Surgent cpe
EDUCATION FOR PROS

Critical Issues That CPAs in Industry Will Need to Face This Year

CII4/25/V1

201 N. King of Prussia Road
Suite 370
Radnor, PA 19087
P : (610) 688 4477
F : (610) 688 3977
info@surgent.com
surgentcpe.com

SURGENT
Continuing**Education**

Calling All **Exceptional** INSTRUCTORS

Surgent is currently accepting nominations

for prospective new Discussion Leaders in the following areas:

Tax	**Accounting & Audit**	**Gov't and Not-for-Profit A&A**	**Business and Industry** (all topics)

If you are an experienced CPA, have strong public speaking and teaching skills, and an interest in sharing your knowledge with your peers by teaching live seminars, we would love to hear from you!

Interested in becoming a Surgent discussion leader?

Reach out to us at
recruitment@surgent.com

SURGENT
Continuing**Education**

SURGENT
ACCOUNTING & FINANCIAL EDUCATION

SURGENT FOR ENTERPRISE

Educational Solutions that Advance the Strategic Value of Everyone in Your Firm

At Surgent, we tailor our offerings—**exam review**, **continuing education**, and **staff training programs**—to meet your organization's specific needs in the most convenient and effective ways possible.

Personalized Exam Review

Help associates pass faster with the industry's most advanced exam review courses

- Adaptive study model offered for CPA, CMA, EA, CISA, CIA, and SIE exams
- Monitor employees' exam review progress with Firm360

Continuing Professional Education (CPE)

Make CPE easy for you and your staff with several ways to buy, earn and track CPE

- Flex Access Program – Secure a pool of CPE hours your staff can pull from in live webinar and/or self-study format
- Onsite Training – Reserve an in-firm training with a Surgent instructor
- Course licensing – License content from Surgent to lead your own CPE training

Staff Level Training

Leverage highly practical sessions, organized into suggested curricula according to staff experience levels

- Audit Skills Training Program
- Internal Audit Training Program
- Taxation Training Program

FIRM CPE PORTAL

Track and manage CPE for all users in your organization quickly and easily with Surgent's Firm CPE Portal.

Request a demo today!

Every firm is unique—and that is why we built our customizable, innovative Surgent for Enterprise program.

Contact our Firm Solutions team today to learn how Surgent can partner with you to create a solution to support staff development for your organization.

(484) 588.4197
salesinfo@surgent.com

Table of Contents

FASB Accounting Standards Updates, Including the Activities of the PCC 1

A Refresher on ASC 606 and the Results of the Final PIR Report for ASC 606 2

Emerging Trends: Digital Asset Compliance 3

Investments, Retirement, and Miscellaneous 4

Revised June 2025

NOTES

FASB Accounting Standards Updates, Including the Activities of the PCC

Learning objectives	***1***
I. Introduction	***1***
II. Key ASUs issued in 2024 and 2025	***1***
A. ASU No. 2025-04, *Share-Based Consideration Payable to a Customer*	**1**
1. Reason for issuance	*1*
2. Entities affected	*1*
3. Main provisions	*1*
4. Effective date and transition guidance	*2*
B. ASU No. 2025-03, *Business Combinations (Topic 805) and Consolidation (Topic 810): Determining the Accounting Acquirer in the Acquisition of a Variable Interest Entity*	**3**
1. Reason for issuance	*3*
2. Entities affected	*3*
3. Main provisions	*3*
4. Effective date and transition guidance	*3*
C. ASU No. 2025-02, *Liabilities (Topic 405) – Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 122*	**4**
1. Main provision	*4*
D. ASU No. 2025-01, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Clarifying the Effective Date*	**4**
1. Main provision	*4*
E. ASU No. 2024-04, *Debt – Debt with Conversion and Other Options (Topic 470-20)*	**4**
1. Reason for issuance	*4*
2. Entities affected	*4*
3. Main provisions	*4*
4. Effective date and transition guidance	*5*
F. ASU No. 2024-03, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Disaggregation of Income Statement Expenses*	**5**
1. Reason for issuance	*5*
2. Entities affected	*5*
3. Main provisions	*6*
4. Effective date and transition guidance	*6*
G. ASU No. 2024-02, *Codification Improvements – Amendments to Remove References to the Concepts Statements*	**6**
1. Reason for issuance	*6*
2. Entities affected	*7*
3. Main provisions	*7*
4. Effective date and transition guidance	*7*
H. ASU No. 2024-01, *Compensation – Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards*	**7**
1. Reason for issuance	*7*
2. Entities affected	*7*
3. Main provisions	*7*
4. Effective date and transition guidance	*8*
III. Key ASUs issued prior to 2024	***8***
A. ASU No. 2023-09, *Income Taxes (Topic 740): Improvements to Income Tax Disclosures*	**8**
1. Reason for issuance	*8*
2. Entities affected	*8*
3. Main provisions	*8*
4. Effective date	*9*
B. ASU No. 2023-08, *Intangibles – Goodwill and Other – Crypto Assets (Subtopic 350-60)*	**9**
1. Reason for issuance	*9*
2. Entities affected	*9*

3. Main provisions *9*
4. Effective date *10*
C. ASU No. 2023-07, *Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures* **10**
1. Reason for issuance *10*
2. Entities affected *10*
3. Main provisions *11*
4. Effective date *11*
D. ASU No. 2023-05, *Business Combinations – Joint Venture Formations (Subtopic 805-60)* **11**
1. Reason for issuance *11*
2. Entities affected *11*
3. Main provisions *11*
4. Effective date *12*
E. ASU No. 2023-02, *Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method* **12**
1. Reason for issuance *12*
2. Entities affected *12*
3. Main provisions *12*
4. Effective date *13*
F. ASU No. 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848* **13**
1. Reason for issuance *13*
2. Entities affected *13*
3. Main provisions *13*
4. Effective date *13*
G. ASU No. 2022-05, *Financial Services – Insurance (Topic 944): Transition for Sold Contracts* **14**
1. Reason for issuance *14*
2. Entities affected *14*
3. Main provisions *14*
4. Effective date *14*
H. ASU No. 2022-03, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions* **14**
1. Reason for issuance *14*
2. Entities affected *15*
3. Main provisions *15*
4. Effective date *15*
IV. Other ASUs effective in 2025 or beyond ***15***
V. FASB's technical agenda ***16***
A. Framework projects **17**
B. Recognition and measurement projects: narrow projects **18**
C. Other presentation and disclosure projects **18**
VI. Update on the FASB's Private Company Council ***18***
A. Responsibilities **18**
B. Makeup of the PCC **19**

FASB Accounting Standards Updates, Including the Activities of the PCC

Learning objectives

After completing this chapter, you should be familiar with:
- Recently issued ASUs of greatest significance to smaller and medium-sized entities;
- Recently issued ASUs impacting SEC registrants and other public entities; and
- Items on the FASB's technical agenda.

I. Introduction

Accounting Standards Updates are used by the FASB to amend its Accounting Standards Codification™ (Codification or ASC), which was launched on July 1, 2009, as the single source of authoritative nongovernmental U.S. GAAP. However, ASUs are not authoritative; they are only used to update the FASB Codification.

This chapter will discuss in depth all significant Accounting Standards Updates (ASUs) issued by the FASB in 2025, 2024, and 2023, that are effective in 2025 and beyond. It also covers ASUs issued prior with ongoing significance or application in 2025.

II. Key ASUs issued in 2024 and 2025

A. ASU No. 2025-04, *Share-Based Consideration Payable to a Customer*

1. Reason for issuance

FASB issued ASU 2025-04 to resolve diversity in practice and improve the clarity and operability of existing guidance related to share-based consideration (e.g., warrants, options, other equity instruments) granted to customers to incentivize them to purchase goods or services. Stakeholders identified uncertainty in distinguishing between service conditions and performance conditions and noted that existing policy elections for forfeiture accounting delayed revenue recognition in ways that reduced decision usefulness. Additionally, there was inconsistency in how the Topic 606 constraint on variable consideration (which is generally a reduction in revenue) was interpreted in conjunction with share-based consideration.

This ASU aims to ensure that revenue recognition reflects the economic substance of customer awards, especially when vesting is tied to purchase volume or value, and better aligns guidance for these awards with the principles of ASC 606 and ASC 718.

2. Entities affected

This Update applies to all entities, public and private, issuing share-based consideration to customers in the scope of Topic 606.

3. Main provisions

The ASU contains three main provisions within the update.

The ASU redefines the term "performance condition" in the Master Glossary to include vesting targets based on the volume or monetary amount of purchases as follows:

a. "For share-based consideration payable to a customer that can result in a reduction of the transaction price in accordance with Topic 606, a condition affecting the vesting, exercisability, exercise price, or other pertinent factors used in determining the fair value of an award that relates to any of the following:
   (i) Achieving a specified performance target that is defined solely by reference to the grantor's own operations (or activities) or by reference to the grantee's (the customer's) performance related to the grantor's own operations (or activities);
   (ii) The grantee's purchase (or potential purchase) of the grantor's goods or services from either the grantor or the grantor's customers; and/or
   (iii) A purchase (or potential purchase) of the grantor's goods or services from either the grantee or the grantee's customers.

   The performance targets listed in this definition for employee and nonemployee awards (for example, a change in control) are also examples of performance conditions for share-based consideration payable to a customer."

For awards with service conditions, the ASU eliminates the forfeitures-as-they-occur election and instead requires entities to estimate forfeitures.

The amendment further clarifies that the ASC 606 constraint on variable consideration does not apply to share-based customer awards. The grantor is required to only apply Topic 718 to such scenarios.

As a result of the ASU, revenue recognition will no longer be delayed when an entity grants awards that are not expected to vest, allowing a better initial estimate of the transaction price under ASC 606.

4. Effective date and transition guidance

The ASU is effective for all entities for annual reporting periods (including interim reporting periods within annual reporting periods) beginning after December 15, 2026. Early adoption is permitted. Modified retrospective (default) or full retrospective adoption is permitted.

"When applying the amendments in this Update on a modified retrospective basis, a grantor should recognize a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the period of adoption and should not recast any financial statement information before the period of adoption. A grantor should apply the amendments as of the date of initial application to all share-based consideration payable to a customer.

When applying the amendments in this Update on a retrospective basis, a grantor should recast comparative periods and recognize a cumulative-effect adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the earliest period presented. Additionally, an entity that elects to apply the guidance retrospectively should use the actual outcome, if known, of a performance condition or service condition as of the beginning of the annual reporting period of adoption for all prior-period estimates. If actual outcomes are unknown as of the beginning of the annual reporting period of adoption, an entity should use its estimate of the probability of achieving a service condition or performance condition as of the beginning of the annual reporting period of adoption for all prior-period estimates."

B. ASU No. 2025-03, *Business Combinations (Topic 805) and Consolidation (Topic 810): Determining the Accounting Acquirer in the Acquisition of a Variable Interest Entity*

1. Reason for issuance

The FASB issued ASU 2025-03 to address inconsistencies in the determination of the accounting acquirer in transactions where a variable interest entity (VIE) is acquired. Under prior guidance, the primary beneficiary of a VIE was always considered the accounting acquirer, even when the transaction was effected by exchanging equity interests. Stakeholders raised concerns about lack of comparability between VIE and non-VIE transactions, especially regarding reverse acquisitions and whether a business combination had occurred. The amendments aim to enhance consistency and comparability by allowing the same accounting acquirer assessment factors that are currently required for determining which entity is the accounting acquirer in other acquisition transactions.

2. Entities affected

This Update affects all entities involved in acquisition transactions effected primarily by exchanging equity interests when the legal acquiree is a VIE that meets the definition of a business.

3. Main provisions

The ASU modifies Topic 805 and Topic 810 to require entities to apply the same set of factors (outlined in ASC 805-10-55-12 through 55-15) to determine the accounting acquirer when:

a. The legal acquiree is a VIE;
b. The legal acquiree meets the definition of a business; and
c. The transaction is effected primarily by exchanging equity interests.

Previously, the primary beneficiary was always the acquirer for VIEs; the ASU removes that automatic designation in the specific case of equity exchange transactions. The factors to consider include relative voting rights, governing body composition, senior management continuity, and size of the entities involved. The ASU does not change the accounting for reverse acquisitions or acquisitions where the legal acquiree is not a business.

4. Effective date and transition guidance

ASU 2025-03 is effective for all entities for annual reporting periods beginning after December 15, 2026, including interim periods within those annual periods. Early adoption is permitted at the beginning of any interim or annual reporting period where financial statements have not yet been issued or made available for issuance. The amendments must be applied prospectively to any qualifying acquisition transactions occurring after the initial application date.

C. ASU No. 2025-02, *Liabilities (Topic 405) – Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 122*

1. Main provision

This Update removed the guidance related to the safeguarding of crypto assets initially issued in SAB 121 that was subsequently repealed by SAB 122.

D. ASU No. 2025-01, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Clarifying the Effective Date*

1. Main provision

The amendment in this Update amends the effective date of Update 2024-03 to clarify that all public business entities are required to adopt the guidance in annual reporting periods beginning after December 15, 2026, and interim periods within annual reporting periods beginning after December 15, 2027. Early adoption of ASU 2024-03 is permitted. This ASU is discussed further in the ASU 2024-03 section.

E. ASU No. 2024-04, *Debt – Debt with Conversion and Other Options (Topic 470-20)*

1. Reason for issuance

ASU 2024-04 was issued to address and improve relevance and consistency in the application of the induced conversion guidance under Subtopic 470-20, with the largest focus being on determining if the conversion should be accounted for as an induced conversion or debt extinguishment. Current guidance was found to be inadequate, particularly after the introduction of cash convertible instruments and changes to accounting for convertible debt instruments with cash conversion features introduced in ASU 2020-06. Current guidance also does not address how the standards should be applied to the settlement of a convertible debt instrument that does not require new equity securities to be issued upon conversion. The Update seeks to clarify the guidance for determining whether a transaction involving the modification of a convertible debt instrument’s terms (particularly a cash convertible instrument) at terms that are different from the original conversion terms should be accounted for as an induced conversion or a debt extinguishment.

2. Entities affected

This Update affects entities, public and private, that settle convertible debt instruments where the conversion privileges have been modified to induce conversion.

3. Main provisions

The main provisions of ASU 2024-04 significantly amend the guidance on induced conversions of convertible debt instruments.

The changes include:

a. **Clarification of inducement offers** – The ASU clarifies that, to account for a settlement of a convertible debt instrument as an induced conversion, the inducement offer must provide the holder with the consideration (in form and amount) that was issuable under the conversion privileges provided in the original terms of the instrument. This clarification addresses ambiguities about whether modifications to terms or the addition of new conversion incentives constitute an induced conversion or a debt extinguishment. The entity must assess this as of the date the conversion offer is accepted by the holder. If, when applying this criterion, the convertible debt instrument had been exchanged or modified (without being deemed substantially different) within the one-year period leading up to the offer acceptance date, an entity should compare the terms provided in the inducement offer with the terms that existed one year before the offer acceptance date.

b. **Treatment of VWAP modifications** – The ASU specifies that incorporation, elimination, or changes to a volume-weighted average price (VWAP) formula or similar provision do not automatically lead to a debt extinguishment classification. Instead, an entity should assess whether the modified terms preserve the form and amount of the conversion consideration stipulated in the original terms as of the offer acceptance date.

c. **Applicability to nonconvertible instruments** – The guidance extends to scenarios where a convertible debt instrument is not currently convertible but has a substantive conversion feature at issuance and at the time the inducement offer is accepted.

4. Effective date and transition guidance

ASU 2024-04 is effective for all entities for annual reporting periods beginning after December 15, 2025, and interim periods within those annual periods. Early adoption is permitted for all entities that have adopted ASU 2020-06.

Entities may apply the new guidance on a prospective or retrospective basis:

a. **Prospective application** – Entities apply the amendments to settlements of convertible debt instruments occurring after the effective date of the guidance.

b. **Retrospective application** – Entities can recast prior periods and recognize a cumulative-effect adjustment to equity at the later of the beginning of the earliest period presented or the date the entity adopted the amendments in ASU 2020-06.

F. ASU No. 2024-03, *Income Statement – Reporting Comprehensive Income – Expense Disaggregation Disclosures (Subtopic 220-40): Disaggregation of Income Statement Expenses*

1. Reason for issuance

ASU 2024-03 was issued in response to feedback from investors and other financial statement users who expressed the need for more detailed information about expenses to better understand an entity's performance, forecast future cash flows, and compare performance across entities. Specific feedback highlighted the importance of disaggregating costs of sales and selling, general, and administrative expenses (SG&A) to better understand an entity's cost structure.

2. Entities affected

The amendments in ASU 2024-03 apply to all public business entities.

3. Main provisions

The main provisions require public business entities to disclose more detailed information about their expenses in the notes to their financial statements. Specifically, entities must:

- Disclose the amounts of (a) purchases of inventory, (b) employee compensation, (c) depreciation, (d) intangible asset amortization, and (e) depreciation, depletion, and amortization recognized as part of oil-and gas-producing activities (DD&A) (or other amounts of depletion expense) included in each relevant expense caption. A relevant expense caption is an expense caption presented on the face of the income statement within continuing operations that contains any of the expense categories listed in (a)–(e);
- Include certain amounts that are already required to be disclosed under current generally accepted accounting principles (GAAP) in the same disclosure as the other disaggregation requirements;
- Disclose a qualitative description of the amounts remaining in relevant expense captions that are not separately disaggregated quantitatively; and
- Disclose the total amount of selling expenses and, in annual reporting periods, the entity's definition of selling expenses.

These disclosures are required for both interim and annual reporting periods and aim to enable investors to better understand the components of an entity's expenses, assess performance, and forecast future expenses.

4. Effective date and transition guidance

The FASB removed the initial effective date that was announced in ASU 2024-03. The effective date of ASU 2024-03 was amended shortly after issuance by ASU 2025-01 to correct for a situation where the guidance made it possible for a public business entity to apply the guidance to an interim reporting period prior to applying the guidance to an annual reporting period. Under ASU 2025-01, ASU 2024-03 is effective for public business entities for annual reporting periods beginning after December 15, 2026, and interim reporting periods within annual reporting periods beginning after December 15, 2027.

Early adoption is permitted. Entities have the option to apply the amendments either retrospectively to all prior periods presented or prospectively to new or modified transactions after the effective date.

G. ASU No. 2024-02, *Codification Improvements – Amendments to Remove References to the Concepts Statements*

1. Reason for issuance

ASU 2024-02 introduces amendments to the Codification to remove references to various FASB Concepts Statements. This action is part of the FASB's ongoing project to address suggestions from stakeholders for improvements and technical corrections to the Codification, facilitating updates for clarifications, simplifications, and minor improvements. By removing references to Concepts Statements, which are nonauthoritative, the FASB aims to clarify the Codification, correct any unintended applications of guidance, and draw a clear distinction between authoritative and nonauthoritative literature, ensuring that the Codification reflects current GAAP without implying the authoritativeness of the Concepts Statements, which are now removed.

2. *Entities affected*

The amendments impact various Topics within the Codification and apply to all reporting entities within the scope of the affected accounting guidance.

3. *Main provisions*

ASU 2024-02 seeks to refine and clarify the Codification by eliminating unnecessary references to nonauthoritative Concepts Statements, thereby enhancing the clarity and application of GAAP for all reporting entities. The main provisions of ASU 2024-02 involve the removal of references to Concepts Statements across a wide range of Codification Topics. These references are often extraneous and not essential for understanding or applying the guidance. In some cases, the references might imply the authoritativeness of Concepts Statements or refer to superseded documents, potentially leading to diverse interpretations. The amendments aim to simplify the Codification, emphasizing the distinction between authoritative guidance and conceptual frameworks that inform the FASB's standard-setting process. This clarification is expected to streamline the application of GAAP by eliminating potential confusion over the role of Concepts Statements in preparing financial statements.

4. *Effective date and transition guidance*

For public business entities, the amendments are effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. For all other entities, the amendments apply to fiscal years beginning after December 15, 2025. Early adoption is permitted for entities for any fiscal year or interim period for which financial statements have not yet been issued or made available for issuance. Entities adopting the amendments in an interim period must do so as of the beginning of the fiscal year that includes that interim period. The transition can be applied either prospectively to all new or modified transactions recognized on or after the date of first application or retrospectively to the beginning of the earliest comparative period presented.

H. ASU No. 2024-01, *Compensation – Stock Compensation (Topic 718): Scope Application of Profits Interest and Similar Awards*

1. *Reason for issuance*

The Financial Accounting Standards Board (FASB) issued ASU 2024-01 to clarify how entities should apply scope guidance in determining whether profits interest and similar awards should be accounted for under Topic 718, *Compensation – Stock Compensation*. This was in response to complexities and diversity in practice (even for similar fact patterns) identified by the PCC regarding the accounting of profits interest awards, which are used by entities to align compensation with performance and provide participants with future profits and/or equity appreciation. The Update aims to add illustrative examples for clarity and improve consistency in applying GAAP.

2. *Entities affected*

The amendments affect all reporting entities that account for profits interest awards as compensation to employees or nonemployees in return for goods or services. Additionally, the amendments that clarify the scope and exceptions section of Topic 718 apply to all entities entering into share-based payment transactions.

3. *Main provisions*

ASU 2024-01 aims to provide clarity and reduce inconsistencies in how entities account for profits interest and similar awards, ensuring a more standardized approach across different entities and situations. ASU

2024-01 introduces an illustrative example with four fact patterns to demonstrate the application of scope guidance for determining whether a profits interest award falls under Topic 718. These examples focus on key considerations such as whether the award grants the right to equity instruments or cash payments based on the entity's share price, among other conditions. This guidance aims to reduce complexity and practice diversity by providing clear criteria for when profits interest awards should be accounted for under Topic 718. The example is comprehensive, covering cases where the awards are share-based payment arrangements and where they are not, based on various conditions like service requirements, participation in distributions, and settlement terms.

4. Effective date and transition guidance

For public business entities (PBEs), the amendments are effective for annual periods beginning after December 15, 2024, including interim periods within those annual periods. For all other entities, they are effective for annual periods beginning after December 15, 2025, and interim periods within those annual periods. Early adoption is permitted for both interim and annual financial statements not yet issued or available for issuance. Entities can apply the amendments retrospectively to all prior periods presented or prospectively to awards granted or modified after the first application date.

III. Key ASUs issued prior to 2024

A. ASU No. 2023-09, *Income Taxes (Topic 740): Improvements to Income Tax Disclosures*

1. Reason for issuance

This ASU was issued to help investors "better understand an entity's exposure to potential changes in jurisdictional tax legislation and the ensuing risks and opportunities." It will allow investors to better assess income tax information that relates to cash flow forecasts and capital allocation decisions and will also aid investors in identifying potential opportunities to increase future cash flows.

2. Entities affected

The ASU affects all entities, public and private, subject to ASC Topic 740.

3. Main provisions

The ASU improves transparency and expands what public and private entities must disclose regarding rate reconciliations, income taxes paid, amounts surrounding the disaggregation of foreign and domestic income before taxes, and income tax expense or benefit from continuing operations disaggregated by foreign, federal, and state. Public entities must disclose specific categories in the rate reconciliation and expand disclosures for all reconciling items that meet a quantitative threshold for items that are greater than or equal to 5 percent of pretax income (loss) by the applicable statutory income rate. Private entities require qualitative, not quantitative, disclosure about categories of reconciling items and tax jurisdictions that result in a "significant difference" between the statutory tax rate and the effective tax rate.

All entities must disclose "the amount of income taxes paid (net of refunds received) disaggregated by federal (national), state, and foreign taxes." They also must disclose "the amount of income taxes paid (net of refunds received) disaggregated by individual jurisdictions in which income taxes paid (net of refunds received) is equal to or greater than 5 percent of total income taxes paid (net of refunds received)." The ASU also provides that entities must disclose (a) income (or loss) from continuing operations before income tax expense (or benefit), disaggregated between domestic and foreign, and (b) income tax expense (or benefit) from continuing operations disaggregated by federal (national), state, and foreign.

Lastly, the ASU eliminates the requirement for all entities to (a) disclose the nature and estimate of the range of the reasonably possible change in the unrecognized tax benefits balance in the next 12 months or (b) make a statement that an estimate of the range cannot be made.

4. Effective date

ASU No. 2023-09 is effective for public entities for fiscal years beginning after December 15, 2024; for private entities, the effective date is for fiscal years beginning after December 15, 2025. Early adoption and retrospective application are permitted.

