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In this article, Rabinowitz and Schneider examine Congress's purpose in enacting the applicable financial statements income inclusion rule under section 451(b), and they explain the need for amended regulations or published guidance.

Final regulations issued December 21, 2020, provide guidance for when taxpayers must include an amount in gross income under section 451(b)(1)(A).[1] Under this rule, an accrual-method taxpayer generally must report an amount in 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). This AFS income inclusion rule effectively accelerates the inclusion in gross income of amounts that don't satisfy the all-events test of section 451 by the close of the tax year (because thus far either the taxpayer has no fixed right to receive the amount or the amount isn't determinable with reasonable accuracy).

The final regulations include an important exception to the AFS income inclusion rule for amounts that the taxpayer wouldn't have an enforceable right to recover if the customer were to terminate the contract on the last day of the tax year (the unenforceable rights exception, or URE).

The URE attempts to implement limitations on the AFS income inclusion rule that Congress expressly provided for in the legislative history of section 451(b)(1)(A). But by limiting the URE to amounts the taxpayer may receive from a customer, the regulations fail to give effect to the full scope of the limitations that Congress intended. This problem is likely to affect many taxpayers across a broad range of industries because, eventually, generally accepted accounting principles will undoubtedly require them to report some non-customer-related item of revenue on their AFS for the year that isn't yet fixed and determinable for tax purposes.

The Whether and When of Income

Section 451 is a timing-of-income provision. It isn't a provision of the code that governs whether an amount is income in the first place; other code sections address that element. However, the AFS income inclusion rule has the potential for blurring the line between whether an amount is includable in gross income and when it is. Thus, to properly understand this issue, a brief review of the fundamentals of gross income is in order.

Section 61 provides that, except as otherwise provided in the code, "gross income means all income from whatever source derived," including specific items enumerated in the statute. Although the statute itself doesn't mention any need for an item to first be "realized" before it can be

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

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considered income, the Supreme Court long ago set forth in *Glenshaw Glass* the standard that gross income encompasses any "undeniable accession to wealth, *clearly realized*, and over which taxpayers have complete dominion."[2] Decades later, in *Indianapolis Power*, the Court held that the key to determining whether a taxpayer has complete dominion over a given sum isn't whether the taxpayer has unconstrained use of the funds during the tax year in question, but whether the taxpayer "has some guarantee that he will be allowed to keep the money."[3]

Glenshaw Glass is said to have signaled the beginning of the Court's retreat from its earlier statements in *Macomber* that the realization requirement is grounded in the 16th Amendment, which was adopted to give Congress the power to levy income taxes that wouldn't be considered "direct" taxes that must be apportioned among the states.[4] *Horst* is sometimes cited as evidence that the Supreme Court abandoned the notion that realization was a constitutional prerequisite for taxable income under the 16th Amendment. There the Court described "the rule that income is not taxable until realized" as "founded on administrative convenience."[5]

The debate about the need for realization of income from a constitutional standpoint is ongoing, most notably in relation to various proposals for Congress to enact a wealth tax on the appreciation of property held by some high-income taxpayers, when the taxpayer still owns the property as of the close of the tax year.[6] The proposals are intended to impose a wealth tax that would be just another type of income tax, which wouldn't need to be apportioned among the states under the 16th Amendment.

We need not, however, resolve the constitutional debate here, because it seems clear that the realization requirement still exists as a fundamental element of gross income under section 61. The regulations under section 61, for example, provide that "gross income includes income *realized* in any form, whether in money, property, or services."[7] By its nature, the realization requirement is a question of timing. That is, at its core, realization is really about when a taxpayer has income. But unlike the myriad timing-of-income rules in the code and Treasury regulations — including section 451 — the temporal concept of clear realization of an accession to wealth has, for decades, been baked into the very definition of gross income itself and thus is also relevant to whether an item is gross income at all. As discussed below, Congress specifically stated that by enacting section 451(b)'s AFS income inclusion rule, it didn't intend to abandon the realization requirement.

