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# Section 451(b): Did You Realize the Need to Recognize the Difference?

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It is time to brush up on two basic tax concepts: realization of income and recognition of income. Accrual method taxpayers are learning that the old fundamentals are important when applying new book-tax conformity rules.

In imposing a new book-conformity requirement for recognizing income, the 2017 tax reform legislation commonly referred to as the Tax Cuts and Jobs Act ("TCJA")[1] might make an already murky area even more so, presenting both opportunities and challenges for accrual method taxpayers. Under new section 451(b)(1),[2] most accrual method taxpayers[3] must treat an item of income as satisfying the all events test (and hence include in taxable income) no later than the tax year in which that item is included in the taxpayer's revenue for financial accounting purposes. As such, most accrual method taxpayers now must accrue income for tax purposes upon the earlier of (1) the taxpayer's right to the income becoming fixed and determinable,[4] or (2) inclusion of the item in book revenues.

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1 Pub. L. No. 115-97, §13221.

2 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

3 The new requirement applies only to accrual method taxpayers having an "applicable financial statement," such as audited financial statements used for credit purposes or filings with the SEC or other non-tax federal regulatory requirements. Section 451(b)(3).

4 Section 451(b)(1)(C).

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This change to a nearly 100 year-old legal standard[5] raises a number of nettlesome questions, including the treatment of cost of goods sold associated with accelerated income, the interaction of the new rule with existing provisions applicable to financial instruments, as well as various procedural questions. Potentially as problematic, however, is a significant exception to the new requirement. The legislative history to section 451(b) makes clear that the new rule accelerates only the *recognition* of an item of income, but does not affect when that item is *realized* for federal tax purposes.[6] As a result, the distinction between realization and recognition has taken on a much broader significance than under prior law.

Realization and recognition are fundamental tax accounting concepts familiar to nearly all tax practitioners. Because taxpayers may now need to dissect the distinction between these concepts with greater precision, a preliminary return to basics is a prudent first step before graduating to the more nuanced analysis that new section 451(b) may require.

At the most rudimentary level, analyzing a potential item of income presents three basic questions:

- Is the item income?
- If so, when does it become income (realization)?
- When must the item of income be included on the taxpayer's return (recognition)?

As discussed below, the second two questions in many cases have been collapsed into a single inquiry for accrual method taxpayers because the distinction has not mattered outside property dispositions. Under new section 451(b), however, the distinction becomes important across a broader spectrum.

The first question looks to whether an item is income at all, in contrast to nontaxable items such as returns of capital, repayment of loans, customer deposits, receipts in the taxpayer's capacity as an agent, and any number of other circumstances in which the receipt of cash or property is not a taxable accession to wealth.[7] Because it affects only the timing of an item of *income*, new section 451(b) does not implicate this first step.

The second analytical step asks when an item converts from potential income in the future to actual income in the present—in other words, when the income is realized. In a now talismanic formulation, the U.S. Supreme Court in *Glenshaw Glass* described income as "instances of undeniable accessions to wealth, *clearly realized*, and over which the taxpayers have complete dominion."[8] The Code also

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[5] United States v. Anderson, 269 U.S. 422 (1926) (articulating what became the all events test). *See also* Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979) (based on differing objectives, rejecting equivalence of GAAP and tax accounting methods).

[6] H.R. Conf. Rep. No. 115-466, at 428 fn. 872 (Dec. 15, 2017).

[7] Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). *See, e.g.*, Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990) (customer deposits); Seven-Up Co. v. Commissioner, 14 T.C. 965 (1950) (company had no income when it received payments as an agent on behalf of others).

[8] 348 U.S. at 431 (emphasis added).

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relies upon the concept of realization as the prerequisite for income inclusion. Section 1001(a)(1) provides that the gain (or loss) from the sale or other disposition of property is the excess of the amount *realized* over the property's adjusted basis (or vice versa), as provided in section 1011.

Because in most cases the U.S. tax system is event driven, the concept of realization essentially looks to whether there has been a closed and completed transaction for tax purposes. In describing new section 451(b) in its "Blue Book," Congress's Joint Committee on Taxation ("JCT") explained that an item of income is not realized until the year in which "the necessary material conditions and requirements for receipt of the [item] have been met and the taxpayer has a fixed and definite right to receive the income."[9]

In contrast, except in specific circumstances (such as the mark-to-market rules), mere fluctuations in the value of property do not result in gross income. Instead, if the taxpayer still owns the asset, gain or loss from increases or decreases in the asset's value have not yet been realized through a closed and completed tax transaction. As watchers of the stock market know, "paper gains" may disappear as quickly as they are created. Until the "accession to wealth" is permanently reduced to the taxpayer's dominion and control through a closed and completed transaction, it is not yet locked in, or "realized." It is the difference between having dreams of wealth, and realizing those dreams.