B. ASU No. 2023-08, *Intangibles – Goodwill and Other – Crypto Assets (Subtopic 350-60)*

1. Reason for issuance

This ASU was issued to establish balance sheet, income statement, and statement of cash flow reporting requirements for crypto assets and other intangible assets meeting the FASB's revised definition of a crypto asset. Prior to the release of the ASU, the best recommendation was for crypto assets to be classified as intangible assets subject to impairment testing and carried at cost less impairment. Gain recognition was disallowed. The ASU expands disclosure requirements for reporting holdings in crypto assets.

2. Entities affected

The ASU affects all entities holding or transacting in crypto assets.

3. Main provisions

The ASU establishes financial reporting guidelines for crypto assets. A crypto asset is defined in the standard as an asset that meets all of the following criteria to be in scope of the amendment:

- a. Meets the ASC definition of an intangible asset;
- b. Does not provide the asset holder with enforceable rights to or claims on underlying goods, services, or other assets;
- c. Is created or resides on a distributed ledger based on blockchain or similar technology;
- d. Is secured through cryptography;
- e. Is fungible; and
- f. Is not created by the reporting entity or its related parties.

The ASU establishes that intangible assets meeting the definition of a crypto asset must be reported separately from other intangible assets (further disaggregation by crypto asset is permitted). The asset must be measured and reported at fair value on the balance sheet. Changes resulting from remeasurement go directly to the income statement (or statement of activity) as a gain or loss on change in fair value from intangible assets, reported separately from other gains and losses.

The ASU further establishes disclosure requirements for entities subject to the guidance. Entities must disclose the name, cost basis, fair value, and number of units for each significant crypto asset holding and the aggregate fair values and cost bases of the crypto asset holdings that are not individually significant. For crypto assets that are subject to contractual sale restrictions, the fair value of those crypto assets, the nature and remaining duration of the restriction(s), and the circumstances that could cause the restriction(s) to lapse must be disclosed.

Other disclosures include:

a. A roll forward, in the aggregate, of activity in the reporting period for crypto asset holdings, including additions (with a description of the activities that resulted in the additions), dispositions, gains, and losses.
b. For any dispositions of crypto assets in the reporting period, the difference between the disposal price and the cost basis and a description of the activities that resulted in the dispositions.
c. If gains and losses are not presented separately, the income statement line item in which those gains and losses are recognized.
d. The method for determining the cost basis of crypto assets.

Annual reconciliation detailing the activity from the opening to the closing balances of crypto assets, separately listing:

a. Additions;
b. Dispositions;
c. Gains included in net income for the period, determined on a crypto-asset-by-crypto-asset basis. Each crypto asset holding that has a net gain from remeasurement as included in net income for the period shall be included in the gains line; and
d. Losses included in net income for the period, determined on a crypto-asset-by-crypto-asset basis. Each crypto asset holding that has a net loss from remeasurement as included in net income for the period shall be included in the losses line.

4. Effective date

ASU No. 2023-08 is effective for all entities for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years. Early adoption is permitted for annual and interim financial statements. Entities are required to make a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the period in which the entity adopts the amendment.

C. ASU No. 2023-07, *Segment Reporting (Topic 280): Improvements to Reportable Segment Disclosures*

1. Reason for issuance

This ASU, which only applies to public entities, was issued in response to the FASB's post-implementation review of Statement No. 131. Prior to the ASU, public entities were required to report segment revenue and profit or loss, with limited expense information disclosed. Investors wanted expanded disclosures about a segment's expenses. The ASU expands such expense disclosure requirements and updates guidance on reportable segments, including disclosure of the title and position of the chief operating decision maker (CODM) and significant expenses reported to them.

2. Entities affected

The ASU only applies to public entities subject to segment disclosure requirements.

3. *Main provisions*

The main provisions of the ASU focus on mandatory disclosure requirements. The public entity must disclose significant segment expenses that are regularly provided to the CODM and included in segment profit or loss. They are required to disclose and break out other segment items not included in the significant expenses, and the other items should be the difference between segment revenue and segment reported profit or loss.

Entities must continue existing reporting requirements under ASC 280. In addition to reporting segment profit and loss that is most consistent under U.S. GAAP, a public entity may report additional profit and loss measures utilized by the CODM. The entity must disclose the title and position of the CODM and describe how they use the identified segment information.

Note that the ASU applies even if the public entity has only one reportable segment.

4. *Effective date*

ASU No. 2023-07 is effective for fiscal years beginning after December 15, 2023, and interim periods within fiscal years beginning after December 15, 2024. Early adoption is permitted, and retrospective application is required for all periods presented in the financial statements.

D. ASU No. 2023-05, *Business Combinations – Joint Venture Formations (Subtopic 805-60)*

1. *Reason for issuance*

This ASU was issued as an amendment to provide clear guidance on accounting for contributions made to a joint venture, upon formation, in a joint venture's separate financial statements. Prior to the ASU, joint ventures took a diverse approach to measuring contributions at the formation date, with some electing to account for net asset contributions at fair value and others electing to account for net asset contributions at the venturer's carrying amount. The Update now provides consistent and decision-useful guidance to investors and reduces diversity in joint venture formation accounting.

2. *Entities affected*

The ASU applies only to entities that meet the FASB ASC Master Glossary definition of a joint venture or corporate joint venture.

3. *Main provisions*

The ASU establishes that newly formed joint ventures should initially measure assets and liabilities at fair value as of the formation date (with fair value measurement exceptions that are consistent with business combination guidance). This approach is consistent with the accounting result that would occur if the joint venture was treated as the acquirer of a business and subject to the guidance in FASB ASC Subtopic 850, *Business Combinations*.

Disclosures for joint venture formation should occur in the period in which the formation date occurs. Note that joint venture formation disclosure requirements are different from the requirements for disclosures in a business combination.

4. *Effective date*

The ASU is effective prospectively for all joint venture formations with a formation date beginning on or after January 1, 2025. Joint ventures formed prior to this date may elect to apply the ASU retrospectively if sufficient information exists. Early adoption is permitted for annual and interim periods for which financial statements have not been issued or made available for issuance, either prospectively or retrospectively.

E. ASU No. 2023-02, *Accounting for Investments in Tax Credit Structures Using the Proportional Amortization Method*

1. *Reason for issuance*

This ASU was issued to allow consistent accounting for equity investments made primarily for the purpose of receiving income tax credits and other income tax benefits. Previously, the proportional amortization method was limited to investments in low-income housing tax credit (LIHTC) structures, while equity investments in other tax credit structures were typically accounted for using the equity method or Topic 321. The ASU affects all entities that hold at least one of the following:

a. Tax equity investments that an entity has elected to account for using the proportional amortization method.
b. An investment in a LIHTC structure through a limited liability entity that is not accounted for using the proportional amortization method and to which certain LIHTC-specific guidance removed by ASU 2023-02 has been applied.

2. *Entities affected*

The ASU applies only to entities that meet the FASB ASC Master Glossary definition of a joint venture or corporate joint venture.

3. *Main provisions*

Entities can elect to account for their tax equity investments utilizing the proportional amortization method if all required conditions are met:

a. It is probable that the income tax credits allocable to the tax equity investor will be available;
b. The tax equity investor does not have significant influence over the operating and financial policies of the underlying project;
c. Substantially all of the projected benefits are from income tax credits and other income tax benefits. Projected benefits include income tax credits, other income tax benefits, and other non-income-tax-related benefits. The projected benefits are determined on a discounted basis using a discount rate consistent with the cash flow assumptions used by the tax equity investor in deciding to invest in the project;
d. The tax equity investor's projected yield is positive based solely on the cash flows from the income tax credits and other income tax benefits; and
e. The tax equity investor is a limited liability investor in the limited liability entity for both legal and tax purposes.

Furthermore, when a reporting entity makes the referenced election related to the proportional amortization method on a tax-credit-program-by-tax-credit-program basis, the entity should disclose the following:

a. The nature of its tax equity investments; and
b. The effect of its tax equity investments, related income tax credits, and other income tax benefits on its financial position and results of operations.

ASU 2023-02 also removes specialized guidance for LIHTC investments. LIHTC investments may elect the proportional amortization method if all conditions are met. However, if an entity does not elect this method, these investments will follow the appropriate GAAP guidance found in Topic 321 and Subtopic 323-10.

4. Effective date

For public business entities, the ASU is effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2024, and interim periods within those fiscal years. Early adoption is permitted.

F. ASU No. 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848*

1. Reason for issuance

This ASU was issued in response to the UK Financial Conduct Authority (FCA) extending the intended cessation date of the USD LIBOR interest rates. ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting* included a sunset provision related to exceptions and optional expedients for contract modifications and hedging relationships. This sunset provision assumed that the LIBOR rates would be discontinued by the end of 2021.

2. Entities affected

The ASU affects all entities that have contracts, hedging relationships, and other transactions that utilize the LIBOR rate or any other reference rate that is expected to be discontinued as a result of reference rate reform.

3. Main provisions

This ASU delays the sunset provision included in ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting.* ASU 2022-06 defers the sunset date of Topic 848 from December 31, 2022, to December 31, 2024. This deferment is based on the FCA delaying the intended cessation date of USD LIBOR rates to June 30, 2023. Entities should note that after December 31, 2024, the exceptions and optional expedients for contract modifications and hedging relationships will no longer be permitted.

4. Effective date

ASU No. 2022-06 was effective for all entities upon issuance.

G. ASU No. 2022-05, *Financial Services – Insurance (Topic 944): Transition for Sold Contracts*

1. Reason for issuance

The FASB issued this ASU in response to stakeholders noting certain provisions within ASU 2018-12, *Financial Services – Insurance: Targeted Improvements to the Accounting for Long-Duration Contracts (LDTI),* were not cost-effective. Practitioner feedback indicated that applying the LDTI guidance to contracts that were derecognized because of a sale or disposal of individual or a group of contracts or legal entities before the LDTI effective date would put an unnecessary burden on insurance entities. This ASU was implemented to reduce costs and complexity related to these transactions.

2. Entities affected

ASU 2022-05 affects insurance entities that have derecognized contracts before the LDTI effective date. Please see further details in the effective date section below.

3. Main provisions

The implementation of ASU 2018-12 requires insurance companies to apply a retrospective transition method from the beginning of the earliest period presented or the prior fiscal year if early application is chosen. This means that the provisions of ASU 2018-12 would apply to contracts that were derecognized prior to the effective date, which would be costly and would not provide useful information.
ASU 2022-05 allows insurance entities to make an accounting policy election on a transaction-by-transaction basis to exclude certain contracts from the application of ASU 2018-12. The derecognized contract must have been sold or disposed of, and the insurance company must have no continuing involvement with the contract to qualify for the accounting policy election.

4. Effective date

The effective dates of the amendments within ASU 2022-05 are consistent with the effective dates of the amendments in ASU 2020-11. ASU 2020-11 extended the effective dates noted in ASU 2018-12 due to the COVID-19 pandemic. Therefore, ASU 2018-12 and ASU 2022-05 are effective for public entities that meet the definition of an SEC filer and are not smaller reporting companies for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. For all other entities, the effective date is fiscal years beginning after December 15, 2024, and interim periods within fiscal years beginning after December 15, 2025. Early adoption is permitted.

H. ASU No. 2022-03, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*

1. Reason for issuance

This ASU was issued to clarify the guidance in Topic 820, *Fair Value Measurement* when measuring the fair value of an equity security subject to contractual restrictions that prohibit the sale of an equity security. The lack of clarity in the guidance has led to a diversity in practice in the accounting for such instruments.

The ASU also updates the related illustrative example of accounting for such restrictions and adds new disclosure requirements for equity securities subject to contractual sale restrictions that are measured at fair value in accordance with Topic 820.

2. Entities affected

The ASU affects all entities that have investments in equity securities measured at fair value that are subject to a contractual sale restriction.

3. Main provisions

Under this ASU, a contractual restriction on the sale of an equity security is not considered part of the unit of account of the equity security and, therefore, is not considered in measuring fair value. Also, an entity cannot, as a separate unit of account, recognize and measure a contractual sale restriction.

The ASU adds the following disclosures related to such securities:

a. The fair value of equity securities subject to contractual sale restrictions reflected in the balance sheet;
b. The nature and remaining duration of the restriction(s); and
c. The circumstances that could cause a lapse in the restriction(s).

4. Effective date

The effective date for ASU No. 2022-03 is as follows:

a. Public business entities – Fiscal years beginning after December 15, 2023, and interim periods within those fiscal years.
b. All other entities – Fiscal years beginning after December 15, 2024, and interim periods within those fiscal years.

Early adoption is permitted. ASU No. 2022-03 should be applied on a prospective basis.

Entities that apply ASC 946 should continue to apply their historical accounting to such investments until the contractual restrictions expire.

IV. Other ASUs effective in 2025 or beyond

The following table details ASUs issued by the FASB prior to 2024 that will become effective for public and nonpublic business entities in 2024 or beyond.

ASU	Title	Summary	Effective Date
ASU No. 2023-06	*Disclosure Improvements: Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative*	Mainly amends requirements surrounding disclosure and presentation of Codification subtopics in an attempt to align SEC mandated disclosures with FASB disclosures. 14 of the SEC's 27 referred disclosures were accepted by the FASB.	The ASU will only become effective if the SEC removes their related disclosure requirements from the regulation by June 30, 2027.
ASU No. 2023-04	*Liabilities (Topic 405)*	Mainly addresses risks unique to holding customer/client crypto assets, including technological, legal, and regulatory risks. Entities hold these assets on behalf of the users as a part of their platform offering; therefore, the entities are responsible for safeguarding the assets. Such operations present a liability, measured at fair value, to these entities that should be reflected in the financial statements.	Effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years for public business entities. For all other entities, effective for fiscal years beginning after December 15, 2024, including interim periods within those fiscal years.
ASU No. 2018-12	*Financial Services – Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts*	Changes the accounting model for long-duration insurance contracts.	Years beginning on or after December 15, 2024.

Details on these previously issued ASUs can be found at the FASB website, www.FASB.org.

Discussion question:

Which of the FASB's new ASUs will have the most significant impact on either your clients or company?

V. FASB's technical agenda

The FASB's technical agenda provides information related to current FASB projects. Projects typically go through a six-step process. These steps include:

1. Topic is added to the agenda;
2. Initial deliberations;
3. Exposure draft;
4. Exposure draft comment period;
5. Exposure draft redeliberation; and
6. Final standard/concept.

The current technical agenda includes the following:

a. Framework projects (3);
b. Recognition and measurement: narrow projects (11); and
c. Presentation and disclosure projects (5).

A. Framework projects

Framework projects do not change the FASB's Accounting Standards Codification (ASC) per se but rather update the theoretical underpinnings of the accounting standards found in the FASB Concepts Statements. These updated concepts are then applied to accounting topics, the changes to which would update the ASC.

Per the FASB website, The FASB Concepts Statements are intended to serve the public interest by setting the objectives, qualitative characteristics, and other concepts that guide selection of economic phenomena to be recognized and measured for financial reporting and their display in financial statements or related means of communicating information to those who are interested. Concepts Statements guide the Board in developing sound accounting principles and provide the Board and its constituents with an understanding of the appropriate content and inherent limitations of financial reporting. A Statement of Financial Accounting Concepts does not establish generally accepted accounting standards.

There are currently five Concepts Statements.

The objective of this conceptual framework project is to develop an improved conceptual framework that provides a sound foundation for developing future accounting standards. Such a framework is essential to fulfilling the Board's goal of developing standards that are principles-based, internally consistent, and that lead to financial reporting that provides the information capital providers need to make decisions in their capacity as capital providers. The new FASB framework will build on the existing framework.

With the issuance of the updated frameworks related to elements of financial statements and presentation in December 2021, the FASB currently has only one framework project on its agenda: measurement. Its project, dealing with its measurement conceptual framework, is focused on agreeing on the meanings of key terms and what the objectives and qualitative characteristics imply for measurement, identifying appropriate types of measurements, and determining which measurements to use in specific circumstances. This project is currently in initial deliberations, with no exposure documents issued.

The FASB completed its elements framework project in 2021 by updating its Conceptual Statement related to financial statement elements. The updated guidance provides an improved conceptual framework that provides a sound foundation for developing future accounting standards.

The FASB also completed its framework project on presentation in 2021. The new guidance provides the FASB with a framework for developing standards that summarize and communicate information on financial statements in a way that best meets the objective of financial reporting. Ultimately, it will become a basis for the Board when creating presentation requirements in future standards.

Following the issuance of the updated Concepts Statement related to disclosures, the FASB issued final ASUs that updated the disclosures related to the following:

a. Fair value measurement; and
b. Defined benefit plans.

B. Recognition and measurement projects: narrow projects

There are 10 active recognition and measurement projects the FASB considers to be narrow projects. New projects added to the technical agenda include:

a. Accounting for investments in tax credit structures using the proportional amortization method;
b. Accounting and disclosure of software costs – Exploring ways to narrow the differences between the current internal use and external use models;
c. Accounting for environmental credit programs – Exploring how to improve the accounting for participants in programs that result in the creation of environmental credits;
d. Business combination project; and
e. Implementation issues related to ASC 606 and ASC 842.

Details on the status of all projects can be found on the FASB website.

C. Other presentation and disclosure projects

The FASB is continuing its work on five presentation and disclosure projects. Significant new presentation and disclosure projects include the following:

a. Disaggregation of income statement expenses;
b. Statement of cash flows targeted improvements; and
c. Disaggregation of performance information – Further disaggregation of certain income statement items.

For a complete overview and all of the details of the FASB's current technical agenda, please refer to the FASB's website at www.fasb.org.

VI. Update on the FASB's Private Company Council

Since its creation, the PCC has become the sounding board for feedback from private companies concerning the costs and benefits of both proposed and enacted accounting standards. Additionally, the PCC has both influenced new standard setting with regard to the concerns of private companies as well as advanced several simplification initiatives that have lightened the existing financial reporting burden on private companies. The influence of these simplification initiatives can be seen as the FASB has adopted similar simplifications in the areas of goodwill impairment testing and hedging. Additionally, the influence of the PCC can be seen in the FASB's decision in 2018, through ASU No. 2018-17, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*, to exempt nonpublic business entities from having to apply the variable interest entity (VIE) rules when determining whether to consolidate an entity, in certain situations. This influence can also be seen in the current direction of the FASB's proposed updated guidance on goodwill accounting, which mirrors the amortization election currently available for private companies.

A. Responsibilities

The PCC has two primary responsibilities:

1. To determine whether exceptions or modifications to existing nongovernmental U.S. GAAP are required to address the needs of users of private company financial statements; and
2. To serve as the primary advisory body to the FASB on the appropriate treatment for private companies for items under active consideration on the FASB's technical agenda.

The PCC has completed this first responsibility and is now generally serving in a consulting and advisory role to the FASB as the FASB progresses on its technical agenda.

B. Makeup of the PCC

The PCC consists of between 9 to 12 members, including a chairperson, all of whom will be selected and appointed by the FAF Board of Trustees. The PCC chairperson is affiliated with the FASB and will have had substantial experience with and exposure to private companies during the course of their career. The Chairman works cooperatively with the FASB liaison member, the FASB Chairman, and the FASB Technical Director to accomplish the functions of the PCC and to help facilitate the work of the FASB with respect to private company standard setting activities.

PCC members include users, preparers, and practitioners who have significant experience using, preparing, and auditing (and/or compiling and reviewing) private company financial statements. Members are appointed for a three-year term and may be reappointed for an additional term of two years. Membership tenure may be staggered for some members to establish an orderly rotation.
The PCC is still chaired by Jere G. Shawver, the managing partner for assurance and risk with Baker Tilly, a top 10 U.S. public accounting firm. The current members of the PCC can be found on the FASB's website.

As mentioned, the PCC still consults with the FASB on the impact of proposed changes to the accounting codification on smaller and nonpublic entities.

The PCC is currently consulting with the FASB on a number of projects, including the following:

a. Business combination project;
b. Consolidation/variable interest entity (VIE) projects;
c. Definition projects;
d. Disclosure projects;
e. Financial instruments projects;
f. Emerging Issues Taskforce (EITF) projects;
g. FASB's Agenda consultation; and
h. Implementation issues related to 842.

Discussion question:

How successful do you feel the PCC has been in attempting to simplify GAAP for nonpublic business entities?

A Refresher on ASC 606 and the Results of the Final PIR Report for ASC 606

Learning objectives ***1***
I. Introduction ***1***
II. Revenue recognition guidance ***1***
A. Key terms **2**
III. Step 1 – Identify the contract(s) with a customer ***3***
A. Collectability **4**
B. Portfolio approach **6**
C. Combining contracts **7**
D. Contract modifications **7**
1. If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification *8*
2. If the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification *8*
3. If the remaining goods or services are a combination of the above two items *8*
IV. Step 2 – Identify the performance obligations in the contract ***9***
A. Implicit promises in contracts with customers **9**
B. Distinct **9**
C. A series of distinct goods or services **10**
D. Licenses **11**
E. Options that grant a material right **12**
V. Step 3 – Determine the transaction price ***12***
A. Variable consideration **13**
1. Refund liability *14*
B. Constraining estimates of variable consideration **14**
C. The existence of a significant financing component in the contract **14**
D. Noncash consideration **16**
E. Consideration payable to a customer **16**
VI. Step 4 – Allocate the transaction price to the performance obligations in the contract ***16***
A. Standalone selling price is the key **17**
B. Discounts **17**
C. Allocation of variable consideration **18**
D. Changes in the transaction price **18**
VII. Step 5 – Recognize revenue when (or as) the entity satisfies a performance obligation ***18***
A. Performance obligations satisfied over time **19**
B. Performance obligations satisfied at a point in time **20**
C. Measuring progress toward complete satisfaction of a performance obligation **20**
1. Output methods *21*
2. Input methods *21*
D. Reasonable measures of progress **21**
E. Gross vs. net presentation **22**
F. Loss contracts **22**
VIII. Contract costs ***22***
A. Incremental costs of obtaining a contract with a customer **22**
B. Costs incurred in fulfilling a contract with a customer **23**
C. Amortization and impairment **23**
IX. FASB Post-Implementation Review Report for ASC 606 – Revenue from Contracts with Customers ***24***
A. Overview of the PIR process **24**
B. PIR timeline and objective **25**
C. PIR key activities and stakeholder engagement **25**
D. Implementation outcomes **26**
E. Impact of ASC 606 **26**
F. Costs vs. benefits **27**

G. Improvements to the standard-setting process **28**
X. What is next? ***28***
XI. Practice exercises ***29***
A. Exercise 1 **29**
B. Exercise 2 **30**
XII. Practice exercises – Suggested solutions ***31***
A. Exercise 1 **31**
B. Exercise 2 **32**

A Refresher on ASC 606 and the Results of the Final PIR Report for ASC 606

Learning objectives

After completing this chapter, you should be familiar with:

- The results and findings of the FASB's Final (Stage 3) Post-Implementation Review (PIR) Report Topic 606; and
- The FASB's revenue recognition guidance in ASC Topic 606, *Revenue from Contracts with Customers*.

I. Introduction

The FASB has completed Stage 3 of the PIR Process for Topic 606, *Revenue from Contracts with Customers* (Topic 606), the revenue recognition standard originally issued in May 2014 as ASU No. 2014-09, *Revenue from Contracts with Customers*, and subsequently updated through a series of Updates issued by the FASB in 2016. These updates provided further clarification and implementation guidance to the original Update. Even with these updates, the standard remains virtually identical to that issued by the International Accounting Standards Board (IASB), leading to a truly converged, global approach to reporting revenue for all entities.

The standard became effective for public entities for financial reporting periods beginning after December 15, 2017, effectively January 1, 2018, for calendar year reporters, including interim periods. The effective date for nonpublic entities was one year later, with reporting on an interim basis for nonpublic entities effectively beginning for calendar year end entities in the first quarter of 2020.

Topic 606 supersedes the revenue recognition requirements in *Accounting Standards Codification* (Codification or ASC) 605, *Revenue Recognition*, most of the industry-specific guidance throughout the Industry Topics of the Codification, and some of the cost guidance included in ASC 605-35, *Revenue Recognition – Construction-Type and Production-Type Contracts*, and affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets, unless those contracts are within the scope of other standards (for example, lease contracts and insurance contracts). So, the standard pretty much impacted everyone.

