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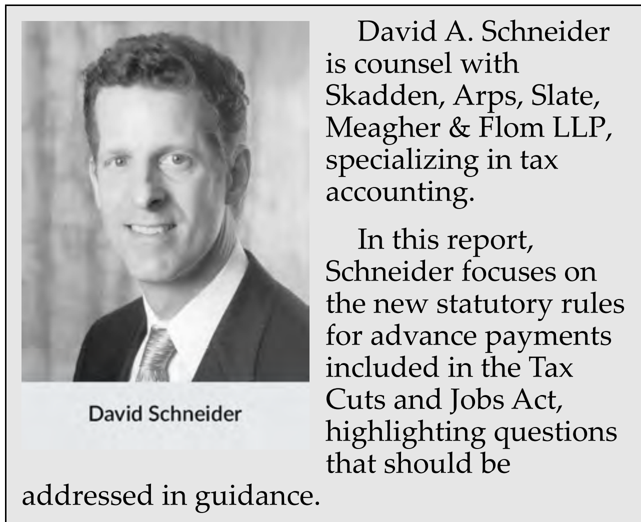
New Advance Payments Statute Raises Questions

by David A. Schneider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In this report, Schneider focuses on the new statutory rules for advance payments included in the Tax Cuts and Jobs Act, highlighting questions that should be addressed in guidance.

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Nestled in relative obscurity among the more attention-grabbing international provisions of the so-called Tax Cuts and Jobs Act[1] are amendments to section 451 regarding the timing for accruing gross income. Both amendments effectively create a closer kinship between financial accounting and tax accounting treatment of income for accrual method taxpayers. One amendment (section 13221(a) of the TCJA, new section 451(b)) codifies that venerable mainstay of the accrual method, the all-events test for income, and it introduces a new twist by providing, with exceptions, that the test will be considered met no later than the tax year in which the taxpayer reports income as revenue on its "applicable financial statements" (or other financial statements identified by the Treasury secretary). This financial statement "backstop" rule was apparently intended to overrule the treatment of items of income such as late payment fees, cash advance fees, and interchange fees, charged by credit card companies, as original issue discount that is generally taken into account over the life of the debt rather than in the tax year of receipt.[2] The financial statement backstop rule of new section 451(b), however, applies more broadly than to just those types of income.[3]

The other amendment (section 13221(b) of the TCJA) codifies long-standing IRS and Treasury safe harbor rules providing limited (one-year) deferral of gross income for tax purposes for some "advance payments" of income, to the extent that the taxpayer does not report the full amount of the revenue associated with the advance payment on its applicable financial statements for the year of receipt. Although both amendments are important and, as we will see, are linked to each other, this report focuses on the new statutory rules for advance payments and highlights some questions that should be addressed in guidance, which the IRS and Treasury have announced is underway, and for which they have requested comments.

The New Advance Payment Statute

New section 451(c) provides that an accrual method taxpayer that receives any "advance payment" during the tax year generally must

[1] P.L. 115-97, 131 Stat. 2054 (2017). The TCJA is formally titled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

[2] *See* H.R. Rep. No. 115-466, at 427-429 (2017).

[3] *Id.* at 429.

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include the full amount of the advance payment in gross income in that tax year.[4] As discussed below, this has been the general rule under case law and IRS pronouncements for decades. New section 451(c) also provides, however, that if the taxpayer elects[5] to do so regarding a specific category of advance payment (specifically, sales of goods, services, or any other category identified by the Treasury secretary), the taxpayer must report in gross income in the tax year of receipt the amount of the advance payment that the taxpayer must report in that year under new section 451(b), and must report the remaining amount of the advance payment in gross income in the following tax year.[6] The amount that must be reported in gross income in the tax year of receipt under section 451(b) is intended to be the amount reported as revenue on the taxpayer's applicable financial statements for the year of receipt.

Thus, new section 451(c) provides for one year of deferral on the recognition of income associated with all or part of an advance payment, depending on how much of the advance payment is reported in revenue on the taxpayer's applicable financial statements in the year of receipt.

As we will see, new section 451(c) codifies many safe harbor rules that were provided well over a decade ago by the IRS and Treasury in Rev. Proc. 2004-34,[7] including the laundry list of excluded types of advance payments that was set forth in that revenue procedure. However, not all the rules of Rev. Proc. 2004-34 were incorporated into the statute, and much of the fine print has been left to the discretion of Treasury and the IRS to provide in later guidance. For example, the statute does not specifically allow for deferral regarding specific types of advance payments for which deferral was permitted under Rev. Proc. 2004-34, leaving to the IRS and Treasury to decide whether to continue to allow for it administratively. This includes advance payments for (1) the use of property (including by license or lease); (2) the occupancy or use of property whose use is an ancillary component to providing services (for example, hotel rooms); (3) the sale, lease, or license of computer software; (4) guaranty or warranty contracts ancillary to one of the above items; (5) some subscriptions;[8] (6) some membership dues;[9] (7) gift cards; and (8) any combination of the above (or with sales of goods or services).

