New IRS Rules on Timing of Income Recognition Raise Questions

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On September 5, 2019, the Treasury Department (Treasury) and the IRS released proposed regulations (Regulations) that would impact when accrual method taxpayers report amounts in gross income. Generally, Section 451 provides rules for when (*i.e.*, which taxable year) an amount must be reported as gross income on the taxpayer's return. The Tax Cut and Jobs Act, or TCJA, amended Section 451 in two ways for accrual method taxpayers: (1) to require them to report an amount as gross income for tax purposes no later than when the amount is reflected as revenue on their "applicable financial statements" (AFS), and (2) to allow them to defer, for one year, tax reporting of certain "advance payments" of income. The Regulations clarify some issues relating to the TCJA amendments, but leave many others unresolved. Treasury and the IRS have asked for public comments on several of these open issues. Taxpayers should review these Regulations carefully to determine how they would impact their businesses and consider whether submitting comments would be helpful.

Section 451(b) — AFS Rule

TCJA amended Section 451(b) to alter an accrual method taxpayer's application of the "all-events" test to bring tax accounting more in line with financial accounting. Under that test, an item of income is included in gross income for tax purposes when all events occur that fix the right to receive the item and the amount of the item can be determined with reasonable accuracy. Prior to TCJA, the all-events test was considered met at the earliest of when: (1) the income is earned through performance, (2) payment becomes due or (3) payment is made. Under Section 451(b), as amended by TCJA, even if an amount does not meet any of these three conditions, it must be reported in gross income for tax purposes to the extent it is reflected in the taxpayer's AFS for the particular year. Under the Regulations, unbilled receivables can no longer be deferred for tax purposes until all services under the contract have been performed (as was the case under prior law) if, and to the extent that, the taxpayer reports the receivables as revenue on the taxpayer's AFS in an earlier year.

The Regulations would clarify that the AFS rule does not change the tax character of a transaction, even if it differs from the AFS character. For example, if a transaction is treated as a lease for tax purposes but a sale for AFS purposes, the character would remain a lease for tax purposes. The Regulations also would clarify that the AFS rule has no impact on amounts that are: (1) contingent on the occurrence or nonoccurrence of a future event (*e.g.*, anticipated earn-outs and commissions on the anticipated renewal of insurance contracts), (2) collected on behalf of third parties (*e.g.*, sales taxes), (3) considered deposits or conduit payments under general tax principles, (4) the result of marking to market for book, but not for tax, (5) governed by a non-recognition provision, such as Section 332, 337, 351, 368, 355 or 721, or (6) governed by a special method of accounting, like the installment method or the percentage of completion method. This is so even if such amounts are treated as revenue on the taxpayer's AFS.

Consistent with the statute, the Regulations would provide that, for certain "specified fees" related to debt instruments, including credit card late fees, cash advance fees and interchange fees, the modified all-events test of Section 451(b), including the AFS rule, trumps the original issue discount (OID) rules of Sections 1271 through 1275. Thus, a taxpayer must include these specified fees in gross income in the taxable year of receipt if they are included in revenue on its AFS in the year of receipt, even though the OID rules otherwise would have allowed the taxpayer to include them in gross income in a later year(s). However, the Regulations would not apply the all-events test to trump the

OID rules with respect to any other items, such as points, that are treated as discount or an adjustment to the yield of a debt instrument for financial reporting purposes. Furthermore, the AFS rule does not preclude the application of the market discount rules provided by Section 1276.

Section 451(c) — Advance Payments

TCJA amended Section 451(c) to provide that an accrual method taxpayer can choose to defer tax reporting of an "advance payment" for goods, services or anything else Treasury provides to the tax year following the tax year of receipt to the extent that the taxpayer does not include the advance payment in revenue on its AFS for the year of receipt (the "deferral method").