In this chapter, we will review the five-step model created by Topic 606 for entities to follow when recognizing revenue.

II. Revenue recognition guidance

The core principle of the standard is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration (that is, payment) to which the entity expects to be entitled in exchange for those goods or services.

To achieve this, an entity will apply the following five step, principles-based approach to recognizing revenue:

Step 1: Identify the contract(s) with a customer.
Step 2: Identify the performance obligations in the contract.
Step 3: Determine the transaction price.
Step 4: Allocate the transaction price to the performance obligations in the contract.
Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation.

The standard also includes enhanced disclosure requirements intended to provide financial statement users with comprehensive information about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a reporting entity's contracts with customers. In addition, a reporting entity is also required to provide quantitative and/or qualitative information about assets recognized from the costs to obtain or fulfill a contract with a customer.

Topic 606 applies to all contracts with customers (including the transfer of nonfinancial assets) except for the following:

a. Lease contracts within the scope of ASC 840, *Leases*;
b. All contracts within the scope of ASC 944, *Financial Services – Insurance*;
c. Financial instruments and other contractual rights or obligations within the scope of other ASC Topics (e.g., ASC 310, *Receivables*);
d. Guarantees (other than product or service warranties) within the scope of ASC 460, *Guarantees* (entities should see Topic 815, *Derivatives and Hedging*, for guarantees accounted for as derivatives); and
e. Nonmonetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. (For example, ASC 606 would not apply to a contract between two oil companies that agree to an exchange of oil to fulfill demand from their customers in different specified locations on a timely basis.)

For a contract with a customer which falls partially within the scope of ASC 606 and partially within the scope of other Codification Topics, for example, a lease with a service contract, if the other Topics specify how to separate and/or initially measure parts of a contract, an entity should first apply those Topics. In other words, the more specific Topic would take precedence in accounting for a part of a contract, and any residual consideration should be allocated to the part(s) of the contract within the scope of that Topic.

A. Key terms

As a result of creating Topic 606, the FASB added the following terms to the ASC Master Glossary:

a. ***Contract*** – An agreement between two or more parties that creates enforceable rights and obligations.
b. ***Contract Asset*** – An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example, the entity's future performance).
c. ***Contract Liability*** – An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.
d. ***Customer*** – A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

e. ***Performance Obligation*** – A promise in a contract with a customer to transfer to the customer either: a good or service (or a bundle of goods or services) that is distinct; or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

f. ***Revenue*** – Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

g. ***Standalone Selling Price*** – The price at which an entity would sell a promised good or service separately to a customer.

h. ***Transaction Price*** – The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

With this as our base of understanding, let us begin our review of the five-step revenue recognition model found in Topic 606.

III. Step 1 – Identify the contract(s) with a customer

The FASB's definition of a contract is based on the common legal definitions of a contract in the United States and emphasizes that a contract exists when an agreement between two or more parties creates enforceable rights and obligations between those parties. Enforceability of the rights and obligations in a contract is a matter of law, and it is important to note that an agreement does <u>not</u> have to be in writing to be a contract. Whether the agreed-upon terms are written, oral, or evidenced otherwise (for example, by electronic assent), a contract exists if the agreement creates rights and obligations that are enforceable against the parties.

Conversely, a contract does not exist if each party to the contract has the unilateral enforceable right to terminate a wholly unperformed contract without compensating the other party (or parties) or the collectability threshold discussed below is not met. A contract is wholly unperformed if the entity has not yet transferred any promised goods or services to the customer and the entity has not yet received, and is not yet entitled to receive, any consideration in exchange for promised goods or services.

Legalese aside, in accordance with Topic 606, an entity can only apply the revenue recognition model to a contract if <u>all</u> of the following criteria are met:

a. The parties have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to performing their respective obligations.

b. The entity can identify each party's rights regarding the goods/services to be transferred.

c. The entity can identify the payment terms for the goods/services to be transferred.

d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).

e. It is probable that the entity will collect the consideration to which it will be entitled in exchange for the goods/services that will be transferred to the customer.

If an agreement with a customer meets the above criteria at inception, an entity should not reassess the criteria unless there is an indication of a significant change in facts and circumstances, for example, if a customer's ability to pay the consideration deteriorates significantly. If that were the case, the entity would reassess whether it is probable that it will collect the consideration to which it will be entitled in exchange for the remaining goods or services that will be transferred to the customer. The word *remaining* here is important because it indicates that a reassessment of the criteria would only be applied to those rights and obligations that have not yet transferred. That is, an entity would not include in the reassessment (and therefore would not reverse) any receivables, revenue or contract assets already recognized.

If an agreement with a customer does <u>not</u> meet the above criteria, an entity should continue to assess the agreement to determine whether the criteria are subsequently met. If an agreement with a customer does not meet the above criteria and an entity receives consideration from the customer, the entity should recognize the consideration received as revenue only when the entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable, or the agreement has been terminated, and the consideration received from the customer is nonrefundable.

An entity should recognize the consideration received from a customer as a liability until either of the above events occurs or until the above criteria are subsequently met. Depending on the facts and circumstances relating to the agreement, the liability recognized represents the entity's obligation to either transfer goods or services in the future or refund the consideration received. In either case, the liability should be measured at the amount of consideration received from the customer.

A. Collectability

As entities digested this guidance in Topic 606, the probability of collectability threshold generated many requests for clarification from stakeholders. These requests resulted in the FASB providing further guidance on this concept in ASU No. 2016-12.

Under Topic 606, collectability is not considered in the transaction price, but it is a factor when determining whether a valid contract exists.

The ASC's Master Glossary defines "probable" as a future event or events that are likely to occur. So, using this definition, to have a contract, it must be likely to occur that substantially all of the consideration will be collected. Unlike with the existing guidance, where the portion of the contract revenue that was reasonably assured to be collected could be recognized, under the standard, no revenue could be recognized if there is not a valid contract. Clearly, understanding how to apply this probability threshold is vitally important to remaining compliant with the guidance.

Some stakeholders narrowly interpreted the guidance related to collectability in a manner that would result in more contracts than the Board intended not meeting the collectability criterion. In response to this feedback, the FASB clarified the objective of the collectability criterion in Step 1. This Update states that the objective of the collectability assessment is to determine whether the contract is valid and represents a substantive transaction on the basis of whether a customer has the ability and intention to pay the promised consideration in exchange for the goods or services that will be transferred to the customer.

The FASB also added additional guidance to Topic 606 via this Update that stated that the assessment <u>does not</u> need to consider the customer's ability and intent to pay the <u>entire</u> amount of the consideration for entire duration of the contract, only that which related to the goods or services expected to be transferred.

The entity should look at the contractual terms and its customary business practices to see if its credit risk is less than the entire amount of consideration promised in the contract. For example, the payment terms of the contract may require the customer to pay for the good or service before its delivery; or the entity may have the ability to stop transferring the promised goods or services in the event that the customer fails to pay. Accordingly, in each of these situations, the entity's credit risk would be less than the entire amount of promised consideration in the contract. In the instance of the latter, the entity should assess the collectability of the consideration to which it is entitled only for the goods or services that the customer has the right to receive or that the customer would receive under the entity's customary business practices.

With this clarified guidance, it is clear that the goal of the FASB is to only prevent revenue from being recognized on contracts that lack true substance.

Further, if a contract fails to meet the collectability criterion at contract inception, an entity should continue to assess the contract to determine whether that criterion is subsequently met. If the criterion is not subsequently met, an entity only recognizes any consideration it received as revenue when one of the criteria in paragraph 606-10-25-7 has been met. The two criteria in the original standard are:

a. When the entity has no remaining obligations to transfer goods or services to the customer, and all, or substantially all, of the consideration promised by the customer has been received by the entity and is nonrefundable; or
b. The agreement has been terminated, and the consideration received from the customer is nonrefundable.

Additionally, some stakeholders expressed the view that it is unclear when these two criteria would be met for certain arrangements.

To help clarify the criteria for recognizing revenue when the collectability threshold is not met at contract inception, the FASB added a third criteria to the two presented above that allows an entity to recognize revenue in the amount of consideration received. When the entity has transferred control of the goods or services to which the consideration that it has received relates, it can recognize that consideration as revenue if all of the following conditions are met:

a. It has stopped transferring goods or services (if applicable);
b. It has no obligation under the contract to transfer additional goods or services; and
c. The consideration received from the customer is nonrefundable.

Essentially, an entity can record revenue on amounts received for already transferred goods if the amount is nonrefundable and it has stopped transferring the good or service and is not required to transfer additional goods or services.

Collectability of the Consideration

In this example, an entity, a service provider, enters into a three-year service contract with a new customer of low credit quality at the beginning of a calendar month. The transaction price of the contract is $720, and $20 is due at the end of each month. The standalone selling price of the monthly service is $20. Both parties are subject to termination penalties if the contract is cancelled.

The entity's history with this class of customer indicates that while the entity cannot conclude it is probable the customer will pay the transaction price of $720, the customer is expected to make the payments required under the contract for at least nine months. However, if, during the contract term, the customer stops making the required payments, the entity's customary business practice is to limit its credit risk by not transferring further services to the customer and to pursue collection for the unpaid services.

In assessing whether the contract meets the collectability criteria for determining whether a valid contract exists, the entity would assess whether it is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the services that will be transferred to the customer. This includes assessing the entity's history with this class of customer and its business practice of stopping service in response to customer nonpayment. Consequently, as part of this analysis, the entity does not consider the likelihood of payment for services that would not be provided in the event of the customer's nonpayment because the entity is not exposed to credit risk for those services.

It is not probable that the entity will collect the entire transaction price ($720) because of the customer's low credit rating. However, the entity's exposure to credit risk is mitigated because the entity has the ability and intention (as evidenced by its customary business practice) to stop providing services if the customer does not pay the promised consideration for services provided when it is due. Therefore, the entity concludes that the contract meets the collectability criterion of Step 1 of the model because it is probable that the customer will pay substantially all of the consideration to which the entity is entitled for the services that the entity will transfer to the customer (that is, for the services the entity will provide for as long as the customer continues to pay for the services provided).

Consequently, assuming the other four criteria for a valid contract are met, the entity would apply the remaining guidance in this Topic to recognize revenue and only reassess those criteria if there is an indication of a significant change in facts or circumstances such as the customer not making its required payments.

Topic 606 contains other examples that help to clarify this guidance.

B. Portfolio approach

Although ASC 606 specifies the accounting required for an individual contract, it does include the following practical expedient that allows an entity to use a "portfolio approach" to apply the guidance:

> As a practical expedient, an entity may apply this guidance to a portfolio of contracts (or performance obligations) with similar characteristics if the entity reasonably expects that the effects on the financial statements of applying this guidance to the portfolio would not differ materially from applying this guidance to the individual contracts (or performance obligations) within that portfolio. When accounting for a portfolio, an entity should use estimates and assumptions that reflect the size and composition of the portfolio.

Of course, an entity will need to apply judgment in selecting the size and composition of the portfolio in such a way that the entity reasonably expects that application of the revenue recognition model to the portfolio would not differ materially from the application of the revenue recognition model to the individual contracts or performance obligations in that portfolio.

However, this is not to say that an entity has to quantitatively evaluate each outcome; that is not the FASB's intention, rather, the entity should take a reasonable approach to determine the portfolios that would be appropriate for its types of contracts.

The portfolio approach may be particularly useful in some industries where entities have a large number of similar contracts and applying the revenue recognition model separately for each contract might be impractical. For example, entities in the telecommunications and cable TV industries are characterized as having a high volume of contracts with various potential configurations; providing multiple goods and services in those contracts; including a discount in the contracts; and providing the goods or services at different times. Because of this, implementing an accounting system to determine the standalone selling price for the promised goods or services in each contract and, in turn, allocating the transaction price to the performance obligations identified in that contract would certainly be quite complex and costly.

C. Combining contracts

In accordance with Topic 606, an entity should combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contracts as a single contract if one or more of the following criteria are met:

a. The contracts are negotiated as a package with a single commercial objective;
b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract; and/or
c. The goods or services promised in the contracts (or some of the goods or services promised in each of the contracts) are a single performance obligation.

In determining whether contracts have been entered into "at or near the same time," an entity should apply judgment, keeping in mind that the longer the period between the commitments of the parties to the contracts, the more likely it is that the economic circumstances affecting the negotiations have changed.

D. Contract modifications

A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract (often described as a change order, variation, or amendment to the contract).
A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract, and can be approved in writing, by oral agreement, or implied by customary business practices.

If the parties to the contract have <u>not</u> approved a contract modification, an entity should continue to apply the guidance in ASC 606 to the existing contract until the contract modification is approved.

It is important to note that a contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity should consider all relevant facts and circumstances including the terms of the contract and other evidence.

If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity should estimate the change to the transaction price arising from the modification in accordance with the guidance on estimating variable consideration and on constraining estimates of variable consideration.

An entity should account for a contract modification as a separate contract if:

a. The scope of the contract increases because of the addition of promised goods or services that are distinct; and
b. The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity adjusts the standalone selling price of an additional good or service for a discount the customer receives because the entity does not incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

If a contract modification is <u>not</u> accounted for as a separate contract, an entity should account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable.

1. If the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification

The entity should account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract.

The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation) is the sum of:

a. The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue; and
b. The consideration promised as part of the contract modification.

2. If the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification

The entity should account for the contract modification as if it were a part of the existing contract.

The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue either as an increase in or a reduction of revenue at the date of the contract modification, that is, the adjustment to revenue is made on a cumulative catch-up basis.

3. If the remaining goods or services are a combination of the above two items

The entity should account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of the contract modifications guidance discussed above.

Under Topic 606, the accounting for contract modifications is much more focused on the type of modification and is applicable to all industries.

IV. Step 2 – Identify the performance obligations in the contract

Entities face many different types of obligations in their day-to-day business activities. As such, the FASB decided to specifically define the term *performance obligation* in the revenue recognition guidance as follows.

Performance Obligation	A promise in a contract with a customer to transfer to the customer either: a. A good or service (or a bundle of goods or services) that is distinct; or b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.

The notion of a performance obligation is similar to those of deliverables, components, or elements of a contract in existing revenue guidance. Although implicit in the existing guidance, the term *performance obligation* is not formally defined.

A. Implicit promises in contracts with customers

Contracts with customers typically state the goods or services an entity promises to transfer to a customer.

However, performance obligations identified in a contract with a customer may not always be limited to the goods or services explicitly stated in that contract.

Promises implied by an entity's customary business practices, published policies, or specific statements at the time of entering into the contract can also create a valid expectation by the customer that the entity will transfer goods or services to the customer.

B. Distinct

A good or service that is promised to a customer is distinct if both of the following criteria are met:

a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct). For example, if an entity transferred a machine to the customer but the machine is only capable of providing a benefit to the customer after an installation process that only the entity can provide, the machine would not be distinct; and

b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract).

In some cases, even though the individual goods or services promised as a bundle of goods or services might be capable of being distinct, those goods or services should not be accounted for separately because it would not result in a faithful depiction of the entity's performance in that contract. For example, many construction- and production-type contracts involve transferring to the customer various goods and services that are capable of being distinct, such as building materials, labor, and project management services.

However, identifying all of those individual goods and services as separate performance obligations would be impractical and, more importantly, it would neither faithfully represent the nature of the entity's promise to the customer nor result in a useful depiction of the entity's performance.

This is because it would result in an entity recognizing and measuring revenue when the materials and other inputs to the construction or production process are provided, instead of recognizing and measuring revenue when the entity performs (and uses those inputs) in the construction or production of the item (or items) for which the customer has contracted. So, when identifying whether goods or services are distinct, an entity should not only consider the characteristics of an individual good or service but should also consider whether the promise to transfer the good or service is separately identifiable, that is, distinct within the context of the contract.

ASU No. 2016-10 provided further guidance on the objective of the concept of distinctiveness. Specifically, the guidance now reads that the objective is to determine whether the nature of the promise, within the context of the contract, is to transfer each of those goods or services individually or, instead, to transfer a combined item or items to which the promised goods or services are inputs.

The ASU also revised the related factors and examples to align with the improved articulation of the separately identifiable principle. The updated guidance now lists the following factors to aid in this assessment:

a. The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element, or unit.
b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

If a promised good or service is not distinct, an entity should combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.

C. A series of distinct goods or services

A promise to transfer a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer would be a single performance obligation if both of the following criteria are met:

a. Each distinct good or service in the series that the entity promises to transfer to the customer meets any of the following criteria and thus considered to be a performance obligation satisfied over time:
   (i) The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (for example, cleaning service).
   (ii) The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced (for example, work in process).
   (iii) The entity's performance does not create an asset with an alternative use to the entity (For example, an asset with design specifications that are unique to a customer), and the entity has an enforceable right to payment for performance completed to date (for example, recovery of the costs incurred by an entity in satisfying the performance obligation plus a reasonable profit margin).
b. The same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

Examples of such arrangements would represent subscription-based services, where each good or service offered is essentially identical, as well as services frequently offered by software as a service (SaaS) providers and outsourced service providers, such as transaction processors.

Entities must use judgment in determining whether offered goods or services represent an identical good or service, such as a help desk or R&D arrangement, where the promise to the customer is access that is provided daily, or a promise which is distinct. In the former, the above criteria would apply, whereby in the latter, each offering of the good or service would be a distinct promise and a separate performance obligation.

D. Licenses

Given the number of complex arrangements which entities enter into, it may be challenging to identify all performance obligations in a contract, as well as determine when control passes to the customer. One such area relates to licenses.

While providing guidance on accounting for license arrangements in Topic 606, stakeholders nonetheless requested further information in applying this guidance. In response, the FASB, in ASU No. 2016-10, further defined license arrangements as follows:

a. **Functional intellectual property** – Intellectual property that has significant standalone functionality (for example, the ability to process a transaction, perform a function or task, or be played or aired). Functional intellectual property derives a substantial portion of its utility (that is, its ability to provide benefit or value) from its significant standalone functionality. Revenue for licenses of functional intellectual property would be recognized when access to the license is granted.
b. **Symbolic intellectual property** – Intellectual property that is not functional intellectual property (that is, intellectual property that does not have significant standalone functionality). Because symbolic intellectual property does not have significant standalone functionality, substantially all of the utility of symbolic intellectual property is derived from its association with the entity's past or ongoing activities, including its ordinary business activities. Revenue for licenses of symbolic intellectual property would be recognized over the period of the license.

Lastly, some licenses contain sale and usage royalty payment provisions. In such instances, the revenue on such licenses would be recognized as the royalty is earned, even if the underlying license is one for functional intellectual property.

E. Options that grant a material right

Entities generally would not account for options until they are exercised. However, certain options that grant a material right to a customer should be considered as separate performance obligations, with a portion of the transaction price allocated to them and recognized when the option is exercised.

Topic 606 defines a material right as an option which provides a material right to the customer that it would not have received without entering into the contract. For example, offering a discount on future purchases over and above one offered to all customers would be considered a material right. Additionally, offering a free item when a customer purchases other products would be another example of an option granting a material right.

Key to accounting for such options is to determine the stand-alone selling price of the option. This may be relatively easy in some instances or more difficult in others, depending on the amount of objective evidence of stand-alone selling price that exists for the good or service. As with all such allocations, you should start with any observable evidence of stand-alone selling price. However, the stand-alone selling price will often need to be estimated. The estimate should reflect both the discount that the customer would obtain when exercising the option, adjusted for any discount that the customer could have received without exercising the option and the likelihood that the option will be exercised.

V. Step 3 – Determine the transaction price

The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, sales taxes). An entity should consider the terms of the contract and its customary business practices to determine the transaction price and should assume that the goods or services will be transferred to the customer as promised in accordance with the existing contract and that the contract will not be cancelled, renewed, or modified.

The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

It is important to note here that the transaction price should only include amounts to which the entity has rights under the current contract; which is to say, the transaction price does not include estimates of consideration from the future exercise of options for additional goods or services or from future change orders. Until the customer exercises the option or agrees to the change order, the entity does not have a right to consideration. In addition, the amounts to which the entity has rights under the current contract can be paid by any party (that is, not only by the customer). For example, in the healthcare industry, an entity may determine the transaction price based on amounts to which it will be entitled to payment from the patient, insurance companies, and/or governmental organizations. This can also occur in other industries in which an entity receives a payment from a manufacturer as a result of the manufacturer issuing coupons or rebates directly to the entity's customer.

At the end of each reporting period, an entity should update the transaction price, including its assessment of whether an estimate of variable consideration is constrained (discussed below), to faithfully represent the circumstances present at the end of the reporting period and the changes in circumstances during the reporting period. The entity should account for changes in the transaction price by allocating the change to the performance obligations in the contract on the same basis as at contract inception. Amounts allocated to a satisfied performance obligation should be recognized as revenue or as a reduction of revenue in the period in which the transaction price changes.

When determining the transaction price, an entity should consider the effects of all of the following:

a. Variable consideration;
b. Constraining estimates of variable consideration;
c. The existence of a significant financing component in the contract;
d. Noncash consideration; and
e. Consideration payable to a customer.

A. Variable consideration

Oftentimes, an amount of consideration in a contract will vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration can also vary if an entity's entitlement to the consideration is contingent on the occurrence (or nonoccurrence) of a future event. For example, an amount of consideration would be variable if a product was sold with either a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone. Variable consideration promised by a customer may be explicitly stated in the contract.

Notwithstanding the terms of a contract, promised consideration is variable if either:

a. The customer has a valid expectation arising from an entity's customary business practices, published policies, or specific statements that the entity will accept an amount of consideration that is less than the price stated in the contract. That is, it is expected that the entity will offer a price concession. Depending on the jurisdiction, industry, or customer, this offer may be referred to as a discount, rebate, refund, or credit; or
b. Other facts and circumstances indicate that the entity's intention, when entering into the contract with the customer, is to offer a price concession to the customer.

An entity should estimate an amount of variable consideration in a contract by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

a. **The expected value method** – The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
b. **The most likely amount method** – The most likely amount is the single most likely amount in a range of possible consideration amounts, that is, the single most likely outcome of the contract. The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes; for example, an entity either achieves a performance bonus or does not.

An entity should apply either the expected value method or the most likely amount method consistently throughout the contract, and should consider all of the historical, current, and forecasted information that is reasonably available to identify a reasonable number of possible consideration amounts. The information that an entity uses to estimate the amount of variable consideration would typically be similar to the information that the entity's management would use during a bid and proposal process or in establishing prices for promised goods or services.

1. Refund liability

An entity should recognize a refund liability if it receives consideration from a customer and expects to refund some or all of that consideration to the customer. A refund liability is measured at the amount of consideration received or receivable for which the entity does not expect to be entitled, that is, amounts not included in the transaction price.

The refund liability and corresponding change in the transaction price, and therefore the contract liability, should be updated at the end of each reporting period for changes in circumstances.

Topic 606 includes implementation guidance covering the accounting for a refund liability relating to a sale with a right of return.

B. Constraining estimates of variable consideration

The FASB decided that in order to provide useful information to financial statement users, some estimates of variable consideration should not be included in the transaction price. This would be the case if the estimate is too uncertain and therefore may not faithfully depict the consideration to which the entity will be entitled in exchange for the goods or services transferred to the customer.

What this means is that an entity should only include in the transaction price an amount of variable consideration estimated to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Under Topic 606, variable consideration is estimated using either the "expected value" or "most likely amount" method, but only to the extent it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty surrounding the variable consideration is resolved. This approach will generally allow more revenue to be recognized sooner than under the existing standards.

C. The existence of a significant financing component in the contract

In determining the transaction price, an entity should adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. Note that the period of time for consideration is not the term of the contract but rather the time between delivery of the good or service and the customer's payment for the good or service.

Notice that the focus here is on whether the payment terms provide the customer or the entity with a significant benefit of financing. That is, an entity should only adjust for financing if the timing of payments specified in the contract provides the customer or the entity with a significant benefit of financing.

This is because although there may be a significant period of time between the transfer of the goods or services and the payment, the reason for that timing difference may not be related to a financing arrangement between the entity and the customer.

An entity should consider all relevant facts and circumstances in assessing whether a contract contains a financing component and whether that financing component is significant to the contract, including both of the following:

a. The difference, if any, between the amount of promised consideration and the cash selling price of the promised goods or services; and
b. The combined effect of both of the following:
   (i) The expected length of time between when the entity transfers the promised goods or services to the customer and when the customer pays for those goods or services; and
   (ii) The prevailing interest rates in the relevant market.