Section 1001(c) provides the final step between having potential income and including the item on a tax return: Except as otherwise provided in subtitle A (Income Taxes), the entire amount of the gain or loss determined under section 1001 on the sale or exchange of property shall be recognized. In other words, once a potential item of income is *realized* under section 1001(b), it will be *recognized* under section 1001(c) in accordance with the taxpayer's accounting method, *unless* another provision of subtitle A permits the taxpayer to defer recognizing that realized gain.

For example, in certain circumstances taxpayers can defer recognizing realized gain through a like-kind exchange of real property under section 1031. The involuntary conversion rules of section 1033 provide another exception to the immediate recognition of gain realized upon the disposition of property. In either case, the gain realized upon the disposition of the original property is preserved through a basis adjustment in the replacement property, resulting in that *realized* gain being *recognized* in accordance with the taxpayer's method of accounting upon the subsequent taxable disposition of the replacement property.

The distinction between realization and recognition becomes murkier outside the context of property transactions. Reflecting the Supreme Court's view that Congress exercised the full breadth of its constitutional authority to impose taxes, section 61 states broadly that except as otherwise provided in subtitle A (Income Taxes), gross income means "all income from whatever source derived," including but not limited to a laundry list of sources. Sources of gross income within the scope of section 61 include not only gains derived from dealings in property, but also compensation for services (including

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[9] Joint Committee on Taxation, General Explanation of Public Law 115-97, JCS-1-18, at 166 Example 6 (Dec. 2018) (the "Blue Book").

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fees, commissions, fringe benefits, and similar items), interest, rents, royalties, dividends, distributive shares of partnership gross income, and several others.

Unlike section 1001, the much broader definition of gross income in section 61 makes no reference to the concepts of realization and recognition. One could read this omission to mean that the realization concept applies only to gain or loss derived from dispositions of property. If so, the exclusion of unrealized gains from the new book-conformity requirement would apply only in the context of property transactions, and not with respect to any other categories of gross income (such as compensation for services). Numerous sources, however, indicate otherwise.

Principally, the Treasury regulations under section 61 make clear that the realization concept is in fact relevant to all categories of gross income, and not just gain or loss from the disposition of property. In defining gross income, section 1.61-1(a) provides that gross income "includes income realized in any form." It provides further that "income may be realized" in the form of services, meals, accommodations, stock or other property, as well as in cash.

The regulations give no indication that the references to "realized" income apply to some but not all types of income within the all-encompassing scope of section 61. Instead, the breadth of the regulations' discussion suggests the opposite. As an example, section 1.61-12 provides that income from the discharge of indebtedness "may result in the realization of income." There is no precondition in section 61(a)(11) that the forgiven indebtedness relate to property transactions.

Other sources confirm this conclusion. First, in defining gross income as an amount "*clearly realized*, over which the taxpayer has dominion and control," *Glenshaw Glass* itself was considering the treatment of punitive damages, rather than gain or loss from the disposition of property.

Second, in describing the new provision, the JCT provides two examples demonstrating the exclusion of unrealized items from the new book-conformity requirement. The first example involves a performance bonus in connection with a contract for consulting services. The second involves commissions related to the sale of insurance contracts. Clearly the JCT anticipates that the exclusion of unrealized gain will be relevant in contexts beyond the disposition of property.

Finally, at least one court has referenced the realization concept in the context of service fees. In *Cox v. Commissioner*,[10] the Tax Court analyzed the taxation of investment adviser fees. In describing the taxpayer's present method of accounting, the court explained how the taxpayer determined when it "would treat [an item] as realized and reportable income."

Otherwise, courts generally have not discussed the realization concept in the context of compensation, service fees, or items of gross income other than gain or loss from dispositions of property. This is not surprising. Prior to new section 451(b), the distinction between realization and recognition had been relevant in the context of property dispositions due to the potential ability to defer recognizing realized gain. As a practical matter, however, because the Code generally does not provide similar deferral

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[10] 43 T.C. 448, 454 (1965).