It is well established that income can be clearly realized in many ways besides just the receipt of cash as compensation for labor or the proceeds of the sale of property. The Supreme Court embellished the concept of clear realization in *Horst*, in which it held that a taxpayer using the cash receipts and disbursements method of accounting must report as gross income the interest payable on bonds that the taxpayer owned, even though that taxpayer gifted the interest coupons to his son before the date the interest was due. In *Horst,* the Court reasoned that the father realized the interest income at the time he gave the coupons to his son because, by that act, the father controlled the disposition of amounts that he later could have received (but

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

[3] *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 210 (1990).

[4] *Eisner v. Macomber*, 252 U.S. 189 (1920) (emphasis added). In *Macomber,* the Court held that the taxpayer wasn't taxable upon receipt of a common-on-common stock dividend, reasoning that the pro rata dividend of additional shares of the same stock that the taxpayer already owned wasn't income within the meaning of the taxing statute.

[5] *Helvering v. Horst*, 311 U.S. 112, 116 (1940); *see also Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991). Other cases that have considered the constitutionality of code provisions that have "deemed" a realization event to have occurred include *Moore v. United States*, No. 2:19-cv-01539 (W.D. Wash. 2020) (one-time repatriation tax imposed under section 965 is a constitutional tax on income); and *Eder v. Commissioner*, 138 F.2d 27, 29 (2d Cir. 1943) (amounts a foreign corporation was prohibited by foreign law from distributing nonetheless were income to the shareholder under the foreign personal holding company rules).

[6] *See, e.g.,* David B. Rivkin Jr. and Andrew M. Grossman, "Can Congress Tax Wealth by 'Deeming' It Income?" *The Wall Street Journal*, Sept. 1, 2021; and Calvin H. Johnson, "A Wealth Tax Is Constitutional," 38 *ABA Tax Times* (Summer 2019); *see also* Mark E. Berg, "Bar the Exit (Tax)!: Section 877A, the Constitutional Prohibition Against Unapportioned Direct Taxes and the Realization Requirement," 65 *Tax Law.* 181 (2012).

[7] Reg. section 1.61-1(a).

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never actually did receive) himself.[8] The Court stated that:

> The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment and hence the realization of income by him who exercises it.[9]

Similarly, in *Murphy*, the Ninth Circuit rejected a cash-method taxpayer's assertion that section 1256 was unconstitutional because it taxed him currently on gains from commodities futures contracts that he asserted he had not yet realized, given that he still held the positions at year-end.[10] The court found, however, that the taxpayer had the right to withdraw cash equal to the gains from his futures account every day, thus giving him constructive receipt of the net gains accruing to his account on the last day of his tax year. As the court noted, constructive receipt is one way of realizing an accession to wealth.

Charles Murphy was an individual presumably using the cash receipts and disbursements method of accounting. Constructive receipt, however, is a doctrine that applies equally to accrual-method taxpayers.[11] Thus, when an accrual-method taxpayer has the right to withdraw gains and profits at year-end without having to dispose of the underlying investment but chooses not to, the court's reasoning in *Murphy* should apply to consider those gains and profits "clearly realized."

More difficult to rationalize with the requirement for clearly realized accessions to wealth is section 475. Like gains under section 1256, gains under section 475 don't stem from actual sales or disposition of securities, but rather from hypothetical sales or dispositions at year-end. Moreover, it is hard to rationalize section 475 with the requirement under section 61 that the taxpayer have complete dominion over its accession to wealth given that, to paraphrase the Supreme Court in *Indianapolis Power*, the taxpayer has no guarantee whatsoever that it will be allowed to keep the gain it is treated as realizing because that gain could evaporate the next day. Marked-to-market gains under section 475 would therefore seem to be the antithesis of clearly realized accessions to wealth.

Further, unlike section 1256, the validity of section 475 cannot be justified on constructive receipt grounds. Thus, *Murphy* is no help in defending section 475. The mark-to-market regime of section 475 is a stark example of Congress's deeming realization of income to have occurred.[12] Other examples include section 877A, which treats all property of an expatriate citizen or former lawful permanent resident as having been sold; section 1259(c), which treats some taxpayers as having sold an appreciated financial position; and the original issue discount rules.