On the other hand, a contract with a customer would not have a significant financing component if:

a. The customer paid for the goods or services in advance, and the timing of the transfer of those goods or services is at the discretion of the customer;
b. A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity (for example, if the consideration is a sales-based royalty); and/or
c. The difference between the promised consideration and the cash selling price of the good or service arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference (for example, "protective" payment terms).

In addition, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.

If a contract does include a significant financing component, an entity should use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity should not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

Interest income or interest expense should be presented separately from revenue from contracts with customers in the statement of comprehensive income and is recognized only to the extent that a contract asset (or receivable) or a contract liability is recognized in accounting for a contract with a customer.

D. Noncash consideration

To determine the transaction price for contracts in which the customer promises consideration in a form other than cash, an entity should measure the noncash consideration, or promise of noncash consideration, at fair value, determined at the date of the contract. If the entity cannot reasonably estimate the fair value of the noncash consideration, it should measure the consideration indirectly by reference to the standalone selling price of the goods or services promised to the customer in exchange for the consideration.

If a customer contributes goods or services, for example, materials, equipment, or labor, to facilitate an entity's fulfillment of a contract, the entity should assess whether it obtains control of those contributed goods or services. If it does, the entity should account for the contributed goods or services as noncash consideration received from the customer.

E. Consideration payable to a customer

Consideration payable to a customer includes amounts that an entity pays, or expects to pay, to a customer, or to other parties that purchase the entity's goods or services from the customer, in the form of cash, credit, or other items that the customer can apply against amounts owed to the entity.

An entity should account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity, in which case the entity should account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers. An example of such an arrangement would be a cooperative advertisement arrangement where the entity contributes to the cost of an advertisement through a reduction of amounts due to it from its customer. An amount equal to the fair value of comparable advertisement if the entity had separately purchased it would be considered advertising expense and not accounted for as a reduction of revenue.

If consideration payable to a customer is a reduction of the transaction price, an entity should recognize the reduction of revenue when (or as) the later of the entity recognizing revenue for the transfer of the related goods or services to the customer, or the entity paying or promising to pay the consideration (even if the payment is conditional on a future event).

VI. Step 4 – Allocate the transaction price to the performance obligations in the contract

Recall the core principle in the revenue recognition guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. What this really means in essence is that an entity should allocate the transaction price to each performance obligation in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each performance obligation. (Practical application examples provided below.)

A. Standalone selling price is the key

The standalone selling price at contract inception of the goods or services underlying each performance obligation should be used to allocate the transaction price to each of those performance obligations. The standalone selling price is the price at which the entity would sell the promised goods or services separately to a customer.

Akin to a level 1 input in the fair value hierarchy, the best evidence of a standalone selling price is the observable price of goods or services when the entity sells those goods or services separately in similar circumstances and to similar customers. For example, a contractually stated price or a list price for goods or services may be (but not always) the standalone selling price of those goods or services.

If a standalone selling price is not directly observable, an entity should estimate it by considering all reasonably available information, for example, current market conditions, entity-specific factors, and information about the customer.

Examples of suitable estimation methods (which should be applied consistently for similar circumstances) include:

a. The adjusted market assessment approach, which uses competitors' prices for similar goods or services and adjusts those prices to reflect the entity's costs and margins;
b. The expected cost plus a margin approach, which forecasts expected costs of satisfying a performance obligation and adds an appropriate margin for those goods or services; and
c. The residual approach, which estimates a standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract.

B. Discounts

If the sum of the standalone selling prices of the promised goods or services in the contract exceeds the transaction price, that is, the customer receives a discount for purchasing a bundle of goods or services, an entity should allocate the discount to all of the performance obligations on a relative standalone selling price basis. However, an entity should allocate a discount entirely to one or more, but not all, performance obligations in the contract if all of the following criteria are met:

a. The entity regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis;
b. The entity also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle; and
c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.

If a discount is allocated entirely to one or more performance obligations in the contract in accordance with the above, an entity should allocate the discount before using the residual approach to estimate the standalone selling price of a good or service.

C. Allocation of variable consideration

It may not always be appropriate for an entity to allocate the variable consideration in a transaction price to all of the performance obligations in a contract. For example, an entity may contract to provide two products at different times with a bonus that is contingent on the timely delivery of only the second product. In that case, it might be inappropriate to attribute variable consideration included in the transaction price to both products. Similarly, an entity may contract to provide two products at different times with a fixed amount for the first product that represents that product's standalone selling price and a variable amount that is contingent on the delivery of the second product. That variable amount might be excluded from the estimate of the transaction price because of the requirements for constraining estimates of the transaction price (discussed above). In that case, it might be inappropriate to attribute the fixed consideration included in the transaction price to both products.

As such, an entity should allocate a variable amount (and subsequent changes to that amount) entirely to a performance obligation or to a distinct good or service that forms part of a single performance obligation if both of the following criteria are met:

a. The terms of a variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service); and
b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective to depict the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer when considering all of the performance obligations and payment terms in the contract.

D. Changes in the transaction price

After contract inception, the transaction price can change for a variety of reasons, for example, the resolution of uncertain events. When this happens, the entity should allocate the change to the performance obligations in the contract on the same basis as at contract inception. This ensures that changes in the estimate of variable consideration that are included in (or excluded from) the transaction price are allocated to the performance obligation(s) to which the variable consideration relates.

An entity should allocate a change in the transaction price entirely to one or more distinct goods or services if the above criteria are met.

Amounts allocated to a satisfied performance obligation should be recognized as revenue or as a reduction of revenue in the period in which the transaction price changes; and an entity should not reallocate the transaction price to reflect changes in standalone selling prices after contract inception.

VII. Step 5 – Recognize revenue when (or as) the entity satisfies a performance obligation

Under the revenue recognition guidance, an entity will recognize revenue when or as it satisfies a performance obligation by transferring promised goods or services to a customer. Transfer occurs when or as the customer obtains *control* of the goods or services, either at a point in time or over time, as applicable.

Control in this context is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from an asset.

Control also includes the ability to prevent other entities from directing the use of and obtaining the benefits from an asset ("defensive control").

When evaluating whether a customer obtains control of an asset, an entity should consider any agreement to repurchase the asset. An entity would need to assess if such an agreement would negate the passage of control necessary for the recognition of revenue.

Lastly, under Topic 606, an entity should consider if revenue should be recognized over time first and, if not, then assess the point in time when control passes. This consideration may result in a change in the timing of revenue recognition for certain entities if their contracts contain certain provisions which require them to recognize revenue over time under Topic 606, whereby they recognized revenue previously at a point in time under existing guidance. An example would be contract manufacturers, which manufacture to customer specifications. Such an arrangement could lead to recognizing revenue over time under Topic 606, whereby most such manufacturers recognize revenue at a point in time currently.

A. Performance obligations satisfied over time

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time if any of the following criteria is met:

a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;
b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced; or
c. The entity's performance does not create an asset with an alternative use to the entity, and the entity has an enforceable right to payment for performance completed to date. The right to payment must include some element of profit, though it does not need to be the negotiated profit percentage in the contract.

An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use.

The assessment of whether an asset has an alternative use to the entity is made at contract inception.

After contract inception, an entity should not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation.

Under Topic 606, revenue is recognized only when or as control of the asset is transferred to the customer, meaning an entity must determine whether a performance obligation in the contract has been satisfied before revenue can be recognized.

B. Performance obligations satisfied at a point in time

Performance obligations are satisfied at a point in time when a customer obtains control of a promised asset at a point in time (that is, not over time as discussed below).

To determine the point in time when a customer obtains control of a promised asset and, therefore, the entity satisfies a performance obligation, the entity should consider the definition of control noted above.

In addition, an entity should also consider the following indicators of the transfer of control:

a. *The entity has a present right to payment for the asset* – If a customer presently is obliged to pay for an asset, then that may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset in exchange.

b. *The customer has legal title to the asset* – Legal title may indicate which party to a contract has the ability to direct the use of, and obtain substantially all of the remaining benefits from, an asset or to restrict the access of other entities to those benefits. Therefore, the transfer of legal title of an asset may indicate that the customer has obtained control of the asset. If an entity retains legal title solely as protection against the customer's failure to pay, those rights of the entity would not preclude the customer from obtaining control of an asset.

c. *The entity has transferred physical possession of the asset* – The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls.

d. *The customer has the significant risks and rewards of ownership of the asset* – The transfer of the significant risks and rewards of ownership of an asset to the customer may indicate that the customer has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. However, when evaluating the risks and rewards of ownership of a promised asset, an entity should exclude any risks that give rise to a separate performance obligation in addition to the performance obligation to transfer the asset. For example, an entity may have transferred control of an asset to a customer but not yet satisfied an additional performance obligation to provide maintenance services related to the transferred asset.

e. *The customer has accepted the asset* – The customer's acceptance of an asset may indicate that it has obtained the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.

C. Measuring progress toward complete satisfaction of a performance obligation

For each performance obligation that an entity satisfies over time, the entity should recognize revenue over time by measuring the progress toward complete satisfaction of that performance obligation.

The objective when measuring progress is to depict the transfer of control of goods or services to the customer, that is, to depict an entity's performance. In this respect, an entity should include in a measure of progress any goods or services for which the entity transfers control to the customer and exclude any goods or services for which the entity does not transfer control to the customer.

As circumstances change over time, an entity should update its measure of progress to depict the entity's performance completed to date. Such changes should be accounted for as a change in accounting estimate in accordance with ASC 250, *Accounting Changes and Error Corrections*.

For each performance obligation satisfied over time, an entity should apply a single method of measuring progress that is consistent with the above objective and should apply that method consistently to similar performance obligations and in similar circumstances. Appropriate methods of measuring progress include output methods and input methods.

1. Output methods

Output methods recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract and include methods such as surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered.

If an entity has a right to invoice a customer in an amount that corresponds directly with the value to the customer of the entity's performance completed to date, the entity should recognize revenue in the amount that the entity has a right to invoice. Such an arrangement may occur in professional services, where a customer is billed on a time and material basis, based on agreed-upon rates. An entity could recognize revenue based on the amount it bills even if the amounts billed increased, as long as the amounts represented the value of the services provided to a customer. However, a lump-sum billing, even if meant to approximate the value provided to date to a customer would not qualify for this right to invoice exemption.

2. Input methods

Input methods recognize revenue on the basis of the entity's efforts or inputs in satisfying a performance obligation, for example, costs incurred, relative to the total expected inputs to satisfy that performance obligation.

If the entity's efforts or inputs are expended evenly throughout the performance period, it may be appropriate for an entity to recognize revenue on a straight-line basis.

Entities that currently record revenue based on achievement of milestones should assure that such milestones represent actual performance on the contract. If not, the entity would need to change to another input or output method.

D. Reasonable measures of progress

An entity should only recognize revenue for a performance obligation satisfied over time if it can reasonably measure its progress toward complete satisfaction of the performance obligation, which requires the entity to have the reliable information required to apply an appropriate method of measuring progress. In some cases, for example, in the early stages of a contract, an entity may not be able to reasonably measure the outcome of a performance obligation but does expect to recover the costs incurred in satisfying the performance obligation. In those circumstances, the entity should recognize revenue only to the extent of the costs incurred until such time that it can reasonably measure the outcome of the performance obligation.

E. Gross vs. net presentation

For each performance obligation within each contract, the entity must determine whether it is a principal in the transaction or whether it is the agent. As a principal, the entity takes control of the good or service which it sells and would record revenue gross, along with related cost of sales. However, if the entity does not take control of the underlying good or service, it is essentially acting as an agent in the transaction. As such, it would record only its agent fee as revenue in the transaction.

Topic 606 contains numerous examples which illustrate characteristics of both principal and agent relationships, along with examples of characteristics which would indicate control of the good or service.

F. Loss contracts

Topic 606 retains the guidance in Topic 605 related to loss contracts that requires an entity to recognize the entire anticipated loss on a contract as soon as the loss becomes evident. A determination that a loss contract exists occurs when the anticipated transaction price of the contract, as determined under Topic 606, is less than the contract costs.

Unless contracts are combined under the guidance in Topic 606, the loss is determined at the contract level. However, per ASU No. 2016-20, an entity may make an accounting policy election to determine the need for a loss provision on a contract at the performance obligation level. If electing this option, the entity should apply this policy in the same manner for similar types of contracts.

VIII. Contract costs

The guidance relating to contract costs can be found in Subtopic, ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers*.

ASC 340-40 provides accounting guidance for the following costs related to a contract with a customer within the scope of ASC 606:

a. Incremental costs of obtaining a contract with a customer; and
b. Costs incurred in fulfilling a contract with a customer that are not within the scope of another Codification Topic.

A. Incremental costs of obtaining a contract with a customer

Incremental costs of obtaining a contract with a customer are costs an entity incurs that would not have been incurred if the contract had not been obtained, for example, a sales commission.

Incremental costs of obtaining a contract with a customer should be recognized as an asset if the entity expects to recover those costs. However, as a practical expedient, such costs may be expensed as incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

B. Costs incurred in fulfilling a contract with a customer

An entity should recognize an asset for the costs incurred to fulfill a contract only if those costs meet all of the following criteria:

a. The costs relate directly to a contract or to an anticipated contract that the entity can specifically identify, for example, costs relating to services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved;
b. The costs generate or enhance resources of the entity that will be used in satisfying or in continuing to satisfy performance obligations in the future; and
c. The costs are expected to be recovered.

For costs incurred in fulfilling a contract with a customer that are within the scope of another Codification Topic, for example, ASC 330, *Inventory*, an entity should account for those costs in accordance with those other Topics (or Subtopics as the case may be).

Costs that relate directly to a contract or a specific anticipated contract include any of the following:

a. Direct materials, for example, supplies used in providing the promised services to a customer.
b. Direct labor, for example, salaries and wages of employees who provide the promised services directly to the customer.
c. Allocations of costs that relate directly to the contract or to contract activities, for example, costs of contract management and supervision, insurance, and depreciation of tools and equipment used in fulfilling the contract (overhead).
d. Costs that are explicitly chargeable to the customer under the contract.
e. Other costs that are incurred only because an entity entered into the contract (for example, payments to subcontractors).

On the other hand, an entity should recognize the following costs as expenses when incurred:

a. General and administrative costs (unless those costs are explicitly chargeable to the customer under the contract, in which case an entity should evaluate those costs in accordance with the above);
b. Costs of wasted materials, labor, or other resources to fulfill the contract that were not reflected in the price of the contract;
c. Costs that relate to satisfied performance obligations or partially satisfied performance obligations in the contract, that is, costs that relate to past performance; and
d. Costs for which an entity cannot distinguish whether the costs relate to unsatisfied performance obligations or to satisfied performance obligations or partially satisfied performance obligations.

C. Amortization and impairment

An asset capitalized in accordance with the above guidance should be amortized on a basis consistent with the transfer to the customer of the goods or services to which the asset relates. The asset may relate to goods or services to be transferred under a specific anticipated contract as well, for example, services to be provided under renewal of an existing contract or costs of designing an asset to be transferred under a specific contract that has not yet been approved.

An entity should update the amortization to reflect a significant change in the entity's expected timing of transfer to the customer of the goods or services to which the asset relates and should account for the change as a change in accounting estimate in accordance with ASC 250, *Accounting Changes and Error Corrections*.

An entity should recognize an impairment loss in profit or loss to the extent that the carrying amount of an asset recognized exceeds:

a. The remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less
b. The costs that relate directly to providing those goods or services and that have not been recognized as expenses.

To determine the amount of consideration that an entity expects to receive, an entity should use the principles for determining the transaction price (except for the guidance on constraining estimates of variable consideration) and adjust that amount to reflect the effects of the customer's credit risk. ASU No. 2016-20 clarified that the entity should also consider expected contract renewals and extensions and include both the amount of consideration it has already received but has not recognized as revenue and the amount it expects to receive in the future.

Before an entity recognizes an impairment loss for an asset recognized, the entity should recognize any impairment loss for assets related to the contract that are recognized in accordance with another Codification Topic (for example, ASC 330, *Inventory*). ASU No. 2016-20 clarified the sequence for impairment testing to be, first, assets not within the scope of Topics 340, 350 (Goodwill and Other) or Topic 360 (PP&E), such as inventory; then assets within the scope of Topic 340 and, lastly, asset groups and reporting units within the scope of Topics 360 and 350.

After applying the impairment test above, an entity should include the resulting carrying amount of the asset recognized in the carrying amount of the asset group or reporting unit to which it belongs for the purpose of applying the guidance in ASC 350, *Intangibles – Goodwill and Other*, and ASC 360, *Property, Plant, and Equipment*, to that asset group or reporting unit.

An entity should not recognize a reversal of an impairment loss previously recognized.

IX. FASB Post-Implementation Review Report for ASC 606 – Revenue from Contracts with Customers

A. Overview of the PIR process

The **Post-Implementation Review (PIR)** process is a comprehensive evaluation conducted by the Financial Accounting Standards Board (FASB) to determine whether a new accounting standard, such as ASC 606, meets its intended objectives. These objectives include providing relevant and reliable financial information to users of financial statements in a manner that justifies the costs of implementation and ongoing compliance. The PIR serves as an essential quality control mechanism embedded in the FASB's standard-setting process and is overseen by the Financial Accounting Foundation (FAF) Board of Trustees.

Objectives of the PIR process for ASC 606 include:

a. **Determining if ASC 606 fulfills its stated purpose**, specifically evaluating whether it resolves the underlying issues that prompted its development, provides decision-useful information, is operational in practice, and has not resulted in significant unintended consequences;
b. **Evaluating the implementation and compliance costs**, as well as the benefits realized by various stakeholders, including preparers, investors, and regulators; and
c. **Gathering feedback to refine the standard-setting process**, particularly regarding effective date selection, coordination with other accounting guidance, and considerations for globally converged standards.

B. PIR timeline and objective

In 2014, ASC 606 was officially issued, marking the culmination of a joint project with the IASB. From 2014 to 2021, Stage 1 of the PIR process was undertaken. Stage 1 focused on monitoring the standard's implementation and providing stakeholder support.

During Stage 1, which occurs before the effective date of the standard, the FASB:

a. Monitors practice as stakeholders prepare for initial implementation of the standard;
b. Creates and distributes implementation guidance and other educational material; and
c. Communicates and performs outreach with stakeholder organizations to generate interest in research activities associated with the standard.

From 2018 to 2024, Stage 2 was undertaken. This stage evaluated the actual costs and benefits of the standard post-implementation. During Stage 2, which begins after the effective date of the final standard and continues for approximately three to five years, the FASB undertakes activities to:

a. Understand the costs that an entity incurred in applying the standard and the costs that investors and other users incurred in analyzing and interpreting the information in the standard;
b. Understand the benefits of the standard to investors, entities, and other stakeholders; and
c. Monitor the ongoing application of the standard.

In 2024, the last stage, Stage 3, was finalized with the publication of the summary report, reflecting a decade of data collection and analysis. In Stage 3, the FASB finalized its final report in written fashion and in a public meeting. The PIR process for ASC 606 stands out due to its scope and duration, reflecting the comprehensive changes introduced and the standard's profound impact across a diverse range of industries.

C. PIR key activities and stakeholder engagement

During the PIR process, FASB engaged with over 2,200 stakeholders, representing a broad and diverse group. As the FASB notes in its final report, "stakeholder feedback is critical to ensure timely support for high-quality implementation of the standard."

They requested and analyzed feedback from the following groups:

a. **Investors** – Including buy-side and sell-side analysts, accounting analysts, credit rating agency professionals, lenders, and private equity firms.
b. **Preparers** – Public and private companies, as well as not-for-profit entities, across a wide spectrum of industries and sizes.
c. **Practitioners** – Representatives from audit and consulting firms at the international, national, and regional levels.
d. **Other stakeholders** – Academics, state CPA societies, trade organizations, regulators, and other standard setters.

The FASB used a multi-faceted approach to gather feedback. The FASB conducted individual interviews and hosted group discussions; organized advisory group meetings, public roundtables, and stakeholder surveys; delivered webcasts and participated in conferences; and solicited and reviewed comment letters in response to exposure drafts.

As a result, the FASB issued 251 public documents, including detailed Board meeting materials, Transition Resource Group (TRG) memoranda, Exposure Drafts, and Accounting Standards Updates (ASUs). The FASB held 56 public Board meetings to deliberate on feedback and PIR updates and responded to more than 500 technical inquiries, aiding stakeholders in the application of ASC 606.

D. Implementation outcomes

Key achievements of ASC 606 as identified by the PIR process include:

a. Developing a unified, principles-based revenue recognition model that applies broadly across all industries and transactions;
b. Introducing comprehensive disclosure requirements, improving investor insight through enhanced revenue disaggregation and qualitative descriptions; and
c. Achieving global convergence by aligning U.S. GAAP with IFRS 15, reducing inconsistencies for multinational organizations.

E. Impact of ASC 606

Most entities experienced minimal impact on the dollar amount of reported revenues but faced significant efforts to revise internal processes and controls. The FASB believes extensive implementation support was crucial and included TRG meetings, ASUs for clarification, and detailed Q&As.

All entities, regardless of the impact on revenue figures, undertook comprehensive reviews of contracts and revenue recognition practices. These reviews and improvements did lead to challenges.

Although overall feedback on ASC 606 was positive, stakeholders identified several areas that posed difficulties due to the increased need for professional judgment and adaptation to new principles.

Top 10 challenging areas:

1. **Licensing of intellectual property** – Determining the timing of revenue recognition and whether licenses are distinct.
2. **Identification of performance obligations** – Assessing whether promises in a contract are distinct and separable.
3. **Standalone selling price determination** – Estimating prices when not directly observable.
4. **Variable consideration constraint** – Estimating and constraining revenue based on expected outcomes.
5. **Sales/usage-based royalties** – Recognizing revenue tied to customer sales or usage metrics.
6. **Principal vs. agent assessments** – Determining control and gross vs. net presentation.
7. **Consideration payable to a customer** – Accounting for payments made to customers or third parties.
8. **Incremental costs of obtaining a contract** – Capitalization and amortization of contract-related costs.
9. **Short-cycle manufacturing revenue recognition** – Recognizing revenue over time for customized, short-cycle products.
10. **Disclosures** – Meeting the expanded requirements effectively and efficiently.

The causes of these challenges were multifaceted. First, given the complexity of revenue recognition, high levels of judgment and estimation were required, particularly in evaluating performance obligations and transaction pricing. The new standard also represented a fundamental departure from previous guidance (Topic 605), and this necessitated process and system overhauls. Additionally, the emergence of complex and hybrid business models, such as SaaS and bundled service arrangements, increased implementation complexity. Despite these challenges, stakeholders did not advocate for revisions to the core model but recommended additional guidance for specific scenarios in the future.

F. Costs vs. benefits

A key goal of the PIR process is to evaluate implementation and compliance costs relative to the benefits accrued from the standard. The FASB completed this step and identified four key benefits that arose as a result of the standard's implementation. First, investors gained deeper insights into contract structures and revenue recognition policies. Second, investors further benefited from enhanced comparability across entities, industries, and global markets, fostering better investment decisions. In short, the income statement has become more comparable. Third, preparers benefited from improved contract analysis and strengthened internal controls over revenue processes. Lastly, global convergence of standards simplified reporting for multinational entities and reduced discrepancies between GAAP and IFRS, making statements across localities more comparable.

The benefits identified came with three key reported costs. Preparers identified significant implementation costs for system upgrades, staff training, and process changes, especially where industry-specific guidance was eliminated. Investors faced initial learning costs, including model updates and analysis changes, though these were generally one-time costs. Many preparers and practitioners identified ongoing costs related to estimating variable consideration, enhanced disclosures, and maintaining robust controls. Despite these costs, "overall, stakeholders agreed that the benefits of the revenue standard outweigh its costs, especially from a long-term perspective."

G. Improvements to the standard-setting process

Key lessons from the PIR include:

a. The need for realistic effective date planning, factoring in implementation complexity and stakeholder readiness;
b. The importance of proactively identifying cross-cutting issues, especially those affecting multiple areas of GAAP;
c. Recognition that early-stage TRGs could enhance guidance clarity and reduce post-issuance amendments; and
d. Knowledge that, while beneficial, global convergence introduces added time, cost, and complexity that must be weighed carefully.

As a result, FASB instituted enhanced internal procedures to better forecast timelines and coordinate guidance across standards.