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vehicles for income from other sources, there has been little need to separately discuss when an item of compensation or service revenue (for example) is realized and when it is recognized.[11]

Instead, courts generally consider when an accrual method taxpayer must report an item of income simply by applying the two-prong all events test familiar to most tax practitioners:

- When have all the facts occurred that fix the taxpayer's right to the income?
- When is that amount reasonably determinable?[12]

In applying this standard, the taxpayer obtains a "fixed right" to payment upon the earlier of (1) the taxpayer's receipt of payment, (2) the contractual due date, or (3) the taxpayer's performance (in common parlance, the earlier of earned, due, or received).[13] An accrual basis taxpayer must report income in the year the right to the income accrues, despite the necessity for mathematical computations or ministerial acts.[14]

While the factual nature of this standard frequently presents analytical challenges (such as those discussed below), these issues have been discussed for so many decades that applicable analytical tools are readily at hand.

Taxpayers, the IRS, and courts have less experience, however, in determining whether accrual is premature due to an item outside of property transactions not yet having been realized, rather than because it has been realized but not yet recognized—a critical distinction in applying the new acceleration requirement. The examples posited by the JCT in the Blue Book underscore the analytical difficulties that may lie ahead.[15]

The Blue Book uses two examples to demonstrate how the realization concept interacts with new section 451(b). In the first example, the taxpayer enters into a three-year contract to provide consulting services. The taxpayer will receive payment as the services are provided and will be entitled to a $4,500 bonus at the end of the three-year period if certain material conditions and requirements are met. Under the new "rev rec" financial accounting standards, the taxpayer allocates one-third of the

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[11] *But see* Rev. Proc. 2004-34, 2004-1 C.B. 991 (permitting limited deferral for advance payments received for goods, services, and other specific types of income, but only to the extent not included in book revenue). The TCJA codified Revenue Procedure 2004-34 as section 451(c).

[12] *See, e.g.*, American Auto. Ass'n v. United States, 367 U.S. 687 (1961) (auto club membership dues); Johnson v. Commissioner, 108 T.C. 448 (1997) (multi-year vehicle service contracts); Charles Schwab Corp. v. Commissioner, 107 T.C. 282 (1996) (brokerage fees); Oak Indus., Inc. v. Commissioner, 96 T.C. 559 (1991) (deposits for subscription television service); Perry Funeral Home, Inc. v. Commissioner, T.C. Memo 2003-340 (pre-need funeral contracts).

[13] Schlude v. Commissioner, 372 U.S. 128, 133, 137 (1963); Rev. Rul. 80-308, 1980-2 C.B. 162; Rev. Rul. 74-607, 1974-2 C.B. 149.

[14] Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 295-297 (1932); *Charles Schwab*, 107 T.C. at 292.

[15] Like other legislative history, the Blue Book does not constitute binding "authority." It is instructive, however, in understanding congressional intent, and may be taken into consideration by Treasury and the IRS in developing forthcoming guidance. Thus, it is insightful but not controlling.

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anticipated $4,500 bonus to each of the three years in the contract term, including an additional $1,500 in its book revenue for each of those three years. New section 451(b) generally deems the all events test to be satisfied no later than the year in which an item is included in revenue for book purposes. On these facts, however, the JCT concludes that the taxpayer is *not* required by section 451(b) to accelerate any portion of the $4,500 performance bonus, notwithstanding the book acceleration. Instead, the JCT concludes:

> For Federal income tax purposes, the performance bonus is not *realized* until year three when the necessary material conditions and requirements for receipt of the performance bonus have been met and the taxpayer has a fixed and definite right to receive the income. Accordingly, the taxpayer includes the $4,500 performance bonus in gross income in year three.[16]

Contrast this example with one posited by the JCT in discussing the interaction of the traditional all events test with new section 451(b). In that example, the taxpayer contracts to expand a customer's warehouse facility for a total of $100,000. Under the contract, the taxpayer will bill the customer $50,000 when construction begins and $50,000 upon the completion of construction. The construction services are "non-severable," and there are no milestone payments over the course of the project—just two payments, one at the beginning of the project and one upon its conclusion. Construction begins in year 1 and is completed in year 2. For financial accounting purposes, the taxpayer recognizes $60,000 in year 1 and $40,000 in year 2. Under the traditional all events test, the taxpayer would have recognized $50,000 in year 1 and $50,000 in year 2. The Blue Book concludes, however, that—because of new section 451(b)—the taxpayer instead must recognize $60,000 in year 1 and $40,000 in year 2.[17]

In this example, section 451(b) *deems* the taxpayer to have satisfied the first prong of the all events test with respect to the additional $10,000 accelerated into its year 1 book revenue.[18] The additional income must be recognized and included on the year 1 tax return even though the all events test previously would not have treated any portion of the second $50,000 contract amount as having been "fixed" prior to completion of the building.