One might understandably wonder why Congress felt the need to codify these rules. The legislative history is not terribly revealing about the why. However, one possible answer may be gleaned from a footnote to the legislative history, in which Congress states its expectation that the IRS and Treasury will now withdraw reg. section 1.451-5. That regulation, discussed below, provides for even longer deferral of advance payments than does Rev. Proc. 2004-34, but only for the sale of goods (and specific long-term contracts). Thus, Congress has chosen its preferred deferral framework for advance payments for goods and services, and it is the more limited deferral of Rev. Proc. 2004-34. However, other deferral provisions of code sections 455 (prepaid subscriptions) and 456 (prepaid membership dues) were left untouched by the TCJA. And it is unclear what impact, if any, new section 451(c) will have on the continued vitality of reg. section 1.451-4 — regarding trading stamps and premium coupons — which was not mentioned in the legislative history.[10]

The law regarding accrual of income for advance payments has had a long and sometimes troubled history. Understanding some of it provides context for the new statutory rules, and the issues they raise.

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[4] Section 451(c)(1)(A).

[5] The election is to be made at the time, and in the manner, to be prescribed by the secretary, and is effective for that tax year and future tax years until revoked with the consent of the secretary. Further, the statute makes clear that the election is a method of accounting. Section 451(c)(2).

[6] Section 451(c)(1)(B).

[7] 2004-1 C.B. 991, modified by Rev. Proc. 2011-14, 2011-4 IRB 330, and modified by Rev. Proc. 2011-18, 2011-5 IRB 443.

[8] Other than those for which the taxpayer has elected to defer under section 455.

[9] *Id.*

[10] That regulation permits specific accrual method taxpayers that issue or sell trading stamps or premium coupons to reduce their sales income by the amount of expected costs of future redemptions.

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Advance Payments and the All-Events Test

We begin with the all-events test, now codified in new section 451(b)(1)(C). Under an accrual method of accounting, income must be reported for tax purposes in the tax year in which all the events have occurred that fix the taxpayer's right to receive the income and the amount of that income can be determined with reasonable accuracy.[11] The all-events test thus comprises the "fixed right" prong and the "reasonable accuracy" prong.

The accrual method of accounting often requires taxpayers to report amounts in gross income in the tax year in which the income is earned, even if it precedes the tax year in which the amounts are received by the taxpayer in cash or cash equivalents, or payment of the amounts is due to the taxpayer under the terms of the contract. Advance payments, however, present the opposite situation. Advance payments are amounts received by, or due and payable to, the taxpayer under the terms of the contract in a tax year before the tax year in which the taxpayer actually earns the income. In *Schlude*[12] and *American Automobile*,[13] the U.S. Supreme Court held that an accrual method taxpayer must recognize gross income for tax purposes from amounts actually or constructively received during the tax year, even if the taxpayer does not actually earn any or all the income until a later tax year. The *Schlude* principle applies regardless of whether, and the extent to which, the taxpayer reports an advance payment in its gross income for purposes of its books and records, or financial statements. In general, historically, there has been no statutory mechanism to permit accrual method taxpayers to delay the tax reporting of amounts actually or constructively received (or due and payable) in the tax year to a later tax year when the taxpayer actually earns the income.

The *Schlude* principle manifests itself in the following oft-repeated description of the fixed-right prong of the all-events test: all the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first.[14] From a federal income tax perspective, the *Schlude* principle often results in income from advance payments being recognized earlier (sometimes much earlier) than when the taxpayer incurs and takes into account the expenses related to earning the income. Thus, *Schlude* can sometimes result in significant mismatching of a taxpayer's income and related expenses.