X. What is next?

The FASB determined that ASC 606 met its core objectives: delivering a robust, consistent, and principles-based revenue recognition framework. The cost-benefit relationship aligned with initial expectations, with long-term benefits justifying the implementation effort. There is no immediate need for standard-setting changes, as ASC 606 is operational and broadly effective. “The staff has not identified any matters that warrant immediate standard-setting action on Topic 606.”

Going forward, the FASB will maintain ongoing support via the Technical Inquiry Service to address emerging questions. The Board will monitor practice developments and consider future agenda items based on evolving needs. Insights from the PIR will be incorporated into the development of future standards and implementation support strategies.

XI. Practice exercises

A. Exercise 1

Answer the questions following the fact pattern with regard to applying the accounting guidance for recognizing revenue over time.

<u>Facts</u>

The entity, Contractor, has been engaged to replace a bridge over a local river by the local municipality. The contract is for $3.0 million, which includes all building materials such as steel, concrete, and other materials, all labor and overhead related to the contract. Contractor expects to make a 10 percent profit margin in the contract. Contractor expects that it will take six months to replace the bridge and bills the municipality monthly for the work performed on the bridge, based on the costs which it incurs in building the bridge. The local municipality controls the work in process as the bridge is replaced and can make changes to the bridge design over the period of time that the bridge is being constructed. The municipality can terminate the project at any time, with Contractor entitled to be reimbursed for any costs that it has incurred to date that have not yet been reimbursed by the municipality, plus reasonable profit. However, reimbursements for material purchased by Contractor but not yet used are limited to the cost of the materials.

<u>Questions for Consideration, Using the Guidance in Topic 606</u>

1. How many performance obligations are there in this contract?

2. How would revenue be recognized for this contract? Why?

3. Assume that after five months, Contractor has incurred $2.4M of costs of the bridge. This includes the cost of the steel and all other materials, which have all been installed by Contractor. Using a cost input method and assuming the same estimated total cost for the bridge as at the beginning of the contract, how much progress has Contractor made on the bridge? How much cumulative revenue and profit would Contractor recognize on the project?

B. Exercise 2

Answer the questions following the fact pattern with regard to applying the accounting guidance for recognizing revenue over time.

Facts

Assume that the entity is a software developer who produces software that customers use to value their investments. The entity provides a license for 12 months to users of the software to access the entity's software at any time in order to use it to assist in valuing the end user's investments. The terms of the license agreement call for an upfront payment by the customer to the entity of $2,000.

Questions for Consideration, Using the Guidance in Topic 606

1. Would the license meet the definition of a performance obligation?

2. Would the license be classified as a license of functional intellectual property or symbolic intellectual property?

3. Would the revenue be recognized at the point in time that access to the license is granted to the customer or over the license term?

XII. Practice exercises – Suggested solutions

A. Exercise 1

Facts

The entity, Contractor, has been engaged to replace a bridge over a local river by the local municipality. The contract is for $3.0 million, which includes all building materials such as steel, concrete, and other materials, all labor and overhead related to the contract. Contractor expects to make a 10 percent profit margin in the contract. Contractor expects that it will take six months to replace the bridge and bills the municipality monthly for the work performed on the bridge, based on the costs which it incurs in building the bridge. The local municipality controls the work in process as the bridge is replaced and can make changes to the bridge design over the period of time that the bridge is being constructed. The municipality can terminate the project at any time, with Contractor entitled to be reimbursed for any costs that it has incurred to date that have not yet been reimbursed by the municipality, plus reasonable profit. However, reimbursements for material purchased by Contractor but not yet used are limited to the cost of the materials.

Questions for Consideration, Using the Guidance in Topic 606

1. How many performance obligations are there in this contract?

   While the material used to build the bridge would most likely be distinctive in and of themselves, as they would have functionality to the municipality, they are not distinct within the context of the contract, as they are being used as inputs to produce or deliver the combined output specified by the customer, the bridge. As such, Contractor would most likely conclude that the contract has one performance obligation, the building of the bridge.

2. How would revenue be recognized for this contract? Why?

   Contractor would recognize revenue for the bridge over time under Topic 606. This is because the municipality controls the work in process as Contractor constructs the bridge.

3. Assume that after five months, Contractor has incurred $2.4M of costs of the bridge. This includes the cost of the steel and all other materials, which have all been installed by Contractor. Using a cost input method and assuming the same estimated total cost for the bridge as at the beginning of the contract, how much progress has Contractor made on the bridge? How much cumulative revenue and profit would Contractor recognize on the project?

   Contractor would estimate its progress on the bridge as follows:

   Total costs incurred $2.4M
   Estimated total costs 2.7M - $3M contract value less 10 percent estimated profit ($300K)

   Progress percentage 89 percent
   Contract price $3.0M

   Revenue recognized $2.667M - $3M times 89 percent completion

B. Exercise 2

Facts

Assume that the entity is a software developer who produces software that customers use to value their investments. The entity provides a license for 12 months to users of the software to access the entity's software at any time in order to use it to assist in valuing the end user's investments. The terms of the license agreement call for an upfront payment by the customer to the entity of $2,000.

Questions for Consideration, Using the Guidance in Topic 606

1. Would the license meet the definition of a performance obligation?

   As the customer can benefit from the license either on its own or together with other resources that are readily available to the customer (the related IT hardware and software), the license would meet the definition of being distinct and thereby would be a separate performance obligation.

   Note that the entity should assess whether its promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract). Given this fact pattern, this does not appear to be the case.

2. Would the license be classified as a license of functional intellectual property or symbolic intellectual property?

   Based on the provided fact pattern, the license appears to be intellectual property that has significant standalone functionality, as it performs a function or task. Accordingly, it would be classified as a license of functional intellectual property.

3. Would the revenue be recognized at the point in time that access to the license is granted to the customer or over the license term?

   As this contract represents the transfer of a license of functional intellectual property to the customer, revenue would be recognized at the point in time that access to the license is granted to the customer.

   However, the entity needs to determine if the exception to this rule exists. It must determine if the functionality of the intellectual property to which the customer has rights is expected to substantively change during the license period as a result of activities of the entity that do not transfer a promised good or service to the customer, and whether the customer is contractually or practically required to use the updated intellectual property resulting from the updates.

In performing this analysis, the entity will need to apply judgment to determine if the updates to the license represent substantive changes to the software. If so, then, it must determine if the customer is contractually or practically required to use the updated software. If it answers yes to both questions, then the entity would recognize the revenue related to the license over the term of the license, or 12 months. As the term of the contract is a year or less, the entity need not consider whether there is a financing element associated with the pricing of the license.

Given the fact pattern, it does not appear that the conditions related to the exception exist. As such, the entity would recognize revenue at the time at which the license is transferred to the customer.

Emerging Trends: Digital Asset Compliance

Learning objectives ***1***
I. Cryptocurrency and the Tax Code: Decoding digital assets ***1***
A. Overview and types of digital assets **1**
B. Taxable/nontaxable events **4**
1. Compensation *4*
2. Mining income *5*
3. Rewards *5*
4. Airdrops *5*
5. Interest income *5*
6. Hard forks *5*
7. Sales/purchases *6*
8. Charitable donations (deductible) *6*
9. Receipt of digital assets after purchase from an exchange *6*
10. Receiving digital assets as a bona fide gift *7*
11. Gifting digital assets *7*
12. Self-transactions (transfers between wallets or accounts) *7*
13. Receipt of digital assets after coin swap/migration *7*
14. Soft forks *7*
C. Reporting **7**
D. Form 1099-DA and broker reporting **9**
E. Digital asset scrutiny **12**

Emerging Trends: Digital Asset Compliance

Learning objectives

Upon reviewing this material, the reader will be able to:
- Identify and apply current IRS guidance and tax reporting requirements for various types of digital asset transactions; and
- Evaluate how artificial intelligence can be integrated into tax practice.

I. Cryptocurrency and the Tax Code: Decoding digital assets

A. Overview and types of digital assets

A digital asset is any digital representation of value recorded on a cryptographically secured, distributed ledger (blockchain) or similar technology. Examples of digital assets include convertible virtual currencies and cryptocurrencies such as Bitcoin, stablecoins, and nonfungible tokens (NFTs). A digital asset is stored electronically and can be bought, sold, owned, transferred, or traded.

The IRS defines virtual currency as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value." In some environments, virtual currency operates like "real" currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in any jurisdiction. Convertible Virtual Currency is virtual currency that has an equivalent value in real, tangible currency or acts as a substitute for real currency.

Cryptocurrency is a specific type of virtual currency that uses cryptography to secure transactions. Cryptocurrency is a specific type of virtual currency that uses "cryptography" to validate and secure transactions that are digitally recorded on a distributed ledger or record keeper. A "blockchain" is a chain or blocks that store digital information in a public database, that functions similar to a ledger. The individual blocks making up the chain contain information about transactions including the date, time, and dollar amount of a transaction. The individual block also contains information about the parties participating in a transaction (via unique digital signatures) as well as a unique "hash," or string of text and numbers, updated for each transaction.

Cryptocurrency transactions are generally pseudonymous as accounts and transactions are not connected to individual identities. As a result, individuals cannot easily connect the identity of a user with an address or transaction. Each transaction on a network must be confirmed by a miner, and once a transaction is confirmed, it cannot be reversed. Bitcoin is the first and most well-known cryptocurrency, although there are several other cryptocurrencies available.

Nonfungible tokens (NFTs) are a type of digital asset that represents a "real-world" physical asset such as artwork, a musical composition, memorabilia, or film/video.

NFTs have gained popularity in recent years due to many factors, including:

a. Blockchain Technology;
b. Digital Ownership;
c. Metaverse; and
d. Speculation/Investment.

One fascinating aspect regarding NFTs is that purchasing or owning an NFT does not automatically grant the purchaser copyright or reproduction rights to the underlying digital asset, instead the purchaser only acquires ownership rights to the specific NFT. For example, only one person owns an original Van Gogh piece, but many people can buy print copies of the same piece. Often, the real "value" provided by an NFT is the satisfaction of ownership and the perceived rarity or uniqueness of the asset. Like traditional art, the value of an NFT is determined by what an individual is willing to pay for those ownership rights, making it largely subjective and market-driven.

Similar to cryptocurrencies, NFTs are stored on a blockchain and can be traded or sold. Unlike cryptocurrency, NFTs are non-fungible (hence the name), as they are unique and cannot be exchanged on a one-to-one basis. Each NFT has distinct attributes, whether in the form of art, music, video clips, or other digital content, that makes it different from every other NFT. On the other hand, cryptocurrency is fungible, like fiat currency, as it can be traded interchangeably, and the value is easily determinable.

Metadata associated with the NFT plays a critical role in providing essential information about the token and underlying asset it represents, including but not limited to:

- **Description** – A description of the NFT, including creator details, any historical/contextual information, as well as any details about the edition or specific features of the NFT;
- **Contractual terms** – Any contractual terms/conditions that govern the use, ownership, and transfer of the NFT;
- **Links** – Any links to digital or media files related to the NFT;
- **Ownership history** – Records about the NFT's previous owners; and
- **Blockchain information** – Information about the blockchain (to verify authenticity of the NFT).

NFT contractual metadata is a key aspect of the NFT ecosystem that provides content creators with the ability to establish specific terms and conditions associated with their digital assets, including ongoing compensation or royalties for secondary sales. To facilitate this, many NFTs are linked to smart contracts that contain metadata that outlines important details about the NFT, such as the creator's name, a description of the digital asset, and other relevant information.

One of the most valuable aspects of NFTs is that creators and artists are able to receive ongoing royalties as their work appreciates in value. When an NFT is resold in a secondary market, contractual metadata embedded within the smart contract automatically ensures that the original creator receives a percentage of the sale.

Traditionally, in the physical world, once a creator or artist initially sells their content, they are unable to benefit from any further future appreciation in value. With NFTs, creators can program royalties directly into the smart contract, allowing them to automatically receive a percentage of the sale price whenever the NFT is resold on the secondary market. The smart contract ensures that the royalty payment is distributed instantly to the creator's wallet, providing them with a continuous stream of income as the value of their work appreciates over time. This innovative feature can serve as a strong incentive for creators and artists to keep producing high-quality content, knowing that they will continue to benefit financially from their creations long after the initial sale. It is important to note that not all NFT marketplaces support royalties. As such, creators should carefully research platforms that offer this feature to ensure they can take full advantage of ongoing compensation if it is a priority for them.

After years of silence, in March 2023, the IRS announced its intent to issue guidance on the tax treatment of certain nonfungible tokens (NFTs). Notice 2023-27 defines a nonfungible token (NFT) as a unique digital identifier that is recorded using distributed ledger technology and may be used to certify authenticity and ownership of an associated right or asset. When an individual has ownership of an NFT, they hold the right to a digital asset that represents a "real-world" physical asset such as artwork, a musical composition, memorabilia, or film/video. As such, the IRS classifies NFTs as having two parts: the digital file/identifier and the underlying right/asset. NFT ownership may also provide the holder a right with respect to an asset that is not a digital file, such as a right to attend an event/concert or certify ownership of a physical item.

Notice 2023-27 states that the IRS and Department of the Treasury intend to issue guidance related to the treatment of certain NFTs as collectibles under IRC §408(m). Per §408(m)(2), the term "collectible" means:

a. Any work of art;
b. Any rug or antique;
c. Any metal or gem;
d. Any stamp or coin;
e. Any alcoholic beverage; or
f. Any other tangible personal property specified by the Secretary for purposes of this subsection.

Note:

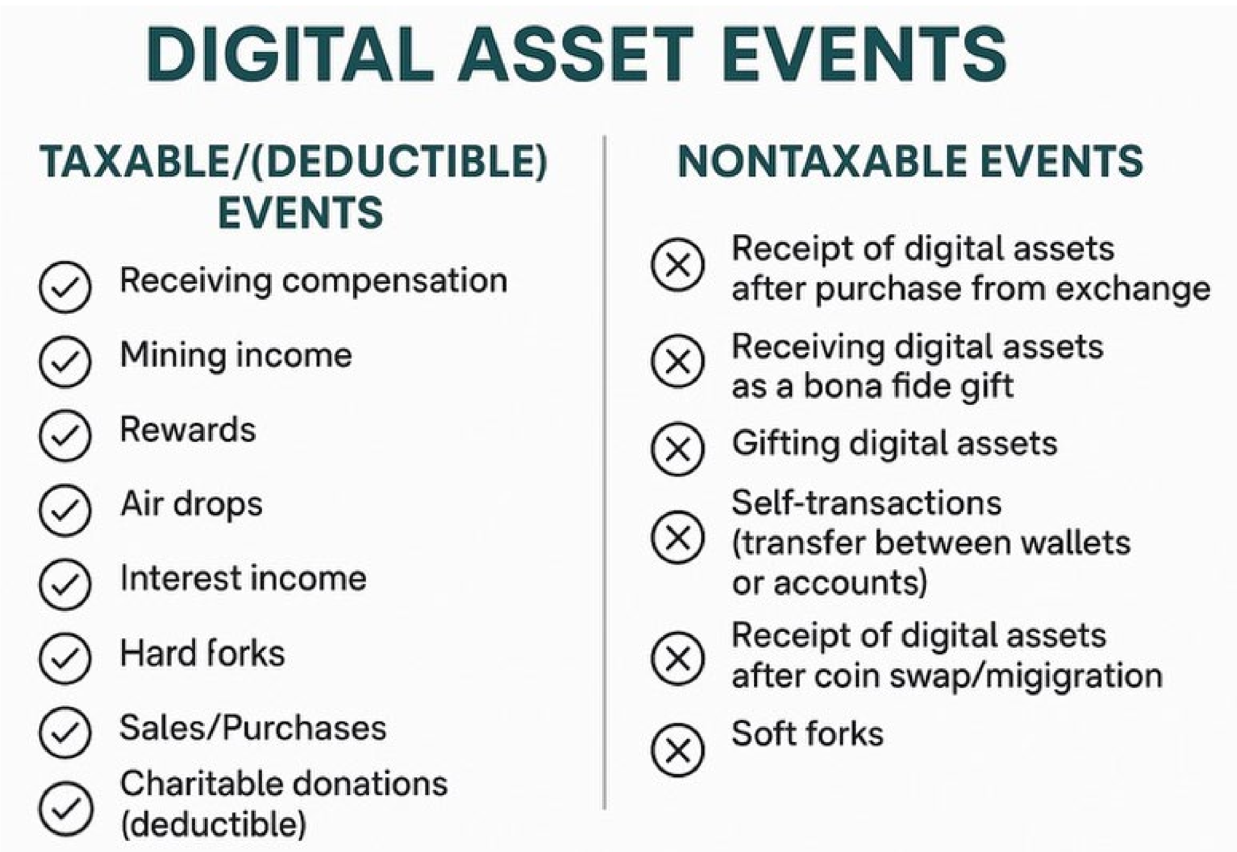
Section 408(m)(3) provides that certain coins and bullion are excluded from the definition of collectible.

The IRS intends to determine whether an NFT is a §408(m) collectible by conducting look-through analysis, meaning they will analyze whether the NFT's associated right or asset is a §408(m) collectible. Using look-through analysis methodology, an NFT constitutes a §408(m) collectible if the NFT's associated right or asset is a §408(m) collectible. Utilizing look-through analysis to an NFT to determine if its associated right or asset is a digital file raises the question as to whether the digital file constitutes a "work of art" under §408(m)(2)(A). If considered a "work of art" under §408(m)(2)(A), the NFT would be a §408(m) collectible. The Treasury Department and IRS are currently considering the extent to which a digital file may constitute a "work of art" under §408(m)(2)(A).

As a result of the guidance provided in Notice 2023-27, individuals who sell collectible NFTs could potentially be subject to higher tax rates than individuals who sell non-collectible NFTs. The sale or exchange of a §408(m) collectible that is a capital asset held for more than one year is subject to a maximum 28 percent capital gains tax rate, whereas other long-term capital assets held for more than one year are subject to a maximum 20 percent capital gains tax rate. Another important consideration is that IRAs are generally prohibited from directly holding certain types of collectibles, which could include NFTs, pending look-through analysis.

B. Taxable/nontaxable events

While Notice 2023-27 sheds light on the potential tax implications of nonfungible tokens (NFTs), particularly in how they may be classified as collectibles, it's essential to recognize that the IRS has already established general principles for the taxation of digital assets as a whole. Notice 2014-21, later confirmed by Notice 2023-34, establishes that for U.S. federal tax purposes, virtual currency, including digital assets, is considered property rather than currency. As a result, digital assets are subject to general tax principles applicable to property transactions. It is critical for individuals to track the underlying basis of each unit of cryptocurrency in order to correctly calculate any potential gain or loss triggered upon sale or transfer. In a broad sense, cryptocurrency can be taxed as either capital gain/loss or ordinary income/loss.



1. Compensation

As with any other form of compensation, digital assets received as payment for services must be reported as income on Form 1040 and taxed at ordinary income tax rates. This requirement applies to all individuals receiving compensation, including:

a. Employees (reported on Form W-2);
b. Independent contractors (reported on Form 1099); and
c. Others providing services who may not receive a formal tax form.

Note:

> Even if no Form W-2 or 1099 is issued, the individual is still responsible for reporting the income received (FMV at time of receipt).

2. Mining income

Cryptocurrency miners verify and authenticate cryptocurrency transactions in exchange for cryptocurrency. Professional miners conduct mining activity as part of a §162 trade or business. Professional miners include the FMV of the mined cryptocurrency as ordinary income at the time it is received.

Like any other §162 trade or business, professional miners can deduct mining-related expenses on Schedule C. Hobby miners mine cryptocurrency on a casual basis, and the activity does not rise to the level of a §162 trade or business. Hobby miners must still include the FMV of mined cryptocurrency in their gross income. However, mining-related expenses are not deductible, as the activity does not meet the requirements of a §162 business.

3. Rewards

Unless specifically exempted, the FMV of the digital asset reward at the time of receipt must be included in taxable income. If an individual receives a reward in the form of a digital asset while shopping on an online platform, the individual should err on the side of caution (no clear IRS guidance exists) and include the FMV of the digital asset reward received in taxable income.

4. Airdrops

Airdrops occur when a company distributes a digital asset (most likely cryptocurrency) to an individual's wallet, usually free of charge, and often as a promotional strategy for launching a new cryptocurrency or raising awareness. Sometimes airdrops are unsolicited, and other times individuals may complete small tasks (like sending a tweet) in exchange for the airdrop.

The IRS defines an airdrop as "a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers." The IRS guidance (Rev. Rul. 2019-24) confirms that individuals are liable for taxes on cryptocurrencies resulting from an airdrop, regardless of whether the cryptocurrency is actually received. Individuals should recognize ordinary income at the FMV of the airdropped cryptocurrency at time of receipt.

5. Interest income

Certain platforms offer users the ability to earn interest on their digital asset holdings. Individuals receiving interest income should report the amount as interest income on Form 1040. If the platform provides a Form 1099-INT or Form 1099-MISC, it can assist with accurate reporting, but even if no form is issued, taxpayers are still responsible for reporting the income.

6. Hard forks

Similar to how computers require software updates or phones require app updates, cryptocurrency networks also require updates in order to improve performance and resolve any known issues. This "update" is often referred to as a "fork" in the cryptocurrency community. Forks arise when there are two different blocks in the same blockchain that have an identical set of blocks preceding it.

In Rev. Rul. 2019-24, the IRS defines a “hard fork” as “unique to distributed ledger technology and occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. Following a hard fork, transactions involving the new cryptocurrency are recorded on the new distributed ledger and transactions involving the legacy cryptocurrency continue to be recorded on the legacy distributed ledger.”

Sometimes an airdrop occurs after the hard fork, distributing the new cryptocurrency to the individual who owned the original (“legacy”) cryptocurrency. The IRS clarifies that if an individual receives an airdrop of new cryptocurrency resulting from a hard fork and has complete control over the new cryptocurrency, the individual must include the FMV of the new cryptocurrency in ordinary income. If an individual does not receive units of a new cryptocurrency through an airdrop following a hard fork, there is no taxable event.

7. Sales/purchases

As digital assets become more widely accepted, individuals increasingly use them not just as investments, but also for everyday transactions, such as sales and purchases. It is important to understand that both sales and purchases involving digital assets can be taxable events.

When an individual sells digital assets, whether for currency or in exchange for another cryptocurrency, they must recognize a capital gain or loss based on the difference between the FMV at the time of sale and their adjusted basis. This applies whether the digital asset was held as a short-term or long-term investment.

Many people assume that spending digital assets (such as buying coffee with Bitcoin) is not taxable, but that is incorrect. The IRS treats the use of digital assets to buy goods or services as a form of disposal, similar to a sale. As a result, taxpayers must calculate a capital gain or loss based on the difference between the FMV at the time of sale and their adjusted basis.

Currently, no de minimis exception exists for small personal transactions involving digital assets. This means that even minor purchases, like a coffee or a sandwich, purchased using digital assets, must be reported if they result in a gain or loss.

8. Charitable donations (deductible)

When a taxpayer donates digital assets directly to a qualified 501(c)(3) organization, they do not recognize income, gain, or loss on the donation, rather they may take a deduction as follows:

a. If the individual held the digital assets for **more than a year**, the amount of the charitable deduction is equal to the FMV of the digital assets at the time of donation; or
b. If the individual held the digital assets for **less than a year**, the amount of the charitable deduction is equal to the lesser of the basis in the digital assets or the FMV of the digital assets at the time of donation.

9. Receipt of digital assets after purchase from an exchange

When an individual purchases a digital asset through an exchange, the receipt of that asset is **not** a taxable event. While no tax is due at the time of purchase, the transaction plays a critical role in tax reporting because it establishes the individual’s cost basis in the digital asset. It is best practice to keep records of purchase date, amount paid, any exchange/transaction fees, and the wallet/exchange where the asset is stored.

10. Receiving digital assets as a bona fide gift

The receipt of digital assets as a bona fide gift is not considered taxable income to the recipient under §102(a). A bona fide gift is a gift given without the expectation of receiving anything in return. While the gift itself is nontaxable upon receipt, the recipient should carefully document the donor's basis and the FMV at the time of the gift. If the recipient later disposes of the digital asset, either by selling, exchanging, or using it, they may incur a capital gain or loss.