One theory for harmonizing section 475 with the requirement for clearly realized accessions to wealth under section 61 is that section 475 is a method of accounting that, in the long run, won't have the effect of taxing the taxpayer on anything more than the amount of the accession to wealth that the taxpayer eventually would "clearly realize" in the absence of section 475 — for example, under section 1001.[13]

Through a combination of the requirement to recognize hypothetical year-end gains and losses and corresponding adjustments to the basis of the underlying security, section 475 ensures that, by the time the taxpayer disposes of the security, it will have been taxed on no more than the amount of gain that it ultimately "clearly realized." Thus, it can be argued that if the mark-to-market rules of section 475 violate any established tenet of federal income tax law, it isn't the realization requirement, but rather the concept of annual accounting that, unlike the realization

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[8] *Horst*, 311 U.S. at 117.

[9] *Id*. at 118.

[10] *Murphy v. United States*, 992 F.2d 929 (9th Cir. 1993).

[11] *See generally* Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, para. 105.3, n.27.

[12] *See* Joint Committee on Taxation, "General Explanation of Public Law 115-97," JCS-1-18, at 149 (Dec. 2018) (describing current law in connection with the amendment to section 451 as including provisions, such as the mark-to-market rules, when "Congress has prescribed the time at which realization is deemed to occur by requiring taxpayers, or allowing taxpayers to elect, to include in gross income amounts that may otherwise be unrealized income or gain").

[13] A method of accounting is the consistent practice of reporting an item of gross income (or deduction) such that a change from the current way of reporting to a different way of reporting would affect only the timing (not the ultimate amount) of the taxpayer's lifetime taxable income. *See* reg. section 1.446-1(a) and (e); Rev. Proc. 2015-13, 2015-5 IRB 419, section 2.01.

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requirement, has no potential constitutional baggage.[14]

To be sure, whether a taxpayer has realized gross income in a specific year is partly a function of the taxpayer's method of accounting. An accrual-method service provider, for example, will generally realize gross income, at the latest, in the year in which it performs the services for which the income is earned, even if the compensation isn't paid until a later tax year, whereas a cash-method taxpayer in the same position won't be treated as realizing gross income until the later year of payment.

The danger of relying too heavily on an accounting method rationale to satisfy the realization requirement of section 61 is that it invites the tail to wag the dog. Literally anything could be considered a "clearly realized" accession to wealth during a specific tax year — no matter how conditional, fleeting, or ephemeral — as long as the taxpayer is eventually permitted under the tax law to correct any overinclusion of deemed income through a corresponding loss or deduction in some later tax year.[15]

Another theory in support of the notion that section 475 doesn't violate the realization requirement is that a taxpayer realizes gains and losses, in satisfaction of section 61, as soon as there is a single penny of variation between the taxpayer's cost basis and the value of that property. The notion is that it is simply a matter of administrative convenience that Congress generally chooses to allow taxpayers to defer recognition of such gains and losses until the property is sold or exchanged under section 1001.

That brings us to section 451, which states clearly in subsection (a) that "the amount of any item of gross income shall be included in the gross income for the taxable 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 as of a different period." Congress's use of the term "gross income" twice in the same sentence is confusing at first, but it can be explained by the rationale that one must first have an "item of gross income" (that is, an accession to wealth, clearly realized, within the meaning of section 61) before being required to determine under section 451 in what tax year that item of gross income must be included in gross income (that is, reported on a tax return).

