IRS Final Regulations on Timing of Income Recognition Provide Much-Needed Clarity, But Leave Some Questions Unanswered

Skadden

01 / 08 / 21

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Scott H. Rabinowitz
Counsel / Washington, D.C.
202.371.7335
scott.rabinowitz@skadden.com

David A. Schneider
Counsel / Washington, D.C.
202.371.7830
david.schneider@skadden.com

One Manhattan West
New York, NY 10001
212.735.3000

1440 New York Avenue, N.W.
Washington, D.C. 20005
202.371.7000

On December 21, 2020, the Treasury Department (Treasury) and the IRS released final regulations (Regulations) under Section 451 for determining the taxable year in which an amount must be reported as gross income on the taxpayer's return. The Regulations implement amendments by the Tax Cuts and Jobs Act of 2017 (the TCJA) to Section 451 to:

i. require accrual method taxpayers to report an amount as gross income for tax purposes no later than the taxable year in which the amount is reflected as revenue on their "applicable financial statements" (AFS) — *i.e.*, the "AFS Inclusion" rule of Section 451(b); and

ii. allow accrual method taxpayers to defer, for one year, tax reporting of certain "advance payments" of income to the extent that the amounts are not reported as revenue on the taxpayer's AFS for the taxable year of receipt — *i.e.*, the "Advance Payments Deferral" rule of Section 451(c).

The Regulations provide much-needed clarity on some of the issues raised in the proposed regulations on each of these rules and will impact taxpayers in a wide variety of industries. Further, the Regulations include a number of special rules, limitations and exceptions, some of which are relevant to taxpayers in specific industries. Therefore, every taxpayer should review the Regulations carefully.

Section 451(b) — The AFS Inclusion Rule

One open issue that the Regulations attempt to clarify is the extent to which the AFS Inclusion rule requires the recognition of income items that the tax law otherwise would not consider to have been realized in the taxable year. In the conference report accompanying the TCJA, Congress noted that unrealized income was not intended to be swept into the AFS Inclusion rule. Nonetheless, how precisely this concept would work in many cases was unclear. Realization is a tax law term often applied to the sale of property, but not typically applied to certain types of income like royalties and compensation.

The IRS and Treasury rejected commentators' requests that they define the term "realization" in the Regulations. Rather, the Regulations provide generally that if amounts are reflected as revenue on a taxpayer's AFS for the year, they are required to be included in gross income for tax purposes in that year. However, to reconcile the general rule with the realization requirement, and to give effect to Congress' statement in the conference report, the Regulations generally require taxpayers to reduce AFS revenue by amounts that, based on the terms of the applicable contract (including liquidated damages provisions) and federal, state, local or international law (including equitable principles), the taxpayer would not have had a right to recover if the customer had terminated the contract on the last day of the taxable year. So, for example, AFS revenue that is subject to a condition precedent that has not occurred by the close of the taxable year is "backed out" if the taxpayer, because of the condition precedent, would have no right to the revenue in law or in equity as of the close of the year. This might include, for example, an investment banker's fee that is contractually contingent on a merger or acquisition that has not closed by the end of the year. Identifying amounts that a taxpayer would not be able to recover in law or equity (for example, under a *quantum meruit* theory) may be difficult, burdensome and uncertain for some taxpayers, as the application of this exclusion may require a detailed factual and legal analysis. Accordingly, the Regulations make this rule optional. The "alternative AFS revenue method" permits taxpayers to bypass this rule. In many cases the trade-off for simplicity is that the taxpayer will be reporting more in gross income than otherwise would be required. If the taxpayer chooses to use the alternative AFS revenue method, however, it must do so for all items of income that would be subject to the AFS Inclusion rule in connection with a particular trade or business.