11. Gifting digital assets

The gift of a digital asset is generally not a taxable event for the donor at the time the gift is made. However, If the value of the digital asset gift exceeds the annual gift exclusion limit ($19,000 for 2025), the donor may be required to file Form 709.

12. Self-transactions (transfers between wallets or accounts)

In the context of digital assets, a self-transaction refers to the act of transferring assets between two wallets or accounts. A self-transaction is not a taxable event, as the individual is still the same beneficial owner of the digital asset.

13. Receipt of digital assets after coin swap/migration

Coin swaps function similarly to stock splits (shareholders receive additional shares, but the overall value of their holdings remains the same), and thus, are not considered a taxable event. However, the individual should allocate basis among the new coins in order to properly calculate basis going forward.

14. Soft forks

A soft fork in the context of digital assets refers to a type of blockchain protocol upgrade or modification that is backward-compatible. A soft fork introduces changes to the protocol that do not invalidate or split the existing blockchain, but rather, update it in a way that does not require all participants to upgrade their software. A soft fork makes the protocol change less disruptive than a hard fork, which often results in the creation of an entirely new blockchain and a new digital asset (coin). A soft fork is generally not taxable because it does not result in the creation of a new asset, nor does it lead to any transfer of ownership or realization of gain.

C. Reporting

As of tax year 2019, taxpayers are required to answer whether, at any time during the tax year, they received, sold, sent, exchanged, or otherwise disposed of any financial interest in virtual currency. Taxpayers who do not properly report the income tax consequences of virtual currency transactions are, when appropriate, liable for tax, penalties and interest. In some cases, taxpayers could be subject to criminal prosecution.

Digital Assets	At any time during 2024, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.)	☐ **Yes** ☐ **No**

As discussed, taxpayers should check "yes" to the digital asset question on Form 1040 if:

a. They received digital assets for:
    (i) Payment for property or services provided;
    (ii) A reward or award;
    (iii) Mining, staking and similar activities; or
    (iv) An airdrop as it relates to a hard fork.
b. They disposed, sold, exchanged, or transferred ownership of digital assets:
    (i) For another digital asset;
    (ii) For U.S. dollars or other currency;
    (iii) In exchange or trade for property, goods or services in any amount;
    (iv) By paying a transfer fee with digital assets; or
    (v) By a transfer of ownership or financial interest.
c. They had a financial interest in a digital asset for which:
    (i) They are recorded as the owner of a digital asset;
    (ii) They have an ownership stake in an account that holds one or more digital assets, including the rights and obligations to acquire a financial interest; or
    (iii) They own a wallet that holds digital assets.

As discussed, taxpayers should check "no" to the digital asset question on Form 1040 if:

a. They did not own any digital assets;
b. Only owned or held digital assets in a wallet or account, but did not engage in any digital asset transactions during the year;
c. Purchased, but did not sell, digital assets using U.S. or other real currency, including through electronic platforms; or
d. Transferred digital assets from one wallet or account they owned or controlled to another wallet or account they owned or controlled.

Note:

> An exception applies if a transaction fee was paid with digital assets. This is considered a digital asset transaction.

If the "Yes" box is selected, taxpayers are instructed to report all income related to their digital asset transactions using Form 8949 to calculate their capital gain or loss. Then, taxpayers are to report such income on Form 1040, Schedule D, Schedule 1 if ordinary income, Schedules C, F, or E if the transaction is business related, or Form 709 in the case of gifts.

In addition to checking the "Yes" box, taxpayers must report all income related to their digital asset transactions:

a. If an investor held a digital asset as a capital asset and sold, exchanged, or transferred it during the tax year, they must use Form 8949, "Sales and other Dispositions of Capital Assets," to figure their capital gain or loss on the transaction and then report it on Schedule D (Form 1040), "Capital Gains and Losses."
b. Similarly, a taxpayer who disposed of any digital asset by gift may be required to file Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return."
c. If an employee was paid with digital assets, they must report the value of assets received as wages.

d. If an individual worked as an independent contractor and was paid with digital assets, they must report that income on Schedule C (Form 1040), "Profit or Loss from Business (Sole Proprietorship)."

e. Schedule C is also used by any taxpayer who sold, exchanged, or transferred digital assets to customers in connection with a trade or business.

Below is a table summarizing some of the forms and schedules that taxpayers involved with cryptocurrency should consider when reviewing digital asset reporting obligations.

Digital Asset Compliance

Form 1040	Schedule 1	Schedule A	Schedule B	Schedule C	Schedule D	Form 8949

• "Check the box" question on page 1 of Form 1040
• Report Ordinary Income (Wages / Compensation)
  • Line 1a
• Report Capital Gains / Losses
  • Line 7
	• Report Ordinary Income (Other Income)
	  • Line 8z
		• Report Charitable Deductions of Digital Asset donations
		  • Line 12
			• Report Interest Income
			  • Part I
			• Report Rewards
			  • Part I
				• Report income generated as part of §162 trade or business
				  • Line 1
				• Deduct any expenses associated with §162 trade or business
				  • Part 2
					• Summarize Digital Asset Capital Gains / Losses from Form 8949	• Report Digital Asset gains and losses

In order to properly report digital asset transactions, taxpayers should maintain adequate records, including, but not limited to:

a. Adjusted basis in the assets sold;
b. Description of the asset;
c. FMV at the time of transaction;
d. Date/time of transaction;
e. Type of transaction;
f. Amount transacted; and
g. Any transaction fees.

Example: John purchased 2 ETH for $4,000 ($2,000 per unit) on May 21, 2022. He sold both units for $8,000 ($4,000 per unit) on March 9, 2024. John paid $0.50 in transaction fees.

John's adjusted amount realized is $7,999.50 ($8,000 amount realized - $0.50 transaction fee). John's capital gain is $3,999.50 ($7,999.50 adjusted amount realized - $4,000 basis).

D. Form 1099-DA and broker reporting

In July 2024, TIGTA released a report regarding virtual currency tax compliance.[1] From April 2020 through July 2023, the number of types of virtual currency has grown from 5,000 to over 26,000. Without information reporting documents, the IRS has been unable to use some of its enforcement tools to match reported virtual currency-related income to taxpayers' tax returns to ensure that taxpayers are accurately reporting their income generated from virtual currencies and other digital assets.

Form 1099-DA, "Digital Asset Proceeds From Broker Transactions," is an IRS tax form introduced to enhance transparency and compliance in the reporting of digital asset transactions, including cryptocurrencies and nonfungible tokens (NFTs). This form is part of a broader effort to standardize tax reporting for digital assets.

---

[1] TIGTA Virtual Currency Tax Compliance Enforcement Can Be Improved. July 10, 2024. Report Number: 2024-300-030.

Prior to the introduction of Form 1099-DA, digital asset transactions lacked standardized reporting. Some exchanges issued Form 1099-MISC, others issued Form 1099-B, and others did not issue any tax forms. Form 1099-DA requires digital asset brokers to report key details of digital asset transactions, such as proceeds, cost basis, and acquisition/sale date. A U.S. digital asset broker (broker) is a U.S. person (other than a foreign branch or office of such person), or a U.S. branch described in Regulations Section 1.1441-1(b)(2)(iv) that is treated as a U.S. person (excluding a territory financial institution) that effects sales of digital assets on behalf of others.

On November 15, 2021, former President Biden signed into law The Infrastructure Investment and Jobs Act (IIJA), containing provisions that significantly expand cryptocurrency reporting requirements for digital asset transactions. Section 80603 of the IIJA made significant changes to the broker reporting provisions under §6045 to clarify the rules regarding how certain digital asset transactions should be reported by brokers, and to expand the categories of assets for which basis reporting is required to include all digital assets.

Notably, the IIJA included a provision related to broker reporting of digital asset transactions. The IIJA intended to expand the reporting requirements to cover cryptocurrency and other digital assets to enhance tax compliance and improve the ability of the IRS to track and collect taxes on transactions involving these assets. Brokers are required to report to the IRS and furnish statements to customers detailing gross proceeds from digital asset sales, adjusted basis, and whether gains or losses are long-term or short-term. The reporting of cost basis and holding period information is mandated for transactions occurring on or after January 1, 2026.

In late 2024, the U.S. Treasury Department finalized regulations implementing broker reporting requirements. The final rules clarified that the reporting obligations would apply to custodial brokers and certain decentralized finance (DeFi) platforms that provide trading front-end services. Under the final rules, these brokers were to report digital asset transactions starting in 2025, with the reporting of cost basis and holding period information commencing in 2026.

However, in April 2025, President Trump signed a bill nullifying a revised IRS rule that sought to classify decentralized cryptocurrency exchanges (DeFi) as brokers. The amendment, finalized in late 2024, aimed to increase tax compliance among crypto users by expanding the IIJA provisions. The cryptocurrency industry opposed the IRS revision, arguing that DeFi platforms, which enable peer-to-peer transactions without intermediaries, lack the necessary user data to meet reporting requirements.

In January 2025, the IRS released the final version of Form 1099-DA and accompanying instructions which provide information for brokers to use to complete Form 1099-DA for each sale a broker has effected in 2025. As discussed, brokers are not required to report basis information with respect to sales effected in 2025. The broker may voluntarily report basis information. For any basis information voluntarily reported by the broker, the broker will not be subject to penalties under §6721 or 6722 for failure to report or furnish the information correctly. For each sale a broker has effected for customers on or after January 1, 2026, of digital assets that are covered securities, the broker must complete Form 1099-DA.

☐ CORRECTED (if checked)

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	Applicable checkbox on Form 8949	OMB No. 1545-2330 **2025** Form **1099-DA**	**Digital Asset Proceeds From Broker Transactions**
	1a Code for digital asset		
	1b Name of digital asset		**Copy B For Recipient**
FILER'S TIN / RECIPIENT'S TIN			
RECIPIENT'S name	1c Number of units		
Street address (including apt. no.)	1d Date acquired	1e Date sold or disposed	
City or town, state or province, country, and ZIP or foreign postal code	1f Proceeds $	1g Cost or other basis $	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
	1h Accrued market discount $	1i Wash sales loss disallowed $	
	2 Check if basis reported to IRS ☐	3a Reported to IRS: ☐ Gross proceeds ☐ Net proceeds	
Account number	3b Check if proceeds from: ☐ Reserved for future use ☐ QOF	4 Federal income tax withheld $	
CUSIP number			
5 Check if loss is not allowed based on amount in 1f ☐ / 6 Gain or loss: ☐ Short-term ☐ Long-term ☐ Ordinary	7 Check if 1f is only cash ☐	8 Check if broker relied on customer-provided acquisition information ☐	
9 Check if digital asset is a noncovered security ☐ / 10		11a Check if gross proceeds reported in 1f is an aggregate amount for: ☐ Qualifying stablecoins ☐ Specified NFTs	
11b If 11a checked, number of transactions / 11c For aggregate reporting of specified NFTs, aggregate gross proceeds reported in 1f that are attributable to first sales by creator or minter $	12a Number of units transferred in	12b If transferred in, provide transfer-in date	13
14 State name	15 State identification no.	16 State tax withheld $ $	

Form **1099-DA** (Keep for your records) www.irs.gov/Form1099DA Department of the Treasury - Internal Revenue Service

Per form instructions, a broker includes "any person who, in the ordinary course of a trade or business, stands ready to effect sales of digital assets to be made by others." An individual/entity is considered a broker with respect to sales of digital assets if:

a. They are a person that regularly offers to redeem digital assets that were created or issued by them; or

b. They effect dispositions of customers' digital assets as an agent, a dealer, or digital asset middleman.

Generally, only a U.S. digital asset broker is required to report on Form 1099-DA. Typically, each transaction is reported on a separate Form 1099-DA. Brokers have an option to report on an aggregated annual basis rather than on a transactional basis for certain stablecoins and NFTs.

Form 1099-DA instructions specifically state that the sales of each of the following types of digital assets should be reported on a separate Form 1099-DA, even if all four types were sold in a single transaction:

a. Covered securities with short-term gain or loss.
b. Covered securities with long-term gain or loss.
c. Noncovered securities if box 9 is checked when reporting their sale. If box 9 was not checked, the sale is reported as the sale of a covered security.
d. First sales by a creator or minter if the sales of specified NFTs are reported using the optional reporting method for specified NFTs.

The Form 1099-DA instructions clarify that if a broker effected a sale of a digital asset that is also a security for which the Form 1099-B would be required (otherwise known as a dual classification asset), the broker should generally file Form 1099-DA and not Form 1099-B. The instructions also clarify that rewards and staking payments should not be reported on Form 1099-DA.

E. Digital asset scrutiny

Although Form 1099-DA streamlines reporting, taxpayers should keep their own detailed records of digital asset transactions to resolve any discrepancies that may arise during tax reporting. The IRS has significantly intensified its scrutiny of digital asset transactions in recent years, implementing various measures to enhance tax compliance and reporting accuracy.

As discussed, as of 2019, the IRS added a question about virtual currency to Form 1040, Schedule 1, asking whether taxpayers had received, sold, sent, exchanged, or acquired virtual currency. Per a recent TIGTA report, from TYs 2019 to 2022, the IRS processed over 662 million Form 1040s, with nearly 12.6 million taxpayers self-reporting digital asset activity. The number of taxpayers answering “Yes” increased significantly, increasing 649 percent from 2019 to 2021, then dropping to 2.7 million in 2022, but still representing a 202 percent increase over 2019.[2]

Some IRS business units use the digital asset question in combination with other data to identify compliance risks, especially during audits. Incorrect answers (e.g., saying “No” while evidence shows digital asset use) raise red flags, but are difficult to act on without being able to validate external data sources. In 2023, the IRS expanded the digital asset question to other tax forms, including Form 1065, Form 1120, Form 1120-S, and Form 709. This expansion is meant to improve compliance and enforcement in digital asset reporting by collecting more information from different types of entities.

In 2021, the IRS launched “Operation Hidden Treasure,” a joint effort between the IRS Criminal Investigation Division and the IRS Office of Fraud Enforcement (OFE). The main goal of this initiative is to seek out fraud and uncover omitted income related to cryptocurrency. The IRS trained 200 employees across all business divisions to address noncompliance related to cryptocurrency. Through this training, the employees became knowledgeable about cryptocurrency and how to spot issues when examining returns. These employees were in addition to the in-house experts in the OFE and IRS Criminal Investigation Division.

One goal of the Operation Hidden Treasure initiative was to determine whether there is a common, recognizable tax evasion pattern amongst digital asset holders. An example of this is structuring a series of transactions, each under $10,000, to avoid reporting requirements. The OFE planned to create a virtual

[2] TIGTA Virtual Currency Tax Compliance Enforcement Can Be Improved. July 10, 2024. Report Number: 2024-300-030.

currency network to assist with tracking cryptocurrency basis and computing gain. This network would not only help train IRS employees but also generate insightful data about cryptocurrency transactions.

Although initially criticized for lack of direct enforcement, this initiative laid the groundwork for future enforcement by:

a. Acquiring forensic tools;
b. Training IRS agents; and
c. Building internal expertise in blockchain auditing.

The IRS Criminal Investigation (CI) has opened hundreds of crypto-related investigations, targeting unreported gains, mixing service, wash trading, and offshore wallets. Additionally, in recent years, the IRS ramped up their cryptocurrency compliance efforts through the use of "John Doe" summonses. The IRS has used this tool to demand records from exchanges like Coinbase, Kraken, and Poloniex. This allows the IRS to identify individuals who failed to report taxable crypto income. More summonses are likely as the IRS seeks to validate data with taxpayer filings.

In summary, the IRS's scrutiny of digital assets is not a passing phase, rather it is a long-term strategic initiative. It is essential for taxpayers to:

a. Keep accurate records;
b. Understand new reporting requirements; and
c. Stay informed about IRS guidance and enforcement trends.

Taxpayers who do not properly report the income tax consequences of virtual currency transactions are, when appropriate, liable for tax, penalties, and interest. In some cases, taxpayers could be subject to criminal prosecution.

Note:

> Not to insinuate all cases qualify; however, practitioners must remember virtual currency is an ongoing focus area for IRS Criminal Investigation. Should practitioners find themselves dealing with a Criminal Investigation case, they should seek proper legal counsel.

Discussion question:

> What practical steps should CPAs take to help clients accurately track, classify, and report digital asset transactions in light of evolving IRS rules and increased scrutiny?

Investments, Retirement, and Miscellaneous

Learning objectives	***1***
I. Investments	***1***
A. Real estate	**1**
1. The law	*1*
2. Procedures to obtain extensions for single rental real estate activity treatment	*2*
B. Cases	**4**
1. Lisa M. Holley v. Commissioner, (T.C. Memo. 2024-54)	*4*
2. James Clark v. Commissioner, (T.C. Memo. 2025-13)	*7*
3. Rosa M. Marcano v. Commissioner, (T.C. Summ. Op. 2024-26)	*9*
4. Denham v. Commissioner, (T.C. Memo 2024-114)	*10*
II. Retirement	***13***
A. Section 401(k) limitations	**13**
1. Maximum elective deferral	*13*
2. Roth contribution programs	*13*
B. Self-employed persons	**13**
1. Simplified Employee Pension (SEP)	*13*
2. SIMPLE	*14*
3. Profit-sharing	*15*
4. Section 401(k) plans	*17*
5. Solo §401(k) plans	*19*
6. Money-purchase pension plan	*20*
7. Defined-benefit plan	*21*

Investments, Retirement, and Miscellaneous

Learning objectives

Upon reviewing this material, the reader will be able to:

- Explain what constitutes a real estate professional in terms of participation and what constitutes a real property trade or business;
- Discuss the advantages of Donor-Advised Funds (DAFs) as well as the IRS proposed regulations for them; and
- Discuss the challenges of self-employed (unincorporated) individuals with no common-law employees, who typically are looking to shelter some income but need the flexibility to make varying contributions each year.

I. Investments

A. Real estate

1. The law

A taxpayer qualifies as a real estate professional and is not engaged in a passive activity from rental activities if: (i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates; and (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates [750-hour service performance requirement]. In the case of a joint return, the foregoing requirements for qualification as a real estate professional are satisfied if, and only if, either spouse separately satisfies the requirements. Thus, if either spouse qualifies as a real estate professional, the rental activities of the real estate professional are not per se passive.

With respect to the evidence that a taxpayer may use to establish his or her hours of participation in a trade or business, the extent of participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of participation may be established by other reasonable means. Reasonable means may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries. While the regulations allow taxpayers some latitude in establishing the extent of their participation in an activity, Tax Courts have consistently held that they do not allow a post-event "ballpark guesstimate."[1] With respect to the requirement that the hours a taxpayer spent on real property trades or businesses accounted for more than one-half of the total hours of personal services the taxpayer performed in all trades or businesses during the subject years, to qualify as a real estate professional, the taxpayer must aggregate all hours of personal services in trades or businesses.

For purposes of determining whether a taxpayer is a real estate professional, a taxpayer's material participation is determined separately with respect to each rental property, unless the taxpayer makes an explicit election to treat all interests in rental real estate as a single rental real estate activity.[2] The Court

---

1 See *Goshorn v. Commissioner*, T.C. Memo. 1993-578; see also *Moss v. Commissioner*, 135 T.C. 365, 369 (2010); *Fowler v. Commissioner*, T.C. Memo. 2002-223.

2 I.R.C. §469(c)(7)(A); *Bailey v. Commissioner*, T.C. Memo. 2001-296; Treas. Regs. §§1.469-9(c)(3), (e)(1).

will evaluate each of a taxpayer's properties separately in order to determine whether taxpayer materially participated in real estate activity for each property.

An individual may meet the material participation requirement by demonstrating that he or she participated in the rental activity for more than 100 hours during the taxable year and that his or her participation is not less than the participation of any other individual (including individuals who are not owners of interests in the activity) during that year. For purposes of the material participation requirement, participation by an individual's spouse can be added to the participation of the individual. Additionally, material participation can be met if historical material participation was met during any five of the ten immediately preceding tax years.

An individual must establish that he or she materially participated in each of the rental activities unless the individual makes an election to treat all interests in rental real estate as a single rental activity.[3]

2. Procedures to obtain extensions for single rental real estate activity treatment

Effective June 13, 2011, the IRS issued guidance allowing some taxpayers to make late elections to treat all interests in rental real estate as a single rental real estate activity.[4] The guidance provides special procedures, in lieu of the letter ruling procedure under §9100, to obtain relief for late elections under Regs. §1.469-9(g). A taxpayer ineligible for relief under this guidance may request relief by applying for a letter ruling.

a. In general, §469(c)(7)(A) provides that a taxpayer's interests in rental real estate are treated as separate activities for determining whether the taxpayer materially participates in each rental real estate activity unless the taxpayer elects to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's **original income tax return** for the taxable year.

The law:

> For purposes of determining whether a taxpayer is a real estate professional, a taxpayer's material participation is determined separately with respect to each rental property, unless the taxpayer makes an explicit election to treat all interests in rental real estate as a single rental real estate activity.[5] The Court will evaluate each of a taxpayer's properties separately in order to determine whether taxpayer materially participated in real estate activity for each property.

b. The Commissioner may under §9100 grant a reasonable extension of time to make a regulatory election, or a statutory election. Requests for relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer meets one of the requirements, which include that the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make the election.

---

3 Treas. Regs. §1.469-9(e)(1).
4 Rev. Proc. 2011-34; 2011-24 I.R.B. 875.
5 I.R.C. §469(c)(7)(A); *Bailey v. Commissioner*, T.C. Memo. 2001-296; Treas. Regs. §§1.469-9(c)(3), (e)(1).

c. The procedures in this revenue procedure are in lieu of the letter ruling procedure that is used to obtain relief for a late §1.469-9(g) election. Accordingly, user fees do not apply to corrective action under this revenue procedure. However, a taxpayer that is not eligible for relief under this revenue procedure may request relief by applying for a private letter ruling, but the Service will not ordinarily issue a private letter ruling if the period of limitations on assessment has lapsed for any taxable year that would be affected by the requested late election. Any taxpayer receiving relief under the guidance is **treated as having made a timely election to treat all interests in rental real estate as a single rental real estate activity** as of the tax year for which the late election is requested.

d. A taxpayer is eligible for an extension of time to file an election if the taxpayer represents on a statement that satisfies the procedural requirements and under penalties of perjury that it meets all of the following requirements.

   (i) The taxpayer failed to make an election **solely because the taxpayer failed to timely meet the requirements** in §1.469-9(g).

   (ii) The taxpayer **filed consistently with having made an election** on any return that would have been affected if the taxpayer had timely made the election. The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years.

   (iii) The taxpayer **timely filed each return** that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within six months after its due date, excluding extensions.

   (iv) The taxpayer has **reasonable cause for its failure to meet the requirements**.

Note:

The taxpayer must attach the statement to an amended return for the most recent tax year and mail the amended return to the IRS service center where the taxpayer will file its current year tax return. The statement must contain the **declaration** required, must explain the **reason for the failure to file a timely election**, and must include the representations required in this revenue procedure. The statement must identify the taxable year for which it seeks to make the late election. Finally, the statement must state at the top of the document "FILED PURSUANT TO REV. PROC. 2011-34."

The declaration and representations required in this revenue procedure must be accompanied by a dated declaration, signed by the taxpayer which states: "Under penalties of perjury I (we) declare that I (we) have examined this election, including any accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the election.

Note:

The granting of an extension of time to file an election and the issuance of a notification do not constitute an express or implied determination concerning whether the taxpayer satisfies the eligibility requirements of this revenue procedure, whether the taxpayer satisfies the real estate professional requirements, or whether the taxpayer materially participates in any activity.

The law:

An individual may meet the material participation requirement by demonstrating that he or she participated in the rental activity for more than 100 hours during the taxable year and that his or her participation is not less than the participation of any other individual (including individuals who are not owners of interests in the activity) during that year. For purposes of the material participation requirement, participation by an individual's spouse can be added to the participation of the individual.

An individual must establish that he or she materially participated in each of the rental activities unless the individual makes an election to treat all interests in rental real estate as a single rental activity.[6]

Planning point:

The additional tax on unearned income also permits a taxpayer to make a grouping election if the taxpayer is first subject to the net investment income tax.

B. Cases

1. Lisa M. Holley v. Commissioner, (T.C. Memo. 2024-54)

Facts

Lisa M. Holley (petitioner), an anesthesiologist and owner of Holley Anesthesia (an S corporation), did not file timely federal income tax returns for 2011 and 2017-2019. In February 2021, she filed delinquent returns for these years, but did not pay the amounts of tax shown as due. In June 2021, the IRS assessed the amounts shown as due on her 2017, 2018, and 2019 returns.