Section 451, therefore, isn't a provision that addresses whether gross income is realized, but rather a provision that addresses when gross income that has been realized has to be recognized. Congress acknowledged as much in the general explanation of the Tax Cuts and Jobs Act discussion of the amendment to section 451(b):

> Once it is determined that gross income is clearly realized for Federal income tax purposes, section 451 and the regulations thereunder provide the general rules as to the timing of when sales, gross receipts, and other items of income are recognized by including such items in gross income under the taxpayer's method of accounting.[16]

The all-events test — historically the product of judicial interpretation of section 451 or its predecessors and now codified in section 451(b) by the TCJA — has never functioned exclusively within this whether-first-when-second framework. Under the all-events test for income, an item of income must be included in gross income in the earliest tax year in which the taxpayer has a fixed right to receive the item, and the amount of that item can be determined with reasonable accuracy.[17] Thus, under that test, amounts to which the taxpayer's right is subject to a condition precedent as of the close of the tax

[14] *See generally Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931). *Sanford & Brooks* is widely recognized as the premier case upholding the concept of annual accounting in federal income tax law. The Court in that case didn't say that annual accounting was required by the 16th Amendment; rather, it rejected the taxpayer's argument in the case that the 16th Amendment prohibited anything other than the taxation of gains and profits on a transactional basis.

[15] Further, the method of accounting theory doesn't provide a rationale for all the code's "deemed realization" provisions. For example, if section 877A weren't in the code, an expatriate's built-in gains would escape U.S. tax entirely.

[16] JCS-1-18, *supra* note 12, at 151.

[17] Reg. section 1.451-2(a); reg. section 1.446-1(c)(1)(ii)(A).

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year aren't included in the taxpayer's gross income for that year.[18]

Those amounts also can be said not to have been "realized" in that tax year because of the condition precedent.[19] Indeed, the Court in *Horst* described the concept of realization in terms that sound remarkably like the fixed right prong of the all-events test when it said, "Realization may occur when the last step is taken by which [the taxpayer] obtains the fruition of the economic gain which has already accrued to him."[20] Thus, it is a mistake to think of the all-events test — stalwart feature of section 451 though it is — as coming into play only after the requirement of section 61 that the taxpayer have clearly realized an accession to wealth has first been satisfied.

All of this demonstrates that there sometimes is a nebulous line between whether and when an amount is income. As discussed below, the text of section 451(b) skates dangerously close to that nebulous line. But at its core, section 451 is a timing provision, not a provision like section 61 that purports to define whether something is income in the first place. Further, Congress stated in the legislative history of section 451(b) that it didn't intend to abandon the realization requirement. Therefore, wherever that nebulous line is, Congress indicated that it didn't intend for the AFS income inclusion rule to cross it.

Nevertheless, by narrowly limiting the URE (which is clearly supposed to preserve the realization requirement according to Congress's stated intent) to amounts to be received from customers, the regulations (without more guidance) present a significant risk that IRS examiners will assert that many items that aren't yet clearly realized by the close of the taxpayer's tax year fall on the wrong side of the line.

Section 451(b)(1)(A)

The text of section 451(b)(1)(A) is straightforward:

> In the case of a taxpayer the taxable income of which is computed under an accrual method of accounting, the all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in . . . an applicable financial statement of the taxpayer, or . . . such other financial statement as the Secretary may specify for purposes of this subsection.

Section 451(b) goes on to: (1) after many decades, codify the all-events test; (2) carve out items of gross income to which a "special" method of accounting under the code applies (such as the installment sale method under section 453 and the long-term contracts methods under section 460), as well as income in connection with mortgage servicing contracts; (3) define the term "applicable financial statements"; (4) provide rules for allocating a transaction price in the case of multiple performance obligations; and (5) clarify that an AFS covering a group of entities nonetheless will be treated as an AFS of each specific taxpayer in the group. Apart from couching the AFS income inclusion rule in terms of "any item of gross income," section 451(b) contains little to reinforce the notion that before the AFS income inclusion rule can apply to an item, that item first must in fact *be* income under section 61 — that is, an accession to wealth that has been clearly realized.