Early Administrative Safe Harbors

Rev. Proc. 70-21[15] and Rev. Proc. 71-21[16] were attempts by the IRS to ameliorate some of the harsh impact of the *Schlude* principle by permitting accrual method service providers to defer for one year the recognition of gross income from some advance payments received for services to be provided after the close of the tax year. Specifically, those taxpayers could defer the recognition of gross income from the advance payments if, and to the extent that, the taxpayer earned the income in a later tax year. However, the taxpayer could never defer any more than the amount of the advance payment that the taxpayer included in gross receipts for the year for purposes of the taxpayer's books and records and all reports (including consolidated financial statements) to shareholders, partners, other proprietors, beneficiaries, or creditors.[17]

Rev. Proc. 70-21 and Rev. Proc. 71-21 were limited in their scope. First, they applied only to advance payments for services. Advance payments that involved a mixture of services and something else (sales of goods, for example) did not qualify. Further, the revenue procedures

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[11] Section 451(b)(1)(C), added by section 13221(a) of the TCJA. *See also* reg. sections 1.451-1(a) and 1.446-1(c)(1)(ii).

[12] *Schlude v. Commissioner*, 372 U.S. 128 (1963) (holding that an accrual method dance studio must report in gross income in the tax year of receipt prepaid amounts it received for dance lessons to be provided after the close of the tax year of receipt).

[13] *American Automobile Association v. United States*, 367 U.S. 687 (1961) (holding that an automobile club must report in gross income in the tax year of receipt prepaid membership dues for membership contracts that extended beyond the close of that year).

[14] *See, e.g.*, *Johnson v. Commissioner*, 108 T.C. 448, 459 (1997), *aff'd in part, rev'd in part on other grounds*, 184 F.3d 786 (8th Cir. 1999); *Route 231 LLC v. Commissioner*, 810 F.3d 247 (4th Cir. 2016); *Massachusetts Mutual Life Insurance Co. v. United States*, 66 Fed. Cl. 217 (2005); *VHC Inc. v. Commissioner*, T.C. Memo. 2017-220; Rev. Rul. 2007-1, 2007-1 C.B. 265; Rev. Rul. 2004-52, 2004-1 C.B. 973; Rev. Rul. 2003-10, 2003-1 C.B. 288.

[15] 1970-2 C.B. 501.

[16] 1971-2 C.B. 549.

[17] Rev. Proc. 71-21, sections 3.02 and 3.11.

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applied only for service contracts that required all services to be performed by the end of the tax year immediately succeeding the tax year of receipt.[18] Both revenue procedures provided that if, in the year of receipt of the advance payment, the taxpayer died or ceased to exist in a transaction other than one to which section 381(a) applied, or the taxpayer's liability to perform the services otherwise ended, there could be no deferral.

Around the same time that the IRS issued the above revenue procedures, it also provided a separate, and in some respects materially different, deferral regime in reg. section 1.451-5 for advance payments received in connection with the sale of goods (and also long-term contracts).[19] Taxpayers can elect under reg. section 1.451-5 to defer, for tax purposes, the recognition of income in connection with the receipt of those advance payments until the amounts are recognized in revenues under the taxpayer's method of accounting for financial reporting purposes.[20] Thus, the deferral regime of the regulation, like that of Rev. Proc. 71-21, is keyed to the amount of the advance payment that the taxpayer defers for financial reporting purposes. Unlike Rev. Proc. 71-21, however, income from advance payments for goods can be deferred under the regulation for longer than just one tax year.

For "substantial advance payments" received in connection with "inventoriable goods," reg. section 1.451-5(c) may operate to cut short the amount of deferral that otherwise would be available under the general rule of the regulation. That more limited deferral, however, is still longer than the one-year deferral offered by Rev. Proc. 71-21. The inventoriable goods exception applies if, on the last day of a tax year: (1) the taxpayer has elected to defer advance payments on the sales of goods; (2) the taxpayer has received substantial advance payments regarding the agreement for the sale of the goods; and (3) there are goods on hand (or available through the taxpayer's normal source of supply) of substantially similar kind and in sufficient quantity to satisfy the taxpayer's obligations under the agreement.[21] In that case, the taxpayer must include in gross income all advance payments received (or due and payable to the taxpayer), and not previously taken into income, by the end of the second tax year following the tax year in which the taxpayer meets the above three conditions.[22] If advance payments are required to be included in gross income during the tax year because, in that tax year, the inventoriable goods exception is met, and if the taxpayer has goods on hand at the end of the tax year in substantially similar kind and quantity to satisfy the contract, the taxpayer must also take into account in that tax year the costs and expenditures included in inventory at the end of the year, as if that inventory had been transferred to the counterparty in that tax year in satisfaction of the agreement.[23] "Substantial advance payments" means an aggregate amount of advance payments received by (or due and payable to) the taxpayer (either in the current tax year or in prior tax years) that equals or exceeds the total costs and expenditures reasonably estimated to be includable in inventory under the agreement.[24]

Unlike Rev. Proc. 71-21, reg. section 1.451-5 can apply to advance payments that represent a mixture of goods and services. However, unless the services component is de minimis,[25] or the services are "integrally related" to the goods, only the portion of the advance payment related to the goods is eligible for deferral under the regulation.

