Proposed IRS Gross Receipts Regs Should Hew To Case Law

By **Scott Rabinowitz** (December 2, 2019, 5:19 PM EST)

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The Internal Revenue Service and the U.S. Department of the Treasury issued proposed regulations, on Sept. 9, that address amendments made to Internal Revenue Code Section 451[1] by the Tax Cuts and Jobs Act.[2] Section 451, as amended, provides that an upfront payment received by (or due to) an accrual method taxpayer is included in gross income in the tax year the payment is received (or due).

The TCJA further amended Section 451 to provide that an accrual method taxpayer can elect to defer reporting of an advance payment for goods, services or any other items provided by the Treasury to the tax year following the tax year of receipt to the extent the taxpayer does not include the advance payment in revenue on its applicable financial statement for the year of receipt (the deferral method).

Under the proposed regulations, a taxpayer that is required to include in gross receipts an advance payment for goods prior to the sale of the goods would be taxed on the receipt of the advance payment without an offsetting deduction for the cost of the goods. This result is questionable given the historic definition of gross income provided by both case law and the regulations.

It appears that the IRS and the Treasury Department may have tried to deal with this problem in the proposed regulations by providing an exception for advance payments for goods where the contract provides that the goods must be delivered to a taxpayer's customers by a date that is specified in the contract and where all of the revenue from the sale will be recognized in the taxpayer's financial statements in the year of delivery.

By excepting such advance payments from the general rules of the regulations, the IRS and the Treasury Department apparently intended to allow the tax treatment of such payments to be governed by pre-TCJA common law, which, arguably, permits deferral in certain cases. Advance payments that are not covered by the exception, however, remain problematic.

The courts, as well as the IRS, have routinely recognized that a mere return of capital does not result in the recognition of gross income.[3] The regulations follow this axiom, providing that in a "manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold."[4]

In other words, gross receipts derived from the sale of goods is not gross income that is subject to tax. Rather, gross income is the excess of a taxpayer's gross receipts derived from the sale of goods over the cost of the goods that are sold.

In fact, a brief review of case law quickly reveals that the courts have rarely, if ever, been comfortable with the proposition that gross receipts without an offsetting deduction for cost of sales are subject to tax.

For example, in Veenstra & DeHaan Coal Co. v. Commissioner[5], the Tax Court held that payments received in advance of the sale of goods were deposits that were not taxable in the year of receipt, but instead should be included in taxable income in the year the related goods were sold.

In contrast, in Hagen Advertising Displays Inc. v. Commissioner[6], the U.S. Court of Appeals for the Sixth Circuit held that the taxpayer was required to include advance payments related to the sale of goods in gross income in the year of receipt even though the sale was not completed until a subsequent year.

The Hagen court recognized that "inclusion of the entire amount of the advances, without an allowance for related costs of goods sold, would constitute the taxation of the return of capital." Nevertheless, the court held that the full amount of the payment was taxable in the year of receipt without an offset for the cost of the related goods because the taxpayer had failed to make an attempt to estimate to the cost of goods sold that would have related to the advances.

However, it must be emphasized that the court's opinion did not entirely foreclose the notion that a taxpayer should be permitted to accelerate cost of sales related to an advance payment if the taxpayer is required to include the advance payment in gross income prior to the year of sale, and if the taxpayer provides sufficient evidence of the estimated cost of goods sold.

Consistent with this background, several commenters have argued that not providing a cost offset when a taxpayer is required to include an advance payment in income prior to the year of sale would result in the taxation of gross receipts. In response to these comments, the preamble states "[a]n allowance to account for future costs of goods sold, for future estimated costs, or other cost offset is inconsistent with Section 461(h), 471, 263A,[7] and the accompanying regulations."

The preamble further indicates that the TCJA did not change the timing rules for liabilities, but rather only changed the rules for timing of income for advance payments for goods.

Despite declining to provide a special cost-offset rule, the proposed regulations provide an exception for advance payments received for certain goods. Treasury Regulation Section 1.451-8(b)(1)(ii)[8] provides that an advance payment does not include payments received in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery for a specified good.

For this purpose, a specified good is defined as a good for which, during the taxable year, the payment is received, the taxpayer does not have on hand (or available to it through its normal source of supply) goods of a substantially similar kind and in sufficient quantity to satisfy the contract to transfer the good to the customer and all the revenue from the sale of the good is recognized in the taxpayer's financial statements in the year of delivery.[9]

The exception provided by the proposed regulations may have been guided by the decision reached by the U.S. Court of Appeals for the Seventh Circuit in Artnell Co. v. Commissioner.[10] Although this exception may exclude certain payments from the rules now provided for advance payments under Section 451(c), it also raises other questions.