When Holley failed to pay these tax liabilities upon notice and demand for payment, the IRS filed the Notice of Federal Tax Lien (NFTL) and issued a timely NFTL Filing on March 24, 2022. Holley timely submitted Form 12153, "Request for a Collection Due Process or Equivalent Hearing" (CDP), checking the boxes for a collection alternative in the form of an installment agreement (IA) or an offer-in-compromise (OIC). Holley's Settlement Officer (SO) ascertained that petitioner's total outstanding federal income tax liability, for all open years, was $2,855,450 as of October 24, 2022. This amount encompassed liabilities for both CDP years and non-CDP years.

On November 29, 2022, the SO received financial information indicating that Holley had equity in assets in excess of $2 million, including real estate valued at $688,884 and a defined benefit plan valued at $1,546,267. Holley's POA stated that Holley was not seeking an OIC. Given the magnitude of Holley's total outstanding tax liability, the SO concluded that Holley might be eligible for a "partial pay" IA (PPIA), but that she would need to use equity in assets to pay down her tax liabilities before a PPIA could be considered.

Upon review of Holley's Form 433-A, "Collection Information Statement for Wage Earners and Self-Employed Individuals," the SO concluded that petitioner had failed to report certain assets and items of income. The SO questioned the "zero" values that Holley had reported for Holley Anesthesia, her S corporation, and for LH Anesthesia, Inc., a related C corporation. The SO also determined that Holley was not in compliance with respect to her 2022 estimated tax liability.

---

6 Treas. Regs. §1.469-9(e)(1).

The SO's further review of publicly accessible court records revealed that Holley filed for bankruptcy four times between 2016 and 2020. Each case was dismissed by the court, which determined that Holley was seeking to delay collection efforts by the IRS and by United Healthcare, a judgment creditor. In Holley's case activity record, the SO noted the determinations by the bankruptcy court that Holley filed for bankruptcy in bad faith, submitted false and misleading documents to the court, made unauthorized payments during the bankruptcy case, and engaged in efforts to hide income and assets.

On November 30, 2022, the SO submitted Holley's Form 433-A and supporting information to the IRS Office of Collections (Collections) to conduct an "appeals referral investigation" (ARI). On January 4, 2023, Collections informed the SO of its conclusion that Holley had the ability to pay down a portion of her outstanding liabilities from available equity in assets. The SO informed Holley's POA that no request for a collection alternative could be considered until Holley took this step and came into compliance for 2022.

Holley retained a new POA, and on January 27, 2023, reiterated her desire for an IA. The SO countered that Holley would need to pay down her liabilities using equity in assets before any IA or PPIA could be approved. On February 27, 2023, the SO received 17 substantially identical Forms 843, "Claim for Refund and Request for Abatement," from Holley's POA, seeking abatement of interest and additions to tax. These forms were unsigned. As justification for abatement, the box was checked for "Reasonable cause or other reason allowed under the law," but no substantiation was provided.

On March 6, 2023, the SO called Holley's representative and explained that the Forms 843 could not be processed because they were unsigned. The SO noted that interest could not be abated absent a showing of IRS error, that "blanket statements, without proof, are not sufficient" to justify abatement of additions to tax, and that the requests for abatement "shouldn't be the same for the 2011, 2017, 2018 and 2019 years, as all circumstances should be different." After receiving no response from Holley or her POA by March 17, 2023, the SO decided to close the case. She noted in her case activity record that Holley had been informed of Collection's determination that she had equity in assets and needed to use equity before an IA could be considered.

The SO noted that Holley was a "serial filer" in bankruptcy court, having "amassed significant personal assets while not paying income taxes and having taken actions to avoid collection efforts of the IRS." For all these reasons the SO determined that the NFTL filing should be sustained. On March 22, 2023, Appeals issued Holley a notice of determination sustaining the NFTL filing.

Issues and analysis

In CDP cases, an abuse of discretion by an IRS SO happens when the SO makes a decision that is unreasonable, arbitrary, clearly wrong, or not based on facts, law, or proper procedures. The "three-prong test" considers the following:

a. The SO properly verified that the requirements of applicable law or administrative procedure have been met;
b. The SO considered any relevant issues the petitioner raised; and
c. The SO considered whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the petitioner that any collection action be no more intrusive than necessary.

The Court found the SO satisfied all of these statutory requirements.

Section 7122(a) authorizes the IRS to compromise an outstanding tax liability, but it is up to the taxpayer to propose an OIC for Appeals' consideration. A taxpayer who wishes to pursue an OIC must submit a Form 656, "Offer in Compromise." Although Holley checked the box for "Offer in Compromise" on her Form 12153, her POA confirmed during the CDP hearing that she was not requesting an OIC. Holley did not make a concrete offer or submit to the SO a completed Form 656.

IRC §6159 allows a taxpayer to pay the IRS only part of their total tax debt over time, instead of the full amount owed, because full payment can't be made within the statutory collection period. Under a PPIA, the taxpayer pays what they can afford monthly, based on income and allowable expenses, and the IRS collects as much as it can during the collection statute expiration period. Any remaining balance at the end of the collection period is written off.

The IRS will only consider a PPIA if:

a. The taxpayer is compliant in making estimated tax payments and filing timely returns;
b. The taxpayer has an inability to pay in full, based on info provided via Form 433-A; and
c. The taxpayer cannot reasonably liquidate assets or borrow against them.

The IRS considered a PPIA for Holley because:

a. She owed more than $2.8 million; and
b. She could not fully pay it within the collection period.

However, the SO rejected the PPIA because:

a. Holley was not making estimated payments; and
b. Holley had over $2 million in assets and refused to use them to pay down the balance.

The Court found there was no abuse of discretion.

Section 6330(c)(3)(C) requires the IRS to balance "the need for the efficient collection of taxes with the legitimate concern of [petitioner] that any collection action be no more intrusive than necessary." The SO performed a balancing test, finding that the NFTL filing adequately balances the need for efficient tax collection with Holley's concerns, citing her estimated payment deficiencies and her equity in assets. Given the magnitude of Holley's outstanding liabilities and her failure to comply with her ongoing tax obligations, the SO did not abuse her discretion in sustaining the NFTL filing.

Conclusion

The IRS will not consider collection alternatives like IAs or PPIAs unless the taxpayer is current with estimated tax payments and filing obligations. The SO found Holley had over $2 million in equity, including retirement assets and real estate. She refused to use or liquidate any of these assets to reduce her liability. Taxpayers must be prepared to tap into available equity before a PPIA will be approved. Holley submitted incomplete and potentially misleading financial statements, undervaluing or omitting her business interests. The SO flagged issues with Holley's Form 433-A and her inconsistent financial picture. It is important for taxpayers to fully and honestly disclose such information.

Holley had a history of four bad-faith bankruptcy filings, including attempts to delay IRS collection and hide assets. A taxpayer's past conduct is taken into account when evaluating credibility and eligibility for relief. Holley filed 17 unsigned Forms 843 seeking penalty and interest abatement based only on "reasonable cause," without any explanation or proof, and the SO rightfully rejected them. Requests for abatement (penalties or interest) must be signed and include documentation supporting the claim (e.g., illness, disaster, reliance on advice). Holley and her POAs failed to propose specific payment terms, missed follow-up deadlines, and ignored the court's orders. Taxpayers or their representatives must be engaged, specific, and responsive throughout the CDP process.

The Court ruled that the IRS did not abuse its discretion in:

a. Sustaining the federal tax lien (NFTL);
b. Rejecting the collection alternatives; and
c. Denying the interest and penalty abatement.

The Court found that the SO acted reasonably, followed procedure, and made determinations grounded in law and fact.

2. James Clark v. Commissioner, (T.C. Memo. 2025-13)

Facts

From the late 1980s until 1995, James Clark ("Clark") solely owned and operated a mobile disc jockey business, working in bars as well as weddings and private parties. Since 1995, Clark worked as a freelance writer, writing movie reviews. In 2019, Clark received $8,250 from freelance movie review writing.

Additionally, since at least 2019, Clark has bought and sold movie-related memorabilia on eBay, and his sale proceeds were paid to him through a PayPal account solely in his name. In 2019, Clark received $41,972 from selling movie-related memorabilia, and PayPal sent the IRS and Clark a Form 1099-K, "Payment Card and Third Party Network Transactions," reporting the $41,972 as the gross amount of payment card/third party transactions for 2019, with no amount of federal income tax withheld.

Clark prepared his 2019 federal income tax return with assistance from a representative at an H&R Block location. Clark did not report any of the income he received from freelance movie review writing or selling movie-related memorabilia on Schedule C, "Profit or Loss From Business"; rather, he reported that income (totaling $50,222, comprised of the $8,250 from freelance movie review writing and the $41,972 from selling movie-related memorabilia) as "other income" on line 7a of Form 1040, not subject to self-employment tax. Clark claimed the standard deduction ($12,200) and reported taxable income of $38,022. Finally, not having reported any federal income tax withheld, other taxes including self-employment tax, or credits, Clark reported that he had an income tax liability of $4,369.

Clark electronically filed, and the IRS received, the 2019 return on July 13, 2020. On July 22, 2020, the IRS processed a payment of $4,369 from petitioner with respect to his reported 2019 income tax liability. On August 17, 2020, the IRS processed petitioner's 2019 return and assessed a penalty of $134 for failure to pay estimated tax, together with interest of $4.

On June 28, 2021, the IRS's Automated Underreporter (AUR) Program sent Clark a Notice CP2000 proposing changes to his 2019 return on the basis that information the IRS had received from third parties, including the Form 1099-K from PayPal, did not match the information reported on the return. On November 15, 2021, upon Clark's failure to respond to the Notice CP2000, the IRS issued a Notice of Deficiency to him, determining that the $50,222 he had reported as "other income" on his 2019 return was subject to self-employment tax and that he was liable for the substantial understatement of income tax penalty under §6662(a) and (b)(2).

Before Clark's case was calendared for trial, the Social Administration (SSA) sent him a letter dated March 20, 2023, advising him, among other things, that "based on information provided to us from the Internal Revenue Service, we are reducing the amount of your self-employment income on your Social Security earnings record from $46,380.00 to $0.00 for tax year 2019." Additionally, the IRS reversed the premature assessment and issued a refund of $2,886 to Clark for 2019 on April 3 and May 5, 2023, respectively.

Issues and analysis

The Commissioner's determinations in a Notice of Deficiency are generally presumed correct. In most cases, the taxpayer has the burden of proving that those determinations are wrong. However, for penalties, additions to tax, or similar amounts, the IRS must first provide evidence before the taxpayer is required to respond.

Section 1401 imposes a self-employment tax on the net earnings from self-employment of individuals. It applies to individuals who are self-employed (e.g., sole proprietors, partners, independent contractors) and earn $400 or more in net self-employment income during the tax year. The self-employment tax is 15.3 percent, composed of 12.4 percent for Social Security (up to Social Security wage base), 2.9 percent for Medicare (no income cap), plus an additional 0.9 percent Medicare surtax for higher earners. Section 1402(b) defines self-employment income as "the net earnings from self-employment derived by an individual … during any taxable year." Section 1402(a) defines net earnings from self-employment as "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions … which are attributable to such trade or business."

Clark claimed he should not owe self-employment tax for 2019 on income from freelance movie reviews and eBay sales of movie memorabilia, arguing the IRS had "conceded" the issue because:

a. The Social Security Administration (SSA) sent a letter showing $0 in self-employment income; and
b. The IRS issued a refund in 2023.

The Tax Court rejected this argument, citing a similar case, *Ashford v. Commissioner*, in which a taxpayer made the same claim. In both cases:

a. The SSA letter merely reflected a temporary status change, not a final tax determination;
b. The refund was procedural, issued to adjust the taxpayer's IRS account during pending litigation, not an admission of no liability; and
c. The taxpayer acknowledged the receipt of income, and it was classified as nonemployee compensation, which is subject to self-employment tax under §1401.

Receiving a refund or an SSA letter showing $0 income does not mean the IRS has waived or conceded tax liability; rather, the taxpayer is still responsible for self-employment tax if the income meets the criteria.

Section 6662(a) imposes a 20 percent accuracy-related penalty on any portion of an underpayment of tax required to be shown on a return if, as provided by §6662(b)(2), the underpayment is attributable to any "substantial understatement of income tax." For purposes of §6662(b)(2), an understatement generally means the excess of the amount of tax required to be reported on the return over the amount shown on the return. An understatement is substantial in the case of an individual if the understatement for the taxable year exceeds the greater of 10 percent of the tax required to be shown on the return for that taxable year or $5,000.

In tax court, the Commissioner (IRS) must first meet the burden of production to impose an accuracy-related penalty under §6662. This means the IRS must provide sufficient evidence showing the penalty is appropriate. Under §7491(c), this includes proving that the procedural requirements of §6751(b) were followed, specifically, that the penalty was approved in writing by a supervisor, unless it was automatically calculated by the IRS system (in which case no approval is needed). Once the IRS meets this burden, the taxpayer (petitioner) then has the burden to prove the penalty is incorrect, using persuasive evidence.

The IRS met its burden of production by proving that the taxpayer's 2019 understatement of income tax was substantial, exceeding both 10 percent of the tax due and $5,000. The penalty was automatically calculated via the IRS's AUR program, so no written supervisory approval was required under §6751(b). A taxpayer can avoid the penalty by showing reasonable cause and good faith, based on their efforts to properly assess tax liability and possibly reliance on professional advice. Although Clark appeared sincere and lacked tax sophistication, his long business experience and failure to provide evidence of genuine reliance on tax advice meant he did not demonstrate reasonable cause. As a result, the accuracy-related penalty was sustained.

Conclusion

Income from freelance work and selling goods online (e.g., via eBay and PayPal) qualifies as self-employment income. Reporting this income as "Other income" on the tax return does not shield it from self-employment tax. The issuance of a Form 1099-K from platforms like PayPal can prompt IRS review, especially if that income is not reported properly on Schedule C. An SSA notice adjusting self-employment earnings does not mean the IRS has conceded the income is not taxable. These adjustments can reflect administrative timing, not a legal tax position.

IRS refunds issued during ongoing litigation (e.g., due to reversed premature assessments) do not equate to concessions or agreements about a taxpayer's liability. Merely using a tax prep service like H&R Block is not sufficient to prove reliance on professional advice unless there is clear evidence of consultation or advice on the specific tax treatment at issue. Even if a taxpayer lacks formal tax training, having long-term experience running a business may undercut claims of honest misunderstanding, especially if they regularly face similar tax obligations (like estimated tax penalties).

3. Rosa M. Marcano v. Commissioner, (T.C. Summ. Op. 2024-26)

Facts

On October 2, 2023, the IRS mailed to Marcano by certified mail a notice of deficiency for tax year 2021. Marcano did not dispute she was in the country when the notice was delivered, which according to the U.S. Postal Service, was October 5, 2023. From October 23, 2023, to October 30, 2023, Marcano was on a trip to Cabo San Lucas, Mexico, and from December 15, 2023, to January 28, 2024, she was on a trip to Bogota, Colombia. On January 17, 2024, 107 days after the mailing of the notice, the petition was filed. The petition is signed and dated January 10, 2024.

Issues and analysis

Under §6213(a), a taxpayer has 90 days to file a petition with the Tax Court after the IRS mails a notice of deficiency. This period excludes Saturdays, Sundays, and legal holidays in the District of Columbia. The 90-day period begins on the date the notice is mailed, and the filing must occur within this timeframe to confer jurisdiction on the Tax Court. If the petition is filed even one day late, the court lacks jurisdiction and must dismiss the case.

Section 6213(a) provides an extended 150-day period for taxpayers who are outside the United States when the notice of deficiency is mailed. This extension accounts for potential delays in mail delivery due to the taxpayer's absence. However, the 150-day rule only applies if the taxpayer's absence from the U.S. results in a delayed receipt of the notice. Merely being outside the U.S. does not automatically qualify a taxpayer for the extended period; there must be a demonstrable delay in receiving the notice.

The Tax Court has consistently held that the 150-day period does not apply if the taxpayer was in the U.S. when the notice was mailed and received, even if they were temporarily outside the country during part of the 90-day period. The Tax Court treats the 90-day and 150-day filing deadlines as jurisdictional requirements. This means that if a petition is not filed within the prescribed time, the court lacks the authority to hear the case and must dismiss it.

Marcano did not dispute that her petition was untimely under the 90-day period normally prescribed by §6213(a). Further, Marcano acknowledged that the 90-day period expired January 2, 2024, and that the petition was filed on January 17, 2024. However, Marcano argued that, because she was outside the United States for 24 days of the 90-day period, she was entitled to the longer 150-day period.

The Court found that the facts Marcano shared were not enough to entitle her to the 150-day period for filing the petition. Marcano was in the United States when the notice was mailed, in the United States when the notice was delivered, and in the United States for almost three weeks thereafter. In total, Marcano was in the United States at least 66 days of the 90-day period. The Court concluded that Marcano was ineligible for the 150-day period because her absence from the country neither delayed her receipt of the notice nor otherwise adversely affected her ability to file a timely Tax Court petition. The Court found they lacked jurisdiction under §6213(a) because the petition was not filed within the 90-day period.

Conclusion

Taxpayers should ensure that their petition is filed within the 90-day or 150-day period, as applicable, to avoid dismissal for lack of jurisdiction. If claiming the 150-day period due to being outside the U.S., taxpayers must provide evidence that their absence resulted in a delayed receipt of the notice. The Tax Court does not have the discretion to extend these filing deadlines, even in cases of hardship or other extenuating circumstances. If a petition is dismissed due to untimely filing, taxpayers may still pay the disputed amount and file a claim for refund with the IRS. If the claim is denied or not acted upon within six months, they may file a suit for refund in the appropriate U.S. district court or the U.S. Court of Federal Claims.

4. Denham v. Commissioner, (T.C. Memo 2024-114)

Facts

The petitioner in this case is the tax matters partner and state law general partner of Denham. Petitioner is a Delaware limited liability company and elected to be treated as a partnership for federal income tax purposes. Denham is organized as a limited partnership under Delaware law and offers investment advisory and management services to affiliated private equity funds that invest in the energy sector. Pursuant to investment advisory agreements between Denham and each fund, Denham was expected to furnish investment advice, negotiate terms of investments, monitor the health of the investments, and complete the day-to-day administrative tasks associated with managing the funds.

In addition to the petitioner, Denham had five limited partners during the years in issue ("The Partners"). The Partners functioned similarly to and were subject to the same general policies and procedures as Denham's employees. Denham's Fifth Amended and Restated Limited Partnership Agreement (LPA), effective May 1, 2014, governed the obligations and authority of Denham's partners for the years in issue. Under the LPA, petitioner, as general partner of Denham, had unlimited liability for Denham's debts. Partners had limited liability and could be held personally liable for the debts and obligations of Denham only to the extent, if any, of capital contributions they made to Denham.

The LPA vested all management authority exclusively in petitioner. Mr. Porter, one of the five limited partners, owned 100 percent of the equity of petitioner, but all of the Partners were voting members of petitioner throughout the years in issue. Denham's limited partners had authority to the extent petitioner delegated authority to them. On November 1, 2013, acting in his authority as managing member of petitioner, Mr. Porter authorized via written resolution to The Partners, along with Denham's chief financial officer, director of tax, general counsel, and associate general counsel, to negotiate and execute any type of agreement or document on petitioner's behalf. Denham's LPA also required that each partner, except for Mr. Porter, "devote substantially all of his or her business time and attention to the affairs of Denham and its affiliates."

The Partners' role with Denham was so fundamental to the firm's operation that investors had the right to withdraw their investments early if one or more of the Partners died, became disabled, or could no longer devote substantially all business time to the funds. Each fund's "key person" provision referred to Mr. Porter, but all five Partners were considered a key person by at least one of the funds active during the years in issue.

The CFO led Denham's finance team and handled financial reporting for Denham and its affiliates. Denham worked in conjunction with PwC to have its financial statements audited and to prepare Denham's Forms 1065. PwC's audit report described the Partners as "active limited partners," a term provided by Denham.

Petitioner made no guaranteed payments or distributions to the Partners in 2016 or 2017. In each of those years Denham made guaranteed payments and capital distributions to the Partners and petitioner. The guaranteed payments were intended to represent the Partners' salaries and included the value of a package of typical employment benefits. The distributions to the Partners were tied to their distributive shares of Denham's income and calculated on the basis of their profits interests. There was no guaranteed minimum for the Partners' distributive shares for the year, and they varied from year to year as they were tied to the profits of the firm.

When computing the Partners' Net Earnings from Self-Employment (NESE) for the years in issue, Denham included their guaranteed payments but excluded their distributive shares of Denham's ordinary business income. For tax years 2016 and 2017, the IRS issued Final Partnership Administrative Adjustment (FPAA) notices that increased Denham's NESE by more than $27.4 million and $22.9 million, respectively.

Issues and analysis

The Commissioner's determinations in an FPAA are generally presumed correct, though the taxpayer can rebut this presumption. To rebut the presumption, the taxpayer must:

a. Provide factual evidence and supporting documentation that contradicts the IRS's position; or
b. Offer legal arguments or interpretations that demonstrate the IRS's adjustment is inconsistent with tax law.

Under IRC §1402(a), Net Earnings from Self-Employment (NESE) generally includes:

a. Gross income from any trade or business the individual personally carries on;
b. (-) Deductions directly attributable to that trade or business; and
c. (+) The individual's distributive share of income or loss under §702(a)(8) from any partnership in which the individual is a member (whether or not the income is actually distributed).

A key exception is the Limited Partner Exclusion. Section 1402(a)(13) excludes from NESE "the distributive share of any item of income or loss of a limited partner, as such, except for guaranteed payments made to that partner for services actually rendered." In other words, limited partners (in the traditional sense) generally do not owe self-employment tax on their distributive share of income, unless:

a. They receive guaranteed payments for services; and
b. Those payments are compensation-like.

The central issue in this case is whether the distributive share of income received by The Partners was subject to self-employment tax, or whether it qualified for the limited partner exclusion under §1402(a)(13).

Recently, *Soroban Capital Partners v. Commissioner* (161 T.C. No. 12) held "that the limited partner exception does not apply to a partner who is limited in name only" and that "Congress intended section 1402(a)(13) to apply to partners that are passive investors." Before Soroban, in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), the Court applied a functional analysis test to determine whether the lawyer-partners of a Kansas limited liability partnership were limited partners under §1402(a)(13). Such test typically evaluates whether a partner is functionally passive and excluded from SE tax under §1402(a)(13), or functionally active (i.e., rendering services, managing), and therefore included in NESE. Key criteria in functional analysis include the level of activity in the business, involvement in management or decision-making, whether income received is tied to services rendered, and capital invested vs. income received (investment return vs. compensation).

The Petitioner argued that The Partners were limited partners under state law, and thus, their income was not NESE. The Court disagreed, noting that Denham's income came from providing investment management services, and The Partners actively managed the firm, funds, and personnel. Further, The Partners were integral to operations, solicited capital, participated in investment and valuation committees, and made strategic and hiring decisions. There were no meaningful capital contributions (except one), yet the Partners received millions in distributions.

As a result, the Court found that The Partners were not passive investors; rather, they were actively engaged and materially participating as self-employed individuals. Therefore, the Court found that The Partners' income was not excluded from NESE.

Conclusion

Merely being a “limited partner” by state designation is insufficient for §1402(a)(13). The economic relationship and duties of the partner control, not the label. Further, even if guaranteed payments are made, a partner’s larger profit shares (disguised compensation) may still be fully subject to SE tax.

II. Retirement

A. Section 401(k) limitations

1. Maximum elective deferral

The maximum amount of deferral in a §401(k) plan in 2025 is $23,500 (increased from $23,000 in 2024).

A qualified plan may now allow up to an $8,000 (2025, same as 2024) additional elective deferral to be made to the plan by a participant who attains the age of 50 before the end of the plan year.

The additional elective deferrals are generally not taken into account under the actual deferral percentage (ADP) or other limitations on such contributions. The applicable dollar amount increases in the cost of living at the same time and in the same manner as adjustments for annual benefits and additions, except that the base period taken into account is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of $500 is rounded to the next lower multiple of $500.