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[18] Rev. Proc. 71-21, section 3.03.

[19] Reg. section 1.451-5(a)(1). Specifically, the regulation allows for deferral of advance payments "for the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" or "for the building, installing, constructing, or manufacturing by the taxpayer of items where the agreement is not completed within" the tax year in which the advance payment is received. *Id.*

[20] Specifically, such advance payments must be reported in gross income for tax purposes in the tax year in which the advance payments are included in gross receipts for purposes of all the taxpayer's reports to shareholders, partners, beneficiaries, and other proprietors, and for credit purposes. Reg. section 1.451-5(b)(1)(ii)(a).

[21] Reg. section 1.451-5(c)(1).

[22] *Id.*

[23] *Id.* If the taxpayer does not have the goods on hand at the end of the tax year but they are available to the taxpayer through its normal sources of supply, the taxpayer must take into account in the tax year an estimate of the costs necessary to fulfill the agreement. If this cost provision is triggered for the tax year, the taxpayer may not also take the same costs into account a second time in the tax year when the goods are actually transferred to the buyer.

[24] Reg. section 1.451-5(c)(3).

[25] For this purpose, de minimis means that the amount allocable to other than the goods or the integrally related services is less than 5 percent of the total contract price. Reg. section 1.451-5(a)(3).

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Like Rev. Proc. 71-21, the regulation provides that if the taxpayer dies or ceases to exist in a transaction other than one to which section 381(a) applies, or the taxpayer's liability under the agreement providing for the advance payment ends, there will be no further deferral.[26]

Although Rev. Proc. 71-21 had a good long run (33 years), it was not without problems. Considerable controversy existed about whether an advance payment in a specific case represented compensation solely for a service (and thus was eligible for the deferral safe harbor) or for a mixture of services and non-services (in which case none of the advance payment was eligible for deferral under the revenue procedure).[27] Along those lines, taxpayers receiving advance payments in connection with a contract calling for a mixture of goods and services could find themselves in a form of tax purgatory — the goods component could disqualify the advance payment from deferral under Rev. Proc. 71-21, while the services component could disqualify that allocable portion of the advance payment from deferral under reg. section 1.451-5. Further, there were disputes between taxpayers and the IRS about whether advance payments qualified for deferral under Rev. Proc. 71-21 if they were made in connection with a series of agreements, or under a renewable agreement, that, when viewed in the aggregate, called for services to be provided beyond the close of the tax year following the tax year the advance payment was received.[28]

Rev. Proc. 2004-34: New, Improved Rev. Proc. 71-21

In issuing Rev. Proc. 2004-34 (modifying and superseding Rev. Proc. 71-21), the IRS substantially broadened the types of advance payments that could qualify for tax deferral beyond just advance payments for services, and ended the two-year contract limitation. Rev. Proc. 2004-34 provides that a taxpayer that chooses to use the deferral method provided in that revenue procedure must include an advance payment in gross income for the tax year of receipt to the extent reported in revenue on the taxpayer's applicable financial statements.[29] A taxpayer that does not have applicable financial statements must include the advance payment in gross income for tax purposes in the tax year of receipt to the extent the taxpayer earned the income in that tax year.[30] In either case, the taxpayer generally must include any remaining amount in gross income by the close of the following tax year. Thus, like Rev. Proc. 71-21, Rev. Proc. 2004-34 allows for up to one year of deferral of an advance payment (to the next tax year after the tax year of receipt), regardless of how much of the advance payment is actually reported in revenue for financial statement purposes (or earned in the case of taxpayers without applicable financial statements) in that next tax year.

Under Rev. Proc. 2004-34, an advance payment is defined to mean a payment received by (actually or constructively, as well as amounts due and payable to) the taxpayer during the tax year, if (1) including the payment in gross income in the tax year of receipt is a permissible method of accounting (referred to as the full inclusion method, which is almost always permissible); (2) the payment is recognized by the taxpayer (in whole or in part) in revenues in its applicable financial statement for a subsequent tax year (or for taxpayers without applicable financial statements, the payment is earned by the taxpayer, in whole or in part, in a subsequent tax year); and (3) the advance payment is for one or more specific types of consideration.[31] The list of consideration that can give rise to an advance payment under Rev. Proc. 2004-34, as amended consists of:

- services;
- the sale of goods;[32]
- the use (including by license or lease) of intellectual property;

[26] Reg. section 1.451-5(f).