The Regulations provide that the AFS Inclusion rule does not change the treatment of a transaction or the character of an item for federal income tax purposes. For example, the fact that the taxpayer's AFS treat a transaction as a sale (as opposed to a lease) and thus reflect all of the revenue upfront does not mean that that the transaction is *per se* treated as a sale for tax purposes. If the transaction is a lease under tax principles, it will continue to be treated as a lease for tax purposes. Similarly, the Regulations provide that a deposit, return of capital or amount received by the taxpayer acting as a conduit for another person is not gross income for federal income tax purposes even if treated as an item of revenue by a taxpayer's AFS. The IRS can, of course, always point to inconsistent book/tax treatment as evidence supporting a challenge to the taxpayer's tax characterization of a transaction, but the AFS Inclusion rule has no bearing on the question. The Regulations do not provide a bypass for this rule, and these amounts may still necessitate book-tax adjustments.

Another important issue that the Regulations resolve is that, in general, costs cannot be accelerated to offset income that is accelerated under the AFS Inclusion rule. So, for example, the preamble of the Regulations specifically provides that credit card issuers cannot reduce the amount of interchange fees that are otherwise required to be reported under the AFS Inclusion rule by the amount of rebates, reward points, bonus miles or other incentives (if, as of the end of the taxable year, those amounts have not yet satisfied the timing rules of Section 461), even if those items reduce revenue on the taxpayer's financial statements. Similarly, pharmaceutical manufacturers that reduce financial statement revenue by the amount of rebates or chargebacks they anticipate having to pay in connection with that revenue in future years must add those amounts back on their tax returns under the AFS Inclusion rule. Also, taxpayers must add back any amounts that were excluded from financial statement revenue because the amounts were anticipated to be uncollectible.

However, the Regulations do permit a taxpayer that must accelerate the reporting of income from the sale of inventory under the AFS Inclusion rule to reduce the amount of the income inclusion by the cost of goods related to the item of inventory that gave rise to the accelerated income (the "AFS cost offset method"). The costs still have to be incurred during the taxable year under the normal rules of Sections 461 and the inventory and UNICAP rules, *i.e.*, they cannot be projections of costs to be incurred in the future. Thus, most taxpayers will not be able to simply follow books to determine the proper amount of costs for this method. Like the alternative AFS revenue method, the AFS cost offset method is elective. A taxpayer can choose not to apply it if, for example, the method would be too burdensome. Also like the alternative AFS revenue method, the AFS cost offset method, if used, must be used for all items of income eligible for the method in the trade or business.

Section 451(c) — The Advance Payments Deferral Rule

The Regulations clarify that in determining the extent to which an advance payment is not reported in AFS revenue for the year of receipt, the taxpayer must adjust AFS revenue consistent with the Regulations' rules for the AFS Inclusion rule. Thus, for example, if a taxpayer reduces revenue on its financial statements for anticipated rebates, refunds, chargebacks or uncollectible amounts, the taxpayer must add those items back to AFS revenue for purposes of both the AFS Inclusion rule and determining the amount of the advance payment that cannot be deferred under the Advance Payments Deferral rule. Consistent with prior IRS administrative guidance and the proposed regulations, the Regulations provide that any amount of advance payment that is not included in gross income in the year of receipt under the Advance Payments Deferral rule must be included in gross income in the following taxable year.

The Regulations generally do not allow for an offset to AFS revenue in respect of an advance payment in the taxable year of receipt by the amount of anticipated costs associated with that revenue. However, consistent with the Regulations' AFS Inclusion rule provisions, the Regulations' Advance Payment Deferral rule provisions do allow taxpayers to reduce the amount of an advance payment related to the sale of inventory that is recognized in AFS revenue by the cost of goods related to the item of inventory giving rise to the advance payment. Similar rules apply for determining what those costs are. No cost-of-goods offset is allowable, however, in respect of advance payments for the sale of gift cards or customer reward points. As with the AFS cost offset method applicable for purposes of the AFS Inclusion rule, the cost offset method provided in respect of the Advance Payment Deferral rule is an elective method of accounting that, if used by the taxpayer, must be used for all advance payments received by a taxpayer related to a trade or business of selling inventory.