Yet that appears to be how Congress meant for the statute to work. In the committee report accompanying the enactment of section 451(b)(1)(A), Congress stated:

> The provision does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, doesn't require the recognition of income in situations in which the Federal income tax realization event hasn't yet occurred.[21]

As an example, the committee report states that the AFS income inclusion rule isn't intended

[18] *See, e.g., Thompson v. Commissioner*, 489 F.2d 288, 292 (4th Cir. 1974); *United States v. Harmon*, 205 F.2d 919 (10th Cir. 1953); *Alexander H. Kerr & Co. v. United States*, 97 F. Supp. 796 (S.D. Cal. 1951); *Charles Schwab Corp. v. Commissioner*, 107 T.C. 282 (1996).

[19] *Connell Brothers Co.*, B.T.A. Memo. 1940-55.

[20] *Horst*, 311 U.S. at 115.

[21] JCS-1-18, *supra* note 12, at 165.

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to require taxpayers to report marked-to-market gains in connection with securities if they aren't otherwise required by the code to use that method.[22] Rather, those taxpayers must continue to report gains regarding a security only in the tax year in which they sell or dispose of the security.[23]

The report goes on to state that "the Committee intends that the provision apply to items of gross income for which the timing of income inclusion is determined using the all-events test of present law."[24] Before the enactment of section 451(b)(1)(A), it was generally understood that an all-events test regarding an item of income was met at the earlier of when payment was due, payment was made, or the income was earned by the taxpayer through performance.[25] Further, the tax law was generally settled that an accrual-method taxpayer has no fixed right to any compensation for services (other than for so-called divisible services) until the taxpayer has fully performed all required services under the contract.[26] According to the committee report, Congress had two types of income in mind, shown by the examples it cited: (1) unbilled receivables for partially performed, non-severable services; and (2) income (including OID) from debt instruments.[27] Treasury and the IRS took the position in the proposed regulations under section 451(b)(1)(A) that unbilled receivables included receivables for both goods and services.[28]

Congress mentioned no other type of income to which it intended the AFS income inclusion rule to apply. That fact, together with Congress's explicit statement that the AFS income inclusion rule isn't intended to revise the realization requirement of section 61, leads inevitably to the question of how far the scope of the AFS income inclusion rule really extends.

The Proposed Regulations

Treasury and the IRS issued proposed regulations under section 451(b) in September 2019. The preamble to the proposed regulations acknowledged and discussed comments that had raised concerns about the interaction between section 61 (and section 461) and the AFS income inclusion rule. Commentators noted that a taxpayer may report an item as revenue on its AFS even though the item is contingent on the occurrence or nonoccurrence of some future event.

In response, Treasury and the IRS noted that the AFS income inclusion rule "was intended to change only the timing of income to ensure that those items of income are not included later than when they are included for AFS purposes."[29] The proposed regulations contained a rule that was therefore intended to give full effect to the limitations that Congress specified regarding the scope of section 451(b)(1)(A). The proposed regulations would have provided that the "transaction price" that was to be used to determine whether an amount has been included in AFS revenue doesn't include items to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event, reductions for amounts subject to section 461 (including allowances, rebates, chargebacks, refunds, rewards, and amounts included in the

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[22] *Id.*; *see also* H.R. Rep. No. 115-466, 428, n.872 (2017).

[23] *Id.* As a further example, the committee report states that income from investments in corporations or partnerships that are accounted for under the equity method for financial reporting purposes will not result in the recognition of income for federal income tax purposes until the realization event occurs — *e.g.*, when the taxpayer receives a dividend from the corporation in which it owns less than a controlling interest or when the taxpayer receives its allocable share of income, deductions, gains, and losses on its Schedule K-1 from a partnership.

[24] H.R. Rep. No. 115-466, at n.874.

[25] *See, e.g.*, Rev. Rul. 2004-52, 2004-1 C.B. 973; Rev. Rul. 80-308, 1980-2 C.B. 162.