[27] *See* Rev. Proc. 2004-34, section 2.04 (explaining the controversies that arose under Rev. Proc. 71-21).

[28] *Id.*; *see also* Announcement 2004-48, 2004-2 C.B. 998 (explaining the significant changes to Rev. Proc. 71-21 in Rev. Proc. 2004-34), implemented by T.D. 9135.

[29] Rev. Proc. 2004-34, section 5.02(3)(a).

[30] *Id.* at section 5.02(3)(b).

[31] *Id.* at section 4.01.

[32] Taxpayers using a deferral method under reg. section 1.451-5 cannot also use the deferral method under Rev. Proc. 2004-34. *Id.* at section 4.01(3)(b).

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- providing hotel rooms and similar occupancy or use of property;
- the sale, lease, or license of computer software;
- guaranty or warranty contracts ancillary to any of the above;
- subscriptions;[33]
- memberships in an organization;[34]
- eligible gift card sales;[35] and
- any combination of the above.

Thus, both Rev. Proc. 2004-34 and reg. section 1.451-5 can apply to advance payments for the sale of goods. Generally, the regulation is regarded as more advantageous because: (1) it often can result in longer deferral of income from the advance payment, and (2) in the case of the inventoriable goods exception, it sometimes allows the taxpayer to take costs into account earlier than they otherwise would be. Unlike reg. section 1.451-5, Rev. Proc. 2004-34 does not permit a seller of goods to accelerate taking its costs into account for tax purposes.[36]

Rev. Proc. 2004-34 adopts a specific definition of applicable financial statements. Modeled after the rules of reg. section 1.56-1(c), applicable financial statements are defined (in order of priority) to mean:

- a financial statement required to be filed with the SEC (that is, the Form 10-K or annual statement to shareholders);
- a certified audited financial statement that is accompanied by the report of an independent CPA (or equivalent professional in the case of a foreign corporation) that is used for credit purposes, reporting to shareholders, or other substantial nontax purposes; or
- a financial statement (other than a tax return) required to be provided to the federal or state government or any federal or state agency other than the SEC and the IRS.[37]

Also, Rev. Proc. 2004-34 provides a solution for some taxpayers with the misfortune of having a short tax year following the tax year the advance payment is received. It provides that if the short year consists of 92 days or less,[38] the taxpayer must report in gross income for tax purposes in that short tax year only so much of the advance payment as is included in the taxpayer's financial statement revenue (or that is earned, as applicable) for that short tax year, and the remaining amount must be included in gross income for tax purposes in the tax year immediately following the short year.[39] Thus, this special rule allows for two tax years of deferral in the case of such short periods, rather than just one.

Like both Rev. Proc. 71-21 and reg. section 1.451-5, Rev. Proc. 2004-34 provides generally that if the taxpayer dies or ceases to exist, or the taxpayer's liability regarding the advance payment ends, there is no more deferral. Also, like both of those earlier authorities, the acceleration rule is not triggered if the death/cessation-of-existence/end-of-liability happens because of a section 381(a) transaction. However, importantly, Rev. Proc. 2004-34 expands on the exception to the acceleration rule by providing that if the taxpayer's liability regarding the advance payment ends in a transaction to which section 351(a) applies, when substantially all of the assets of the trade or business (including the advance payments) are transferred, the transferee adopts the deferral method, and the transferee stays within the consolidated group, income recognition by the transferor regarding the advance payment will not be accelerated. The same courtesy is not extended to transfers to or

[33] Other than subscriptions for which an election under section 455 is in effect. *Id.* at section 4.01(3)(g).

[34] Other than memberships for which an election under section 456 is in effect. *Id.* at section 4.01(3)(h).

[35] Eligible gift card sales were added to the list by Rev. Proc. 2011-18, as modified and clarified by Rev. Proc. 2013-29, 2013-33 IRB 141. Eligible gift card sales are sales of a gift card or gift certificate if: (1) the taxpayer is primarily liable to the customer or holder of the gift card for the value of the card until redemption or expiration; and (2) the gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer as payment for the items listed in section 4.01(g) of Rev. Proc. 2004-34.

[36] *See* Announcement 2004-48, implemented by T.D. 9138.

[37] Congress adopted this definition of applicable financial statement for purposes of new section 451(b), and indirectly, for purposes of new section 451(c).

[38] Other than a short tax year in which the taxpayer died or ceased to exist in a transaction other than one to which section 381(a) applied. Rev. Proc. 2004-34, section 5.02(2).

