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In this article, Rabinowitz and Schneider explore the details and tax planning implications, advantages, and considerations regarding the "unenforceable rights exception" to the applicable financial statement income inclusion rule provided by section 451(b).

Final section 451 regulations issued by Treasury on December 21, 2020, provide guidance on when an accrual-method taxpayer is required to include an amount in gross income under section 451(b)(1)(A),[1] which the final regulations call the "AFS income inclusion rule." Under this rule, an accrual-method taxpayer is required to report an amount as gross income for tax purposes no later than the tax year in which the amount is reflected as revenue on the taxpayer's applicable financial statements (AFS). The final regulations include an important exception for revenue that is related to rights that are not enforceable by a taxpayer by the end of the tax year (the "unenforceable rights exception"). The application of the unenforceable rights exception is optional, but its use or nonuse are methods of accounting that cannot be changed without the consent of the IRS commissioner. This optionality may provide an opportunity for tax planning given the uncertainty that exists regarding a potential change in tax rates with a new administration. As the regulations are effective for tax years beginning on or after January 1, 2021, taxpayers should develop an understanding of how the unenforceable rights exception applies to their businesses to identify potential opportunities and avoid potential pitfalls.

Taxpayers also have the option to apply the final regulations to earlier tax years (for example, the 2020 tax year), provided that the rules are applied in their entirety and in a consistent manner to all subsequent years.[2]

Background

Under an accrual method of accounting, income is includible in gross income when (1) all events have occurred that fix the right to receive that income and (2) the amount of that income can be determined with reasonable accuracy. Before the enactment of section 451(b)(1)(A), it was generally understood that all events regarding an item of income were met at the earlier of when payment was due, when payment was made, or when the income was earned through performance.[3] Section 451(b)(1)(A) now provides that the all-events test for any item of gross income (or portion thereof) shall not be treated as met any later than when that item is taken into account as revenue in a taxpayer's AFS. As a result, even if payment is not due, payment has not been made, or the income has not been earned by the taxpayer, the taxpayer must generally report an amount as gross income for tax purposes if that amount has been reflected in its AFS for the particular year. The final regulations refer to income required to be reported under section 451(b)(1)(A) as "AFS revenue."

Before the enactment of section 451(b)(1)(A), it was generally understood that section 451 did not address *whether* a taxpayer had income, but only provided *when* a taxpayer was required to account for or include the item of income on a tax return. Instead, whether a taxpayer had income generally depended on whether it had an accession to

[1] Reg. section 1.451-1(a).

[2] Reg. section 1.451-3(n)(3).

[3] Rev. Rul. 2004-52, 2004-1 C.B. 973; Rev. Rul. 80-308, 1980-2 C.B. 162.

wealth that was clearly realized.[4] When Congress amended section 451, lawmakers considered that financial accounting standards may require amounts to be reported as revenue in financial statements even though those amounts have not yet been "clearly realized" for tax purposes. For example, financial accounting standards for revenue (Accounting Standards Codification Topic 606, "Revenue From Contracts With Customers") may require a taxpayer to report amounts as revenue in the taxpayer's financial statements even though the taxpayer does not have an enforceable right regarding that income. Recognizing this conflict, Congress provided in the legislative history underlying the section that it did not intend to "revise the rules associated with when an item is realized for federal income tax purposes and, accordingly, does not require the recognition of income in situations where the federal income tax realization event has not yet occurred."[5]

Unenforceable Rights Exception

To reconcile the realization concept with the intended scope of section 451(b), the final regulations provide that AFS revenue is reduced by amounts that a taxpayer would not have an enforceable right to recover if the customer were to terminate a contract on the last day of the tax year.[6] The regulations define an enforceable right as any right that a taxpayer has under the terms of a contract or under applicable federal, state, or international law, including rights to amounts recoverable in equity and liquidated damages.[7] The regulations also provide that a taxpayer may choose to use the "alternative AFS revenue method," under which its gross income for federal income tax purposes includes amounts that it would not have an enforceable right to recover if the customer were to terminate the contract on the last day of the tax year, if those amounts were reported as revenue in the taxpayer's AFS for the particular tax year.[8] The general rule provides that AFS revenue is reduced by amounts to which the taxpayer does not have an enforceable right. Under the alternative rule, AFS revenue is not reduced, but rather includes revenue to which the taxpayer does not have an enforceable right, provided that the unenforceable revenue is included in AFS (book) revenue. A taxpayer that uses the alternative AFS revenue method for a trade or business is required to apply the method to all items of gross income in the trade or business that are subject to the AFS income inclusion rule.[9]

Also, reg. section 1.451-3(g) generally provides 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, a transaction that is a lease or license for federal income tax purposes must continue to be treated as a lease or license for that purpose, even if the transaction is treated as a sale or financing for AFS purposes, or vice versa.[10] As another example, a transaction or instrument that is not required to be marked to market for federal income tax purposes is not required to be marked to market for that purpose even if it is marked to market for AFS purposes.[11] Also, a deposit, return of capital, or conduit payment that is not gross income for federal income tax purposes should not be included in gross income even if that item is reported as revenue on the taxpayer's AFS.[12]

Some Key Takeaways

- The AFS income inclusion rule generally requires taxpayers to exclude from AFS revenue amounts that they do not have an enforceable right to collect at the end of the tax year. However, the application of this rule requires a detailed understanding of the facts of the transaction resulting in the revenue, as well as a comparison of the AFS standard used to report that revenue and a legal analysis of whether the taxpayer has an

[4] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

[5] H.R. Rep. No. 115-466, at 428 n.872 (2017).