[26] *See, e.g.*, *Decision Inc. v. Commissioner*, 47 T.C. 58 (1966) (holding that income doesn't accrue upon partial performance of a contract before an agreed billing or payment date); *cf.*, Rev. Rul. 79-195, 1979-1 C.B. 177 (ruling that a correspondence school has a fixed right to receive a tuition payment for a lesson when the student completes the lesson, even though the student is enrolled in courses under which lessons will be given over 36 months; under the terms of the contract, the school's right to receive the payment was conditioned on the school's rendering educational instruction services on a lesson-by-lesson basis).

[27] JCS-1-18, *supra* note 12, at 162 (taxpayer provides construction services for $100,000 on a two-year project, begins providing services in year 1, and completes work in year 2; taxpayer is entitled to bill customer for $50,000 in year 1 but includes $60,000 in AFS revenue in year 1; taxpayer's income is accelerated in year 1 (by $10,000) by the modification to section 451(b)).

[28] Prop. reg. section 1.451-3 (preamble); REG-104870-18, 84 F.R. 47191, 47193 (Sept. 9, 2019) (reasoning that "there is no distinction in section 451(b) between unbilled receivables for services and unbilled receivables for the sale of goods, and service providers and sellers of goods that are including unbilled receivables in revenue for AFS purposes should be treated similarly for Federal income tax purposes").

[29] *Id.*

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cost of goods sold), and amounts collected on behalf of third parties.[30]

However, the proposed regulations would have created a presumption that an amount included in the transaction price for AFS purposes isn't contingent future income unless, on examination of all the facts and circumstances existing at the end of the tax year, it can be established to the satisfaction of the commissioner that the amount is contingent on the occurrence or nonoccurrence of a future event. The IRS and Treasury explained that this presumption was included "in order to reduce compliance burden and prevent abuse and undue administrative burden."[31]

At the same time, the proposed regulations would have provided that "an amount included in the transaction price for AFS purposes that is actually or constructively received, that is due and payable, *or for which the taxpayer has an enforceable right to payment for performance completed to date* . . . will not be treated as contingent on the occurrence or nonoccurrence of a future event."[32] The preamble to the proposed regulations makes clear that an enforceable right for those purposes could be equitable, contractual, or otherwise.[33] Thus, at least regarding income items stemming from some performance obligation of the taxpayer, the proposed regulations would have applied the AFS income inclusion rule when the taxpayer could have sued to recover partial payment based on the taxpayer's partial performance at the close of the tax year.

Thus, the exception to the AFS income inclusion rule in the proposed regulations wasn't limited to any specific type of income or contract. A condition precedent regarding any type of potential income, not just receivables from customers, presumably would have been given effect to exempt the item from the AFS income inclusion rule, although it would have been the taxpayer's burden of proof to show that the item truly was contingent.

The URE

The final regulations didn't include the "transaction price" rule that was in the proposed regulations. Rather, the URE in the final regulations under section 451(b) relies on the concept of an unenforceable right in an apparent attempt to walk the line between the book-tax conformity requirement of the AFS income inclusion rule and section 61's requirement for clearly realized accession to wealth, but only regarding amounts from customers. The URE (reg. section 1.451-3(b)(2)(i)(B)) provides that, unless the taxpayer elects otherwise, AFS revenue is reduced by an amount that the taxpayer doesn't have an enforceable right to recover if the customer were to terminate the contract on the last day of the tax year (regardless of whether the customer actually terminates the contract). The regulations make clear that the determination of whether the taxpayer has an enforceable right to recover amounts of AFS revenue is governed by the terms of the contract and applicable federal, state, or international law and includes amounts recoverable in equity and liquidated damages.[34]

The AFS income inclusion rule is supposed to capture amounts to which the taxpayer, at the close of the tax year, has a right under equitable principles such as *quantum meruit.* The URE thus exempts from the AFS income inclusion rule customer-based amounts to which the taxpayer has neither a legal nor an equitable right at the close of the tax year. Phrasing the URE in terms of amounts from customers therefore preserves the clear realization requirement of section 61 for the unbilled receivables that Congress said it intended the AFS income inclusion rule to apply to in the legislative history.

