the taxpayer's AFS for the taxable year of receipt, thus deferring the payment of income tax on the deferred income. Section 451(c)(1)(A) provides the general rule requiring an accrual method taxpayer to include an advance payment in gross income in the taxable year of receipt. However, §451(c)(1)(B) permits an accrual method taxpayer to elect to include any portion of the advance payment in gross income in the taxable year following the year of receipt to the extent income is not included in AFS revenue in the year of receipt. The deferral election is effective for the taxable year that it is first made and for all subsequent taxable years, unless the taxpayer receives consent to revoke the election.

Conclusion

If you have questions about these changes, contact your **BKD Trusted Advisor™** today.

Contributor

Anne Coughlan
Director
317.383.4000
acoughlan@bkd.com