[6] Reg. section 1.451-3(c)(2)(i)(B).

[7] Reg. section 1.451-3(b)(9).

[8] Reg. section 1.451-3(c)(2)(ii).

[9] *Id*.

[10] Reg. section 1.451-3(g)(1).

[11] Reg. section 1.451-3(g)(2).

[12] Reg. section 1.451-3(g)(6).

unenforceable right to that revenue (taking into account potential equitable recoveries).

- Understanding that the above rule may be administratively burdensome, the regulations allow a taxpayer to use the alternative AFS revenue method, which permits a taxpayer to avoid the detailed fact-finding and analysis required by the rule. However, the application of the alternative AFS revenue method comes at a cost, as it requires a taxpayer to include in gross income amounts to which it as yet has no legal or equitable right. Moreover, use of the alternative AFS revenue method by a taxpayer requires it to include all amounts in AFS revenue that would otherwise be excluded under the general rule (that is, amounts to which the taxpayer does not have an enforceable right by the end of the tax year) for each trade or business that uses the method. Lastly, the use of the general AFS income inclusion rule or the alternative AFS revenue method are methods of accounting and can only be changed with the consent of the commissioner.[13]
- As the regulations were only recently issued, it is unclear how the AFS inclusion rule, the alternative AFS revenue method, and the rule provided by reg. section 1.451-3(g) of the regulations (that is, that the AFS inclusion rule does not affect the treatment or character of a transaction) will interact. Therefore, whether a taxpayer using the alternative AFS revenue method is permitted to follow its AFS (book) method for federal income tax purposes irrespective of the proper treatment or characterization of the transaction for federal income tax purposes is uncertain. For example, would the alternative AFS revenue method permit a taxpayer to include amounts in gross income for federal income tax that have been included in AFS revenue based on its AFS treating a transaction as a sale where the transaction for federal income tax purposes should be treated as a lease? Presumably not, but the regulations are unclear on this point. Similarly, if reg. section 1.451-3(g) applies, is the taxpayer still required to apply the unenforceable rights exception to reduce its AFS revenue by the amount to which it has no enforceable right by year-end? For example, if the taxpayer treats a transaction as a sale for financial accounting purposes, but as a lease for tax purposes, and the tax law supports the treatment of the transaction as a lease, must the taxpayer nonetheless substantiate that it has no enforceable right to the full contract price if its AFS reflects the full contract price in revenue in the year in which the transaction is entered into, or is that taken as a given?
- The unenforceable rights exception may not extend to all amounts included in AFS revenue to which a taxpayer does not have an enforceable right, although there is no discernable tax policy reason why it should not. The unenforceable rights exception applies to amounts that a taxpayer would not have an enforceable right to recover if its *customer* were to terminate a contract on the last day of the tax year. However, the regulations are unclear whether the unenforceable rights exception would apply to amounts that a taxpayer has included in AFS revenue that it anticipates receiving from someone other than a customer, such as a vendor (for example, a purchase price adjustment or rebate) or the government (for example, a state tax refund), but to which the taxpayer does not have an enforceable right to by the end of the tax year. Logic would seem to dictate that the exception should apply to these amounts as well.
- The final regulations are effective for a taxpayer's tax years beginning after January 1, 2021. Given the detailed analysis required to properly apply the rules, taxpayers should now take the time to properly understand the rules provided by the final regulations, the facts surrounding transactions that result in amounts being included in AFS revenue, the extent to which those amounts are not enforceable in law or equity at year-end, and whether the

[13] Reg. section 1.451-3(c)(m)(1).

use of the general AFS inclusion rule or the alternative AFS revenue method is preferable.

- As of the date of this article, the corporate tax rate for tax years beginning on or after January 1, 2020, and January 1, 2021, is generally 21 percent. However, the Biden administration has previously proposed increasing the rate to 28 percent, and there is even some thought that the Biden proposal, if enacted, would be applied retroactively to increase the rate for the tax year beginning on or after January 1, 2021. As noted above, the regulations provide for optionality regarding the unenforceable rights exception in that taxpayers may elect to use the AFS revenue method, which allows a taxpayer to include in gross income amounts that have been included in revenue in its AFS but for which it does not have an enforceable right. Moreover, the regulations allow for early adoption of this rule (for example, the 2020 tax year) provided that a taxpayer also applies the other rules provided by the final regulations. The acceleration of income that may result from the application of the AFS revenue method may present an opportunity for taxpayers to include amounts in gross income for tax years subject to a 21 percent tax rate, as opposed to a later tax year in which the corporate tax rate could be increased to 28 percent. ■