For example, although the specified goods exception provides an exception from the advance payments rules provided by Section 451(c), it is unclear as to whether payments that meet the specified goods exception are also exempt from the application of the so-called all-events test that is now codified in Section 451(b)(1)(C).[11] An accrual method taxpayer generally includes items of income in gross income in the taxable year when all the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[12]

The IRS and the Treasury Department have historically asserted that all the events that fix the right to receive income occur at the earliest of when (1) the required performance takes place, (2) payment is due, or (3) payment is made.[13] Absent further guidance, application of this standard to a payment that is received by a taxpayer that otherwise meets the exception provided for specified goods, would meet the all-events test, requiring the payment to be included in gross income.

Given this interplay between the advance payment rules and the all-events test, the IRS and Treasury Department have questioned whether the secretary has the authority under Section 451(c)(4)(B)(vii) to exclude certain payments from the definition of an advance payment under Section 451(c), and also permit an exception for those payments from the rules regarding the all-events test under Section 451(b).

Although the proposed regulations as drafted do not provide an explicit exception from the application of Section 451(b)(1)(C) — the codification of the all-events test — conceptually it stands to reason that payments that satisfy the exception provided by proposed regulation Section 1.451-8(b)(1)(ii) could be viewed as earnest money or a deposit (i.e., retention of the payment by the taxpayer is conditioned on the taxpayer delivering the contracted for goods).

In fact, one may read cases such as Veenstra & DeHaan Coal as taking this view.[14] Although the payments here may be distinguishable from the characterization of a deposit provided by Commissioner v. Indianapolis Power & Light Co.,[15] the scope of a deposit perhaps should be different for goods and services given the historical difference between the definition of income for services (gross receipts related to services) and goods (gross income being defined as the excess of amount realized over basis).

If it is decided that these types of payments are not generally income upon receipt and, therefore, do not meet the all-events test, there would be no need to provide an exception for these types of payments under Section 451(c) given the definition of advance payments provided by the proposed regulations (i.e., Section 1.451-8 provides, in part, that an advance payment is a payment received by a taxpayer if "the full inclusion of the payment in the gross income of the taxpayer for the taxable year of receipt is a permissible method of accounting”).

The exception presently provided by the proposed regulations for specified goods is narrowly tailored to apply to payments where the taxpayer is obligated to provide the promised goods by a contractual delivery date and where all of the revenue from the sale will only be recognized in the taxpayer's financial statements in the year of delivery. This requirement does not provide any relief to a taxpayer that sells goods pursuant to a contract that does not provide a definite delivery date in the contract.

Additionally, this exception would not apply where the taxpayer's financial statement method of accounting for the sale uses a percentage of completion method that includes amounts in revenue as the taxpayer incurs costs. Further, notwithstanding a statement in the preamble to the proposed regulations that Section 451(c) and the proposed regulations, absent a cost offset rule, "merely change the timing of income recognition," this assertion is questionable when viewed in the light of past precedent.

The IRS and the Treasury Department have scheduled a hearing to address comments to the proposed regulations. However, previous and future written comments with respect to the proposed regulations continue to question whether advance payments for goods without a cost of goods offset results in the proper taxation of gross income as opposed to the improper taxation of gross receipts.

The specified good exception provided by the proposed regulations likely reflects the IRS' and the Treasury Department's attempt to avoid future challenges. As such, the IRS and the Treasury Department should be commended for proposing a rule that would avoid the taxation of gross receipts.

However, as noted above, the IRS and the Treasury Department may want to think about revising the proposed rules so as to recognize that historically payments for goods received in advance of a sale were not conceived of as advance payments, but instead deposits or earnest money provided in anticipation of the actual sale. This resolution would avoid the potential application of the all-events test as now codified in Section 451(b)(1)(C) to specified goods payments.

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[1] Internal Revenue Code Section 451 .

[2] 115 P.L. 97 .

[3] See e.g., Veenstra & DeHaan Coal v. Commissioner , 11 T.C. 964 (1948) acq., 1949-1 C.B. 4. See also CCA 201504011.

[4] See Treas. Reg. § 1.61-3 .

[5] Veenstra & DeHaan Coal v. Commissioner, supra.

[6] Hagen Advertising Displays, Inc. v. Commissioner , 407 F.2d 1105 (6th Cir. 1969).

[7] IRC Sections 461(h) , 471 , 263A.

[8] Prop. Treas. Reg. § 1.451-8(b)(1)(ii).

[9] Prop. Reg. § 1.451-8(b)(9).

[10] Artnell Co. v. Commissioner , 400 F.2d 981 (7th Cir. 1968)(court held that the taxpayer's method of accounting that deferred the recognition of advance payments for tickets to baseball games until the games were played may clearly reflect income where the games were scheduled to be played on specified dates).
[11] Section 451(b)(1)(C) .

[12] Treas. Reg. § 1.451-1.

[13] See e.g., Rev. Rul. 2003-10, 2003-1 C.B. 288.

[14] Veenstra & DeHaan Coal v. Commissioner, supra.

[15] Commissioner v. Indianapolis Power & Light Co. , 493 U.S. 203 (1990).