[30] Prop. reg. section 1.451-3(c)(6)(ii). The proposed rule would have provided that the term "transaction price" doesn't include increases in consideration to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event (for example, bonuses contingent on performance and insurance contract commissions contingent on renewal) for the period in which the amount is contingent. The rule's reference to "increases in consideration" was odd because it raised the question whether an amount would be exempted from the AFS income inclusion rule only if it was part of a larger amount of consideration, at least some of which wasn't contingent. Treasury and the IRS noted in the preamble to the final regulations that commentators had expressed confusion about the use of this phrasing. However, because the final regulations ultimately didn't adopt the proposed regulations' rule, Treasury and the IRS didn't address the point definitively.

[31] 84 F.R. at 47193.

[32] *Id*. (emphasis added).

[33] *Id.*

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

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If the taxpayer doesn't have, at the close of the tax year, an enforceable right in law or equity to compensation for partially performed services (for example, because some agreed-upon, still unsatisfied condition precedent exists), the taxpayer won't be required to report the amount in gross income for that year under the AFS income inclusion rule. The problem is that although unbilled receivables are the only type of income that Congress specifically said it was targeting (other than income in connection with debt instruments), the statute is drafted broadly enough to apply to all types of potential income except those that it specifically carves out (for example, income in connection with mortgage servicing rights).

For example, suppose Corp. A, which issues an AFS, files in year 3 a claim for a refund of state income taxes that it paid for year 1 (and that it fully deducted on its federal income tax return for year 1). Suppose further that although Corp. A feels confident that its claim is meritorious, at the end of year 3 the state hasn't yet processed the refund claim, much less conceded Corp. A's right to it. GAAP may well require Corp. A to report revenue on its AFS for year 3 in connection with the refund claim, even though the tax law would have recognized the state's approval of the refund as a condition precedent to Corp. A's right to receive the refund that causes the all-events test (without regard to section 451(b)) not to be met by the close of year 3.[35] Further, has Corp. A, at the close of year 3, clearly realized an accession to wealth by that date? Surely not, because the "last step . . . taken by which [the taxpayer] obtains the fruition of the economic gain"[36] hasn't yet occurred.

As another example, suppose Corp. B, which issues AFS, purchases and receives goods from its supplier in year 1 and discovers that some of the goods are defective or damaged. Corp. B notifies its supplier of the issue, but the supplier initially disputes any liability, and the issue is unresolved by the end of year 1. Again, GAAP might require Corp. B, which at the end of year 1 feels confident about the merits of its claim, to reflect the amount of the expected refund from the supplier on Corp. B's AFS for year 1. However, for federal income tax purposes, the all-events test (without regard to section 451(b)) wouldn't be met by the end of year 1.[37] And, as with the first example, Corp. B wouldn't seem to have clearly realized an accession to wealth by the close of year 1.

The URE cannot help Corp. A or Corp. B out of its fix. The state that is auditing Corp. A is not a "customer" of Corp. A in the ordinary sense of that term.[38] Similarly, Corp. B is the customer of its supplier, not the other way around. Thus, if things are left as they are now, Corp. A and B would appear to have an uphill battle ahead of them in arguing for excluding from gross income for tax purposes the amounts that they reported as revenue on their AFS.

The final regulations give them no such exclusion, leaving them perhaps no alternative but to argue that reg. section 1.451-3 is arbitrary and capricious for failing to give full effect to the intent of Congress. To be successful, Corp. A and B would first have to persuade a court to look beyond the plain language of the statute to its legislative history. Perhaps the statute's use of the word "income" would be the foot in the door that the court would need to do so, but there is no guarantee that a court would agree that the use of that term in section 451(b)(1)(A) makes the statute's text sufficiently ambiguous to warrant consideration of the statute's legislative history.

[35] *Doyle, Dane, Bernbach Inc. v. Commissioner*, 79 T.C. 101 (1982), *nonacq.*, 1988-2 C.B. 1, *nonacq. withdrawn and acq. substituted*, 2003-2 IRB 251; Rev. Rul. 2003-3, 2003-1 C.B. 252 (stating IRS's earlier non-acquiescence in *Doyle, Dane* was predicated on the conclusion that approval by the state of the refund claim was ministerial in nature; the IRS later concluded that state review is substantive).