The Regulations would expand the types of payments that qualify for the deferral method beyond just those for goods and services to include all of the items that are considered "advance payments" under Rev. Proc. 2004-34 (which provides a similar deferral method under prior law), *i.e.*, payments: (1) for the use of intellectual property, (2) for the occupancy or use of property ancillary to services, (3) for computer software, (4) related to certain guaranty or warranty contracts, (5) for subscriptions, if not accounted for under Section 455, and (6) for memberships, if not accounted for under Section 456. Thus, for example, under the Regulations, advance payments of royalties for the use of intangibles would continue to be eligible for deferral. Similarly, all of the items that are ineligible for deferral under Rev. Proc. 2004-34 would remain ineligible under the Regulations, including rent, insurance and payments under financial instruments.

In addition, the Regulations exclude upfront payments for goods from the definition of advance payments if the taxpayer: (1) requires a customer to make an upfront payment at least two taxable years prior to the contracted delivery date of the good, (2) does not have the good or a substantially similar good on hand (or available through normal supply sources) at the end of the year the upfront payment is received, and (3) recognizes all of the revenue from the sale of the good in its AFS in the year the good is delivered to the customer. This exclusion from the definition of advance payments may permit a taxpayer to defer the upfront payment for a number of years (*i.e.*, beyond the single-year deferral otherwise provided) if the taxpayer establishes that the deferral of the payment is otherwise permitted (*e.g.*, under case law). This proposed exception is significant for many taxpayers that enter into contracts for the sale of goods well in advance of expected delivery.

The Regulations would address certain issues that are not addressed by Rev. Proc. 2004-34. For example, they clarify that a taxpayer cannot defer the recognition of a payment that has been earned in the year it is received under applicable tax principles, even if the payment has not yet been reported as revenue in the taxpayer's AFS. In addition, the Regulations clarify that a taxpayer that defers inclusion of all or a portion of an advance payment must include the remainder of the advance payment in gross income in the subsequent year, notwithstanding that the advance payment may be subject to a write-down or adjustment for financial accounting purposes.

A number of other rules in Rev. Proc. 2004-34 are incorporated into the Regulations including: (1) a deferral regime for taxpayers without AFS, (2) rules for short taxable years, and (3) elimination of deferral in some situations where the taxpayer ceases to exist or is relieved of an obligation associated with the advance payment.

Some Open Issues for Which the IRS and Treasury Will Accept Comments

Among the issues for which the IRS and Treasury specifically seek comments are:

- How the AFS rule should apply to foreign persons (including controlled foreign corporations (CFCs)), particularly given that mismatches can occur from the rule between a CFC's taxable income for U.S. and foreign tax purposes;
- How the AFS rule should apply in situations where book revenue might be viewed as future contingent income, such as escalating rental agreements not subject to Section 467, and certain variable consideration;
- Whether the IRS and Treasury have the authority to provide rules mitigating the timing mismatch between gross income and related costs that is often exacerbated by the AFS rule and/or the general rule for including advance payments in income in the year of receipt (no such mitigation rules are provided in the Regulations);
- Whether the Treasury has the authority to permit a taxpayer to use a book percentage-of-completion method as its tax method; or
- Whether it would be appropriate to expand the definition of "unique item" provided by the Section 460 regulations so that the application of the tax percentage-of-completion method is expanded.

Effective Dates

The Regulations related to the application of the AFS rule and to the treatment of advance payments are generally proposed to apply to taxable years beginning on or after the date the final regulations are published. However, a taxpayer may rely on the Regulations (other than the proposed rules related to specified fees related to debt instruments) for years beginning after December 31, 2017, provided the taxpayer applies all of the rules contained in the Regulations and consistently applies the Regulations to all items of income (other than income related to specified fees related to debt instruments). In contrast, the effective date of the proposed rules related to specified fees would be delayed until the taxpayer's first taxable year beginning one year after the date the final regulations are published. Notwithstanding the delayed effective date of the Regulations to specified fees related to debt instruments, a taxpayer may rely on the Regulations for specified fees for tax years beginning after December 31, 2018, provided the taxpayer applies all of the rules contained in the Regulations.