[39] *Id.*

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from a partnership in a transaction to which section 721 or 731 applies.[40]

Rules for Deferral of Advance Payments

Our review of the prior advance payment guidance reveals two important points. First, other than advance payments for the sale of goods, the IRS and Treasury have consistently held the line on one year of deferral (except in the limited case of very short tax years). Second, apart from the length of deferral, the IRS and Treasury have consistently made the advance payment safe harbor more taxpayer-favorable over the years, for example by (1) broadening the types of advance payments eligible for one-year deferral, (2) eliminating restrictions on the length of the underlying contract, and (3) narrowing the circumstances in which acceleration of the deferral occurs.

The IRS and Treasury had included a project on the 2016-2017 guidance priority plan involving "regulations under section 451 regarding advance payments received for goods and services, including amounts received in exchange for the sale or issuance of gift cards, trading stamps, and loyalty points that can be redeemed for goods or services."[41] It was hoped that, in keeping with the prior trend, they would have found ways to make deferral even more widely available. But the project was removed from the 2017-2018 version of the plan, the initial version of which was issued in October 2017, apparently in anticipation of the legislative change.

Congress Steps In

As discussed, section 13221(b) of the TCJA codifies the basic rules of Rev. Proc. 2004-34 in new section 451(c). Thus, the statute allows for only one year of deferral and Congress expressed its intention that reg. section 1.451-5, which provided for longer deferral, should be withdrawn. No provision is made in the statute for extending deferral for some short tax years.

The only types of consideration for which an advance payment that the taxpayer receives that are explicitly eligible for deferral under new section 451(c)(1)(B) are services and sales of goods. As discussed, Rev. Proc. 2004-34 applied to more than just services and goods. Congress left open the possibility of extending deferral to advance payments received for other types of consideration "as may be identified by the Secretary."[42] However, for whatever reason, it did not see fit to explicitly include those other types of consideration in the statute. Congress also specifically included in the statute the laundry list of types of consideration for which an advance payment is *not* eligible for deferral. But even that list is not written in stone, as it is prefaced with the phrase "except as otherwise provided by the Secretary."

Unlike Rev. Proc. 2004-34, deferral under the statute is limited to taxpayers that defer the inclusion of the advance payment in revenues in their applicable financial statements. Like Rev. Proc. 2004-34, the statute does not extend the availability of deferral to taxpayers that do not have applicable financial statements (for example, based on how much of the advance payment is earned in the tax year of receipt).

Also like Rev. Proc. 2004-34, the statute attempts to link the amount of the advance payment that must be reported in gross income in the tax year of receipt to the amount of the payment that is reported on the taxpayer's applicable financial statements for the tax year of receipt. Any remaining amount of the advance payment must be included in gross income for tax purposes in the next tax year.

However, the attempted link to the financial statement backstop rule of new section 451(b)(1)(A) results in a presumably unintended glitch. In describing the deferral method, section 451(c)(1)(B) provides that:

> If the taxpayer elects the application of this subparagraph with respect to the category of advance payments to which such advance payment belongs, the taxpayer shall —

[40] These acceleration rules are consistent with the rules for determining when a taxpayer has ceased to engage in a trade or business for purposes of the IRS procedures to obtain consent to change a method of accounting. *See* Rev. Proc. 2015-13, 2015-5 IRB 419, section 3.04.

[41] Treasury, "2016-2017 Priority Guidance Plan," at 20 (Aug. 15, 2016).

[42] Section 451(c)(4)(A)(iii).

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> (i) *to the extent that any portion of such advance payment is required under subsection (b) to be included in gross income in the taxable year in which such payment is received*, so include such portion, and
>
> (ii) include the remaining portion of such advance payment in gross income in the taxable year following the taxable year in which such payment is received.[43]

Clearly, Congress meant for the cross-reference to "subsection (b)" in section 451(c)(1)(B) to isolate the portion of an advance payment that is included in revenue on the taxpayer's applicable financial statements for the tax year of receipt. Congress intended for a taxpayer electing to use the deferral method of new section 451(c) to have to report only that portion of the advance payment in gross income for tax purposes for the tax year of receipt, and for the taxpayer to report the remaining portion of the advance payment in gross income for tax purposes in the next tax year. However, that is not the result that is achieved from a literal reading of section 451(c)(1)(B).