Planning point:

> Elective deferrals remain an annual addition; however, the amount subject to the 25-percent-of-compensation limitation does not include them, but only the matching and any other nonelective employer contributions. Subject to any other limitations (such as the annual-additions limitation), an employee may defer 100 percent of current salary **and** the employer may deduct not only the amount so deferred by the employee, but also up to 25 percent of the total participant compensation for the year for other contributions.

2. Roth contribution programs

A §401(k) plan may permit an employee who makes elective contributions under a qualified cash or deferred arrangement to designate some or all of those contributions as **designated Roth contributions**. Although designated Roth contributions are elective contributions under a qualified cash or deferred arrangement, unlike pre-tax elective contributions, they are currently includible in gross income. However, a **qualified distribution of designated Roth contributions is excludable from gross income**.

B. Self-employed persons

Self-employed (unincorporated) individuals with no common-law employees provide a specific challenge. This group typically is looking to shelter some income but needs the flexibility to make varying contributions each year.

1. Simplified Employee Pension (SEP)

The SEP works quite well for most self-employed persons. The individual can contribute 20 percent of self-employment income (after reducing income by the deduction for 1/2 of the Social Security taxes paid). Contributions are **flexible**, the plan can be established with a simple document, and no annual reporting is required. The maximum contribution in 2025 is $70,000. As noted below, this has advantages over a profit-sharing plan in all instances where the self-employed has no other employees. But the allocation of contributions is not flexible and is pro rata with compensation levels (and no more than $350,000 in 2025 may be taken into account).[7]

As discussed, SECURE 2.0 implemented various changes to SEP plans, including:

a. Allowing employers to offer employees the ability to treat employee and employer SEP contributions as Roth in whole or in part; and
b. Permitting employers of domestic employees (such as nannies) to provide retirement benefits for such employees under a Simplified Employee Pension ("SEP").

Note:

> A SEP is another excellent choice for the employer looking for a plan that provides for discretionary contributions. The rules are as flexible as the profit-sharing plan. However, the employer also wanting to skew contributions toward the business owner will choose the cross-tested profit-sharing plan over the SEP.

2. SIMPLE

For self-employed persons with relatively small income, the SIMPLE can result in a larger contribution than a SEP. In 2025, an individual can defer up to $16,500 to the SIMPLE, and the employer is then **required** to make a matching contribution of 3 percent of compensation of a participating employee or an additional contribution (2-percent of compensation of all eligible employees). Eligibility is narrower than a SEP, using employees who make a certain amount in compensation over the immediate three years. The maximum total contribution to a SIMPLE is $33,000.[8]

Note:

> In contrast to a §401(k) plan, the SIMPLE is an easy way to give employees the opportunity to participate in a pre-tax salary-reduction plan, although there are required contributions by the employee. The IRS has provided model documents, participant election forms, and instructions. And, for most part, these documents even satisfy participant notification requirements. Other than determining the required contribution and monitoring the $16,500 deferral limit, the employer has little other responsibility. Unlike qualified plans, the service providers are required to prepare the summary plan description and provide benefit statements. No annual reporting is required and there are few rules to violate.

a. Employers with 100 or fewer employees that already sponsor §401(k) plans may not want to switch to SIMPLEs due to the tremendous flexibility that the §401(k) plan provides. The maximum salary deferrals are higher ($23,500 a year in 2025) and the employer can sponsor other plans in addition to the §401(k) plan. With a §401(k) plan, the eligibility, vesting, and contributions requirements are more flexible. The employer matching contribution can take various forms and be subject to a vesting schedule. Employer profit-sharing contributions are discretionary, and allocations can be skewed to the highly compensated through Social Security integration or cross-testing. Another important §401(k) feature is the ability to allow participant loans, giving participants access to their savings without income tax consequences.

---

[7] Notice 2024-80.
[8] Notice 2024-80.

b. If a business owner is looking for a plan that allows contributions for the owner in excess of $33,000, the SIMPLE is generally not the right plan. With other defined-contribution type plans – or combination of plans – the business owner can often have total contributions of $70,000[9] for the year in 2025. However, the higher contribution amount will have a cost – both in terms of contributions for employees and the cost of administering the more complicated plans. If the owner's spouse is providing services to the company, the owner could leave the spouse off the payroll, because of the additional income increased taxable income and increased payroll taxes. However, with a SIMPLE, adding the spouse to the payroll is a way to get more money into the SIMPLE, for the cost of only payroll taxes.

c. Since the SIMPLE salary deferral and matching contribution are not subject to either the 25-percent deduction limits or the §415 allocation limits that apply to other plans, an individual with low earnings can actually make larger deductible contributions to the SIMPLE than other plans. This might be helpful to a second wage-earner in a family that can afford to contribute significant amounts to a retirement plan. It can also be helpful for an individual that has self-employment income in addition to employment income. However, for this second type of individual, there are several possible traps. First, income earned from personal services could be aggregated with the individual's employer under the controlled group or affiliated service group rules. Second, remember that if an individual sponsoring the SIMPLE is also a participant in a §401(k) plan, §403(b) plan, SARSEP or SIMPLE of another employer, total salary deferrals for a calendar year cannot exceed $23,500 in 2025.[10]

As discussed, SECURE 2.0 implemented various changes to SIMPLE plans, including:

a. Allowing SIMPLE IRAs to accept Roth contributions;
b. Allowing an employer to make matching contributions under a SIMPLE IRA with respect to "qualified student loan payments";
c. Permitting an employer to make additional contributions to each employee of the plan in a uniform manner, provided that the contribution does not exceed the lesser of up to 10 percent of compensation or $5,000 (as indexed for inflation), effective for taxable years beginning after December 31, 2024;
d. Increasing the annual deferral limit and the catch-up contribution at age 50 by 10 percent for employers with no more than 25 employees; and
e. Permitting employers with 26 to 100 employees to provide higher deferral limits, but only if the employer either provides a four percent matching contribution or a three percent employer contribution.

3. Profit-sharing

The profit-sharing plan is the most common form of defined-contribution plan. The other types of defined-contribution plans are simply a variation of a profit-sharing plan combined with features of a pension plan. A profit-sharing plan is a type of defined-contribution plan. A defined-contribution plan is one in which individual accounts for each participant are maintained. The account balance at any time measures the

---

9 I.R.C. §415 provides that contributions to all qualified plans that are defined-contribution plans, as well as contributions to SEPs, cannot exceed the lesser of $69,000 (inflation adjusted) or 25 percent of compensation for the year.

10 As a result of the amendment to I.R.C. §457(c) by the Economic Growth and Tax Relief Reconciliation Act of 2001, an employee is able to exceed such an elective deferral limitation if a §457 plan is combined with another plan that permits elective deferrals, such as a §401(k) plan.

participant's accrued benefit. At any time, the participant is entitled to the product of the participant's account balance and vested percentage.

a. The profit-sharing plan is another alternative that provides the same contribution opportunity. The profit-sharing plan for the sole proprietor is generally not very complicated, since the plan's service provider may supply a prototype document at no or little cost. Also, a plan that only covers an owner (and the owner's spouse) that has less than $250,000 in assets is not required to file IRS Form 5500. In most cases; however, the SEP seems more appropriate, since no reports are ever required, and IRA assets can be withdrawn or rolled over more easily. The profit-sharing plan does allow investments in life insurance, and if the sole proprietor expects to have employees in the near future, the sole proprietor may prefer the qualified plan eligibility and vesting provisions. The maximum annual addition to an individual's account balance is $70,000 in 2025.

b. The profit-sharing plan is incredibly versatile. Contributions are completely discretionary (unless the plan is drafted to require employer contributions), and, if contributions are made, can be allocated in ways favorable to the business owner (see discussion of cross-tested allocations). There are several limitations to the discretionary contribution rule.

   (i) If there is a "complete discontinuance" of contributions, the plan is deemed to be terminated and participants become 100-percent vested in their benefits. As a rule of thumb, if an employer makes no contributions for more than two years, the plan could be considered terminated.

   (ii) Except for "complete discontinuance" issues, profit-sharing plans (even top-heavy plans) can skip contributions entirely for a year. Remember that under the top-heavy minimum-contribution requirement, no contributions have to be made for non-key employees if no employer contributions are made on behalf of key employees.

4. Section 401(k) plans

Note:

Employees have often wanted to be able to add to their retirement by making contributions to qualified retirement plans. In the past, this was done through thrift plans by which the employee made contributions to an employer-sponsored plan. The disadvantage of such arrangements was that the contributions from the employee were after-tax. In other words, the employee had federal income and employment taxes withheld from their salary in respect of such contributions. While the employees enjoyed tax-deferred accumulation of earnings in the thrift plan, they did not enjoy the tax leverage on their contributions as the employer did on its deductible contributions.

Section 401(k) permits contributions to come not only from bonuses and other additions to normal salary, but also from the normal salary itself by the affirmative election by the employee to reduce that salary by the amount the employee wanted contributed to the plan on the employee's behalf. This suits employers quite well, as in many cases it eliminates the need for the employer to come up with additional funds above the normal salary levels.

In order to reduce salary without the employee being in constructive receipt, it is necessary for the employee to sign a salary-reduction agreement, in advance of earning that salary, by which the employee's normal salary is reduced in the payroll system to reflect the amounts that are put in the plan. The employee has a choice between current cash and deferred payments, and this system is referred to as a cash or deferred arrangement (CODA).

While the qualified salary reduction agreement is sufficient to eliminate the amount from wages for income-tax purposes – it is not reported as such on the employee's W-2 – the amounts remain wages for employment-tax purposes and are reported as such on the employee's W-2. This is an exception to the rules discussed earlier for profit-sharing and other qualified plans. However, such reductions to a self-employed person's draw are **not reflected in earnings from self-employment** and thus do not escape employment tax.

Because of the inclusion of elective deferrals in wages for Social Security tax purposes, it would appear that one cannot avoid the .9 percent tax on excess earnings in 2025 and later years by salary reduction.

Only a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan can include a cash or deferred arrangement (§401(k) arrangement) and be a qualified plan. A cash or deferred arrangement is part of a plan for these purposes if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement.[11]

A cash or deferred election can only be made with respect to an amount that is **not currently available** to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to amounts that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.[12]

In general, elective contributions under a qualified cash or deferred arrangement (including designated Roth contributions) are treated as employer contributions. Thus, for example, elective contributions under such an arrangement are treated as employer contributions for purposes of §401(a) (qualification requirements), §401(k) (special requirements), §402 (contributions), §404 (deductions), §411 (minimum

---

[11] Treas. Regs. §1.401(k)-1(a)(1).
[12] Treas. Regs. §1.401(k)-1(a)(3)(iii)(A).

vesting), §415 (limitations on contributions and benefits), §416 (top-heavy rules), and §417 (minimum survivor benefits).[13]

Note:

> Such a characterization would suggest that the elective contributions made to the plan would be treated as employer contributions to a defined contribution retirement plan that would be subject to the limitation on tax benefits, if enacted.

Generally, a partnership or sole proprietorship is permitted to maintain a cash or deferred arrangement, and individual partners or owners are permitted to make cash or deferred elections with respect to compensation attributable to services rendered to the entity, under the same rules that apply to other cash or deferred arrangements. For example, any contributions made on behalf of an individual partner or owner pursuant to a cash or deferred arrangement of a partnership or sole proprietorship are elective contributions unless they are designated or treated as after-tax employee contributions. In the case of a partnership, a cash or deferred arrangement includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf.

In the most common type of CODA, **a salary-reduction arrangement**, the participant is given the option of having wages reduced in return for having an employer contribution made to the plan.[14]

Elective deferrals increase to the applicable amount.

In the case of taxable years beginning after December 31, 2006, the $15,000 applicable dollar amount is indexed for inflation based on July 1, 2005 indexes, rounded to the next lower multiple of $500 (currently $23,500 in 2025).

A qualified plan may now allow additional elective deferrals to be made to the plan by a participant who attains the age of 50 before the end of the plan year.

The additional elective deferrals are not taken into account under the ADP or other limitations on such contributions. The applicable dollar amount increases in the cost-of-living at the same time and in the same manner as adjustments for annual benefits and additions, except that the base period taken into account is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of $500 is rounded to the next lower multiple of $500. It is currently $8,000.

The limitation on the total contributions to a §401(k) account for an individual is at $70,000 in 2025, so employer contributions can be used to enhance the contribution above the limitation on elective deferrals noted above. However, such employer contributions are subject to different nondiscrimination rules; there is no ADP test to give leeway from a compensation proportionate contribution standard.

---

13 Treas. Regs. §1.401(k)-1(a)(4)(ii).
14 Treas. Regs. §1.401(k)-1(a)(3)(i).

Note:

> The problem areas in §401(k) plans are two-fold. First, a cash or deferred arrangement satisfies the coverage and nondiscrimination requirement for a plan year only if: (i) the group of eligible employees under the cash or deferred arrangement satisfies the requirements of §410(b) (including the average benefit percentage test, if applicable);[15] and (ii) the cash or deferred arrangement satisfies either the ADP test, the ADP safe harbor, or the SIMPLE §401(k) provision.[16] These provisions deal with (i) coverage and (ii) nondiscrimination in funding. Coverage simply means that an adequate number of employees, regardless of the level of contributions made, are participants – i.e., contributing something – to the plan. The nondiscrimination in funding requirement compares the level of elective contributions as a percentage of compensation by the class of non-highly compensated employees with that of the highly compensated to make sure that the latter does not vary greatly from the former. Strict equality is not required, but this is certainly an area where employers have had trouble because (a) employees have not participated, or (b) their participation is at such low levels that higher-compensated individuals have an elective deferral limitation that is less, often much less, than what they may have wanted. Alternatives include (a) automatically entering employees into the plan at a specified level of salary reduction unless the employee affirmatively opts out, and (b) sweetening the pot with employer matching contributions, which may defeat the employer's purpose of limiting cash outlays (other than those that otherwise would have paid any way in salary).

5. Solo §401(k) plans

Because §401(k) plans are generally profit-sharing plans, the same objections raised against the profit-sharing plan in favor of a SEP generally apply. However, in the case of a true sole proprietor (or one whose only employee is a spouse), the low-cost, flexible SEP may have to give way in favor of a **solo §401(k) plan** at certain levels of Schedule C income.

Note:

> A §401(k) plan can be designed primarily to allow for employee pre-tax salary deferrals. The plan can then allow for discretionary profit-sharing contributions or even discretionary employer-matching contributions. A discretionary match may not encourage employee salary deferrals, which is the normal reason to have the match. One caution, however: an employer will be required to contribute 3 percent of compensation for non-key employees if the plan is top-heavy and any key employee makes a 3-percent-of-compensation salary deferral.

a. One advantage of the SEP was generally the low installation costs and nondiscrimination rules that are minimal in cases where there are several employees. But in a solo operation, nondiscrimination is not an issue, as there are no other employees against which to measure disparities of treatment.

b. The proprietor with other employees in a §401(k) plan must bridle any instinct to make the maximum elective deferral of $23,500 in 2025, since ADP testing might preclude this and limit the amount of the elective deferral in accordance with the rules discussed. Again, this is not a concern in a case where there is a single participant in the plan.

c. Yet, for one major reason solo §401(k) plans have gained traction in the last couple of years, the availability of elective deferrals in such plans, a feature not now generally available in a SEP, and only available in a SIMPLE to a much lesser extent. This presents an opportunity for the proprietor who wants to maximize his contributions advantageously for some Schedule C proprietors.

---

15 Treas. Regs. §1.401(k)-1(b)(1)(i).

16 Treas. Regs. §1.401(k)-1(b)(1)(ii).

(i) In either case, the maximum annual addition to the participant's account in the plan is $70,000 in 2025. But how the owner gets there is very different.

(ii) The SEP is a straight profit-sharing plan that limits employer contributions to 25 percent of the proprietor's earned income (20 percent of self-employment income before taking into account the contribution itself).

(iii) By contrast, the proprietor in a §401(k) plan may first make an "employee" contribution by an elective deferral of up to $23,500 in 2025. At low levels of self-employment income this could generate a high ADP. But because there are no other employees, this will not be a problem. Thus, the proprietor now only has to fund $47,000 by an employer contribution, and it is only the employer contribution that is limited by the 25 percent of earned income rule applicable to defined contribution plans.

(iv) At some point, the additional cost of having a document prepared for a §401(k) plan and making annual reports may overweigh the additional available contribution.

d. The solo §401(k) also works well when the proprietor has the spouse as the sole common-law employee. The spouse is treated as a highly-compensated employee regardless of the level of compensation actually paid by reason of the relationship to the proprietor as a highly compensated employee.

Note:

The economics tilt toward the solo §401(k) because of the availability of an up-front contribution that is largely independent of self-employment income or compensation paid.[17] This gives the plan a head start on contributions compared to the simpler and less expensive SEP.

6. Money-purchase pension plan

A money-purchase pension plan must specify a fixed annual contribution by the employer. The contribution must be definitely determinable and cannot be ambiguous in any way.[18] Any contribution formula must meet the nondiscrimination rules. These rules provide design safe harbors and several general tests, whereby the plan can demonstrate nondiscrimination by performing an annual mathematical test. Note that compensation must be capped, for purposes of determining the applicable contribution, to $350,000 (as indexed in 2025). The most common contribution formula is a level percentage (up to 25 percent) of compensation for all participants. This formula satisfies a design safe harbor (meaning that no nondiscrimination testing must be performed) if: (i) the plan has a single uniform formula for all participants; and (ii) the plan has a uniform normal retirement age and vesting schedule applicable to all employees.[19]

For the sole proprietor, the money-purchase plan had been used as a supplement; because today's annual additions and deduction limitations are the same, its major use is not a tax one; the required contributions to the money-purchase plan may provide greater certainty to employees than a profit-sharing plan. The maximum contribution is $70,000. For the self-employed individual with no employees, it produces the same bottom line result as a profit-sharing plan, but because of the obligation to make a fixed level of contribution, lacks the degree of flexibility of a profit-sharing plan.

---

17 The elective deferral cannot exceed the self-employment income or compensation.

18 Rev. Rul. 73-379, 1973-3 C.B. 124.

19 Treas. Regs. §1.401(a)(4)-2.

7. Defined-benefit plan

In a defined-benefit plan, the employer promises to provide a benefit, which is generally expressed as an amount payable as a **single life annuity** beginning at a stated **normal retirement age**. In order to fulfill this obligation, the employer must not only make sufficient contributions to fully fund all obligations under the plan, as determined by an actuary, but also make payments in the future. The actuary will adjust the contribution levels in accordance with the mix of life expectancies and remaining time to retirement with respect to each obligation as well as the actual investment experience of the fund. **Each year**, the actuary must take a new plan census and determine the projected benefit at retirement for each participant based on the participant's current and projected salary, and the time left to complete funding, i.e., at the projected retirement. In determining the amount the employer must contribute each year, the actuary takes into account the actual investment and mortality experience of the fund in light of its obligations.

Note:

> The employer's annual contribution to the plan is the amount that is actuarially estimated to be required to fund expected plan benefit liabilities. ERISA generally requires that a defined benefit plan's assets be valued at least annually, and that at that time, there be a new determination of the plan's experience gains and losses and, hence, of the plan's total liability. This illustrates the greatest impediment to these plans: significant overhead in plan administration and the necessity of a trained professional actuary to determine the status of the plan's funding each year.

In a defined-benefit plan, the promise to make contributions is not to any one participant's account (there are none), but to actuarially create a separate fund that will be sufficient to pay fixed benefits at retirement of each participant. This requires an actuary to determine, based on mortality and presumed investment assumptions, the amount required to be set aside to meet the particular benefits of the plan's particular participants.

The employer is liable for the payment of the promised benefit without regard to the investment experience of the fund. This has two corollaries:

a. If the fund has investment experience less favorable than the initial assumptions, the amount of future contributions will have to be increased over any original projected contribution scales; and

b. If the fund has investment experience more favorable than the initial assumptions, the amount of future contributions will have to be decreased over any original projected contribution scales.

Planning point:

> The contribution level may fluctuate each year based on the performance of the plan's assets, a factor that is somewhat outside of the control of the plan sponsor. Since the sponsor is required to make contributions to satisfy the minimum-funding requirements, only the most stable plan sponsors will be able to sponsor defined-benefit plans. Cash flow is not predictable because it depends on investment performance as well as mortality of the employee group, both of which can vary wildly from the actuarial assumptions used in the plan.

Defined-benefit plans have been disappearing over the past 15 years from most small businesses because of the high overhead in maintaining them and the difficulty in communicating its features to employees. Costs cannot be projected and controlled without the aid of the arcane ways of the actuary. This may be particularly important to employers with cash-flow concerns.

a. Another difficulty lies in the mandatory nature of pension contributions because the contributions cannot be easily determined and can change rapidly depending on changes in current market rates. Employers with **steady, dependable cash flow** are the only ones who should venture into this area. Contributions to a defined-benefit plan must be made, without regard to the employer's financial condition, subject to obtaining a funding waiver from the government.

b. In a defined-benefit plan, the employee benefits from the certainty of a specified benefit. The employer is responsible to make contributions necessary to fund promised benefits. If the plan's investment experience exceeds the actuarial assumptions, the employer's required contributions will be lowered. Similarly, if investment experience is inferior, contributions will increase.

Planning point:

Assuming the small business has at least two employees, a defined-benefit plan can generally maximize income for older owner-employees and provide maximum tax shelter for the employer as discussed below in connection with the deduction available. They are unique in being able to take into consideration service that predates the adoption of the plan.

A defined-benefit plan could turn into a tax shelter if limitations are not placed on the amount of benefit that can be defined at retirement. This limit applies to the annual benefit payable beginning at the Social Security retirement age. A defined-benefit plan may not provide an annual benefit greater than the lesser of 100 percent of the average of the employee's compensation in the employee's three highest-paid years (the "percentage limit") or $280,000 in 2025 (the "dollar limit").

a. The highest three years is the period specified in the plan of consecutive calendar years (not in excess of three) during which the employee was both a participant and had the greatest aggregate compensation.[20]

b. The dollar limit must be actuarially increased for participants who work beyond the normal retirement age, since benefits continue to accrue.[21]

Planning point:

Funding levels to the extent attributable to individual participants are functions of age/mortality, years to normal retirement age, and interest (return) rate assumptions. In all cases, an older person at a given salary level will require more annual funding than a younger employee at the same compensation. An individual at a given age with high compensation will require more funding than another employee at the same age, but with a lower salary. Together, an older employee with a high wage will require considerably more funding than a younger employee with a lower compensation base. Thus, in many defined benefit plans, the cost for other employees may be very small compared to that of the principal of the company, and certainly the percentage of annual contributions to the plan for a lower-salaried employee would be far less than that based on compensation.

For maximum reduction in income (given a tax rate rise), reduction in AGI (given the 3.8 percent tax), reduction in wages subject to Social Security (given the .9 percent tax on excess earnings), and its apparent favored status as a deduction (given the potential application of tax savings limitations on certain deductions and some exclusions), the defined benefit plan is hard to beat. However, taxpayers could also consider the **cross-tested profit-sharing** plan discussed above which also can create a disproportionality of contribution level (but apparently without the benefit of not being subject to the limitation on tax benefits).

---

20 I.R.C. §415(e)(3).
21 I.R.C. §415(b)(2)(D).

There is no rule prohibiting a self-employed person from establishing a defined-benefit plan. In some ways, the self-employed person is a good candidate because there will be no benefit costs for other employees. However, due to the additional administrative expense, few self-employed persons have been interested in a defined-benefit plan.

Note:

> The greatest impediment to the defined benefit plan is the loss of flexibility with respect to contributions and its counter-intuitive requirement that as the performance of the investments in the plan declines, the level of required contributions goes up. At a time when the lower investment prices may show a problem in the economy – when a business might want to be most protective of its flexibility with respect to cash – the mandatory contribution rules may prove a major problem.

The reason to consider a defined-benefit plan is if the self-employed person is either looking for a deductible contribution in excess of $70,000 or a contribution in excess of 25 percent of compensation. A consultation with an actuary is needed to determine if it is possible to meet one of these objectives. It is more likely that this goal can be met for an individual over age 45. Given the additional tax that applies either to excess earnings or investment income when AGI exceeds $250,000, the most dramatic way of reducing AGI – assuming it does not conflict with the client's economic needs and lifestyle – is to shift income from current earnings to deferred compensation. Given the current interest rate environment, the discount factors will be so small that substantial contributions will be actuarially required annually in order to fully fund a maximum benefit of an individual in their 50s; advisors need to determine from an actuary these current levels.