[36] *Horst*, 311 U.S. at 115.

[37] *See, e.g.*, Rev. Rul. 2003-10, 2003-1 C.B. 288 (manufacturer and wholesaler that ships goods in tax year 1 does not accrue income in tax year 1 to the extent that the customer disputes the charge and the parties don't resolve the dispute until tax year 2).

[38] The term "customer" isn't defined in reg. section 1.451-3, nor do Treasury and the IRS discuss the meaning in the regulation's preamble. Indeed, the term is used almost 50 times in the code and several hundred times in the Treasury regulations, and rarely is a specific definition given. This suggests that Congress (and Treasury and the IRS in the case of regulations) intended that the term be given meaning consistent with its dictionary definition, which is "a person who purchases goods or services from another; buyer, patron." In the rare cases when the term "customer" is specifically defined in the code, the definition has been consistent with that commonly understood meaning. *See, e.g.*, section 954(h)(5)(A) ("The term 'customer' means, with respect to any controlled foreign corporation or qualified business unit, any person which has a customer relationship with such corporation or unit and which is acting in its capacity as such."); section 6045(c)(2) ("The term 'customer' means any person for whom the broker has transacted any business.").

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Paths Forward

In explaining its enactment of section 451(b)(1)(A), Congress clearly indicated it wasn't attempting to change the rules for whether an amount was included in gross income — only the rules for when it is.[39] Yet the text of section 451(b)(1)(A), apart from a single reference to the word "income," provides no meaningful restriction on the broad literal scope of the AFS income inclusion rule. It is up to Treasury and the IRS to effectively bridge this gap, and the URE, being limited to amounts to be received from customers, simply doesn't do it.

That leaves two obvious options. The first is to amend the final regulations to eliminate the reference to customers in the URE. That is, the regulations could be amended to provide simply that "AFS revenue is reduced by an amount the taxpayer does not have an enforceable right (in law or in equity) to recover on the last day of the taxable year." The second is for the IRS and Treasury to exercise the authority that they reserved in reg. section 1.451-3(b)(2)(i)(D) to provide by published guidance in the Internal Revenue Bulletin for other increases or decreases to AFS revenue.

The latter approach would give the IRS and Treasury the ability to scrutinize specific types of income individually and thus to except them from the AFS income inclusion rule in a more surgical fashion. Further, issuing nonregulatory guidance is often less involved than amending a regulation. The downside of that approach, however, is that the resources of the IRS and Treasury historically have always been limited, and a piecemeal approach to resolving this issue would result in confusion for taxpayers and IRS examiners for a potentially much longer period. Thus, the best approach would be to amend the regulations.

Conclusion

Section 451(b)'s AFS income inclusion rule is Congress's attempt to narrow the gap between tax accounting and financial accounting for income. In essence, it borrows on GAAP to fashion a tax rule for *when* something must be included in gross income. But, by Congress's own admission, it doesn't change the rules for whether something is income in the first place. Congress in the TCJA made no amendment to section 61, which, as interpreted by the courts, the IRS, and Treasury, still requires that an accession to wealth be clearly realized. When a condition precedent exists to a taxpayer's right to an accession to wealth, the whether and when of income overlap, and neither is satisfied until the condition is satisfied. There may be many incidents of potential income that are subject to a condition precedent that the taxpayer is confident enough will occur to reflect the amount in revenue on an AFS, but that is sufficiently doubtful to occur as to be more than "ministerial" and thus fail both the fixed right prong of section 451 and the clear reflection requirement of section 61. The URE doesn't go far enough in ensuring that potential income (other than income from customers) that is subject to a condition precedent isn't swept into taxable income too early. ■

[39] H.R. Rep. No. 115-466, at 428 (Section 451(b)(1)(A) "revises the rules associated with the timing of the recognition of income.").

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