As discussed above, subsection (b) (that is, section 451(b)) codifies the general all-events test in section 451(b)(1)(C) "for purposes of this section," and provides the financial statement backstop rule in section 451(b)(1)(A) (which, by definition, applies to amounts that otherwise would *not* satisfy the general all-events test of section 451(b)(1)(C) for the tax year). Also, under the *Schlude* principle, the entire amount of an advance payment received by a taxpayer is included in gross income in the tax year of receipt because in that tax year, the taxpayer has a fixed right to receive the entire amount[44] and the entire amount is determinable with reasonable accuracy.[45] Thus, typically, the entire amount of an advance payment will satisfy the general all-events test of section 451(b)(1)(C) in the tax year it is received (or due and payable). Logically then, no portion of any advance payment would be included in a taxpayer's gross income in the tax year of receipt because of the financial statement backstop rule of section 451(b)(1)(A).

Because the entire amount of an advance payment "is required under subsection (b) [that is, subsection (b)(1)(C)'s general all-events test, not the financial statement backstop rule of subsection (b)(1)(A)] to be included in gross income in the taxable year in which such payment is received," section 451(c)(1)(B)(i), read literally, requires the taxpayer to "so include such portion" in that tax year. Carrying through this literal reading, it follows that section 451(c)(1)(B)(ii), as drafted, would never permit deferral of any portion of any advance payment, because there would never be a "remaining portion" to which section 451(c)(1)(B)(ii) could apply. Obviously, this is not the result Congress intended. The glitch is fixable by amending section 451(c)(1)(B)(i) to read as follows:

> to the extent that any portion of such advance payment is described in paragraph (b)(1)(A) of this section (giving effect to paragraph (b)(1)(B), but without regard to paragraph (b)(1)(C)), include such portion in gross income in the taxable year in which such payment is received.

Although the definition of the term "applicable financial statements" is similar to the definition in Rev. Proc. 2004-34, there are some notable differences. First, under Rev. Proc. 2004-34 an applicable financial statement can, under some circumstances, include uncertified financial statements (other than tax returns) that the taxpayer is required to provide to the federal

[43] Section 451(c)(1)(B) (emphasis added).

[44] As discussed above, taxpayers have a fixed right to receive an amount in the tax year in which (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. *See supra* text accompanying note 16.

[45] To add to the confusion, advance payments arguably would never be analyzed under section 451(b) because of the operation of section 451(a). That section provides that the amount of any item of gross income shall be included in the gross income for the tax year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for in a different period. Thus, advance payments must be included in gross income under section 451(a) unless they are to be accounted for differently under the accrual method, which they are not. *See Schlude*, 372 U.S. 128.

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government or a state government. That does not appear to be the case under the statute. Generally, an applicable financial statement under section 451(c) must be certified as being prepared in accordance with generally accepted accounting principles. The only uncertified financial statements that qualify as applicable financial statements under section 451(c) are some financial statements made on the basis of international financial reporting standards and filed with an SEC-equivalent agency of a foreign government.

The statute provides that, except as otherwise provided by the Treasury secretary, the election to use the deferral method under section 451(c)(1)(B) shall not apply to advance payments received by the taxpayer during the tax year if the taxpayer ceases to exist during (or with the close of) such tax year.[46] Recall that all the previous deferral guidance has had such a feature. However, the rule in the previous guidance (including Rev. Proc. 2004-34) was broader, eliminating deferral not just when the taxpayer ceased to exist, but also explicitly when the taxpayer died, and when the taxpayer's liability regarding the advance payment ended. Also, some exceptions were provided in the previous guidance for transactions to which section 381(a) or 351 applied. The statute provides no such exceptions, and it is unclear from the legislative history whether the omission is meant to imply that Congress disfavors them.

As with all the IRS's administrative safe harbors previously discussed, new section 451(c) makes full inclusion of the advance payment in gross income in the year of receipt the default rule, and deferral of income recognition for advance payments the electable exception. Under the statute, a change from including the full amount of an advance payment in the tax year of receipt to a method of deferring the advance payment under section 451(c)(1)(B) (and vice versa) is a change in method of accounting that requires the consent of the IRS commissioner under section 446. However, Congress saw fit to require taxpayers who wish to change to the deferral method provided in new section 451(c)(1)(B) to have the consent of the commissioner, if the change is made for the taxpayer's first tax year ending after December 31, 2017.[47]

Where Do We Go From Here?