In contrast, in the earlier example, the JCT concluded that section 451(b) did *not* apply to any portion of the $4,500 performance bonus accelerated for book purposes, because the taxpayer did not yet have a "fixed and definite right to receive the income." As a result, no portion of the performance bonus was *realized* prior to contract completion, so section 451(b) could not accelerate *recognition* despite the book treatment.

Setting aside the correctness of either conclusion, the JCT's having reached differing results on relatively similar facts suggests that an already fine line is about to become even thinner. Courts have long distinguished between a present, fixed right to income that might be extinguished by a later event

16 Blue Book, at 166, Example 6.

17 Blue Book, at 162-163, Example 2 (emphasis added).

18 In these examples, there is no issue as to whether the amounts are "reasonably determinable" under the second prong of the all events test.

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(a "condition subsequent") and an inchoate right to income that will become fixed only if and when a specific event occurs (a "condition precedent").[19] For example, a condition precedent may forestall accrual if the taxpayer has no contractual right to payment unless and until the customer formally accepts the product, and the customer's acceptance is more than ministerial.[20] The taxpayer has no "fixed right" to the income until formal acceptance by the customer. On the other hand, a condition subsequent exists if the taxpayer has a contractual right to payment upon delivery, but the customer has the right to demand a refund within six months following delivery. The taxpayer has a "fixed right" to the income immediately upon delivery, but a subsequent event may defease that right and require the taxpayer to reverse the income inclusion. In some cases, the line between a condition precedent (potential income in the future) and a condition subsequent (income immediately) is gossamer fine.

Layering in the realization concept only blurs the line further. Consider this example: On December 1, year 1, the taxpayer enters an agreement entitling it to receive $100 so long as a specified stock index is above 20,000 on July 1, year 2. At the time of the agreement, the specified index is 21,000. Assume books recognizes the $100 when the agreement is entered in year 1.[21] On these facts, which of the following is correct?

(1) There is no realization event in year 1 when the contract is entered because "the necessary material conditions and requirements for the receipt" of payment (the JCT formulation) will not be satisfied until July 1.

(2) The specified index being above 20,000 on July 1 is a condition precedent, preventing satisfaction of the first prong of the all events test until the index can be measured on that date in year 2.

(3) Because the market index is already above 20,000, its declining below 20,000 as of July 1 is a condition subsequent that might terminate the taxpayer's present "fixed right" to payment established in year 1.

Under the first answer, section 451(b) has no application prior to July 1, year 2 because the income has not been *realized* until that date. As a result, accrual (i.e., recognition) of the income *cannot* be accelerated into year 1 for tax purposes, regardless of the book treatment of the $100. Result: Income in year 2.

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[19] *Charles Schwab*, 107 T.C. at 293; Wien Consol. Airlines, Inc. v. Commissioner, 60 T.C. 13, 15 (1973), *aff'd*, 528 F.2d 735 (9th Cir. 1976); Buckeye Intl. Inc. v. Commissioner, T.C. Memo. 1984-668.

[20] *See*, *e.g.*, Doyle, Dane, Bernbach, Inc. v. Commissioner, 79 T.C. 101 (1982) (state tax refund not included in income until state tax authority reviews the claim and approves the refund (or payment, if earlier)); Rev. Rul. 2003-3, 2003-1 C.B. 252 (because state tax authority's review of refund claim is not ministerial, claimed refund is not income until completion of that review and approval).

[21] For purposes of this example, disregard any special tax provisions governing financial instruments as well as the actual financial accounting treatment required. This example is for general illustrative purposes only.

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Under the second answer, because accruing the income in year 1 for tax purposes is prevented by the condition precedent (i.e., the first prong of the all events test is not satisfied as of the end of year 1), section 451(b) *deems* the all events test to have been satisfied in year 1 when the $100 is included in revenue for book purposes. Result: Income in year 1, but only through application of section 451(b).

Under the third answer, despite the possibility of a condition subsequent extinguishing the taxpayer's present right to the $100, the all events test is actually satisfied as of the end of year 1. Result: Income in year 1 under pre-existing tax law.

This example illustrates the exercise in fine line drawing that accrual method taxpayers have grappled with for many years. The addition of the realization concept where it has not been relevant (or considered) previously will only further blur those lines. At least until Treasury and the IRS issue regulations clarifying the distinction between realization and recognition outside of property dispositions, taxpayers face both opportunities and challenges in attempting to discern the difference for purposes of new section 451(b).

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