Apart from the presumed demise of reg. section 1.451-5, it is unclear at this point what exactly will change because of new section 451(c). The IRS and Treasury introduced a new published guidance plan project as part of the second-quarter update of the guidance priority list, cryptically entitled "definitional and other guidance under new section 451(b) and (c)."[48] Further, in Notice 2018-35 (issued on April 12, 2018), the IRS announced transitional guidance on new section 451(c). Notice 2018-35 extends the availability of deferral under Rev. Proc. 2004-34 until permanent guidance can be issued. Among the questions left open by the new law are:

- Will the IRS and Treasury continue to permit deferral regarding advance payments for consideration other than services and goods — specifically the types of consideration listed in Rev. Proc. 2004-34? Congress certainly left to the Treasury secretary the ability to include other types of consideration, and did not expressly indicate any disapproval of Rev. Proc. 2004-34's scope in that regard.[49] Given that, one might presume that the IRS and Treasury would be as comfortable with permitting deferral for these other types of consideration as they were before the TCJA. Because Notice 2018-35 extends the availability of Rev. Proc. 2004-34 until guidance is issued under new section 451(c), for the time being deferral continues to be allowed under that revenue procedure for advance payments other than for services and sales of goods, such as royalties for licenses of intangibles, proceeds of sales of gift cards, and amounts received for the sale, lease, and license of computer software. The

[46] Section 451(c)(3).

[47] A change from the full inclusion method to the deferral method, or vice versa, under Rev. Proc. 2004-34 qualified for the automatic consent of the commissioner under Rev. Proc. 2015-13, section 9. Rev. Proc. 2017-30, 2017-18 IRB 1131, section 16.07.

[48] Treasury, "2017-2018 Priority Guidance Plan," at 3 (Feb. 7, 2018).

[49] Section 451(c)(4)(A)(iii).

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IRS requested comments on the types of income items for which deferral should be permitted under the new section 451(c) guidance. Notice 2018-35 gives mixed signals as to where the IRS and Treasury are leaning on this issue. On the one hand, it requests comments on "the extent, if any, to which the Service may provide procedures expanding the rules of [section] 451(c) to apply to additional . . . types of income." Presumably, "additional" refers to types of income other than from sales of goods and services, which are specifically mentioned in the statute. This request could suggest that all the other types of advance payments for which deferral was allowed under Rev. Proc. 2004-34 are on the table. On the other hand, Notice 2018-35 also asks "whether other items in addition to those [already listed in] Rev. Proc. 2004-34 should be included in the definition of advance payment," suggesting that those items are safe and that the IRS and Treasury are even considering expanding that list.

- Will the IRS and Treasury expand the black list of items that are definitively not considered advance payments? Notice 2018-35 asks for comments on that question.
- Will the IRS and Treasury reconcile the differences between the definitions of "applicable financial statements" in the statute and the revenue procedure? It appears from Notice 2018-35 that they are considering whether further clarification of the term is needed and, if so, what the definition should be.
- Will the IRS and Treasury continue to provide administratively for the availability of deferral of advance payments by taxpayers that do not have applicable financial statements? Again, for now those taxpayers can continue to rely on Rev. Proc. 2004-34. In section 451(b)(1)(A) Congress authorized the Treasury secretary to apply the financial statement backstop rule for "such other financial statements as the Secretary may specify for purposes of" that section. Thus, the IRS and Treasury can extend section 451(b)(1)(A)'s financial backstop rule to taxpayers other than those with "applicable financial statements." However, Rev. Proc. 2004-34's rule permitting deferral for taxpayers without applicable financial statements is based on how much of the advance payment the taxpayer has earned during the tax year, not on how much the taxpayer has reported in revenue for financial statement purposes. Notice 2018-35 asks for comments on the extent to which the IRS can provide procedures expanding the rules of section 451(c) to apply to additional taxpayers. Hopefully, the IRS and Treasury will not read the new statute as a congressional directive to eliminate the opportunity for deferral for such taxpayers.
- Will taxpayers that are already using the deferral method under Rev. Proc. 2004-34 be deemed to have elected to use the new deferral method under section 451(c), or will they have to affirmatively make an election?
- Will an administrative exception be provided to the general rule, requiring all remaining amounts of an advance payment to be included in gross income in the tax year immediately following the tax year of receipt, for taxpayers with a short tax year following the tax year of receipt? No comments were specifically requested on that point in the notice.
- Will administrative guidance provide for the same exceptions to the acceleration rules for section 381 and 351 transactions as were provided in Rev. Proc. 2004-34? Again, Notice 2018-35 did not specifically ask for comments on this point, but the availability of continued deferral in those situations is an important issue for many taxpayers.
- Will there be any impact on reg. section 1.451-4, regarding sales of trading stamps and premium coupons? Congress did not mention the regulation in the legislative history, but before the TCJA the guidance plan project announced by the IRS and Treasury referenced trading stamps.

Rev. Proc. 2004-34 was a vast improvement over Rev. Proc. 71-21, and it was a sound and balanced use of the IRS and Treasury's administrative discretion. Hopefully, guidance implementing the new statute will be as well. ■

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