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Proposed Income Recognition Regulations Provide Clarity for Accrual Method Taxpayers

On September 5, 2019, the IRS and Treasury released proposed regulations addressing the timing of income recognition for accrual method taxpayers under Sections 451(b) and 451(c), as amended by the 2017 tax reform bill known as the Tax Cuts and Jobs Act (TCJA). These eagerly-anticipated regulations provide additional clarity for taxpayers by adding applicability and definitional guidance in several areas, as well as addressing key interactions with ASC 606 (the new revenue recognition standard for financial reporting purposes).

The regulations also specify certain fact patterns that will require taxpayers to file a change in method of accounting. To assist taxpayers with compliance, the IRS and Treasury added new automatic accounting method changes through the concurrent release of Rev. Proc. 2019-37, which offers taxpayers streamlined procedures to effectuate accounting method changes related to the proposed regulations.

The regulations are generally applicable for taxable years beginning on or after the date the final regulations are published in the Federal Register. However, taxpayers have the option of relying on the proposed regulations for taxable years beginning after December 31, 2017, provided that all applicable rules in the proposed regulations are consistently applied. As the clarifications provided under the proposed regulations are either generally taxpayer favorable or neutral as compared to the statutory language in the TJCA, taxpayers may want to consider "early adopting" the proposed regulations. Thus, taxpayers should familiarize themselves with the guidance to determine whether any immediate action items may be necessary for their 2018 tax year, especially given the short time frame between the issuance date of the proposed regulations and the extended due date for calendar year end 2018 federal income tax returns.

As discussed below, while the proposed regulations provide taxpayers with additional insights to apply Sections 451(b) and (c), many of the most pressing issues still remain unanswered. Taxpayers therefore will likely continue to encounter significant uncertainty in attempting to comply with the provisions unless Treasury and IRS address these concerns in the final regulations.

Highlights of Proposed Section 451(b) Regulations

Prior to the enactment of Section 451(b) under the TCJA, an accrual method taxpayer recognized income in the tax year when all the events occurred to fix the right to receive such income (the "all events test") and the amount was determinable with reasonable accuracy. The courts and the IRS have generally held that the all events test is met at the earliest of when the income is earned, due, or received. Due to the divergent principles governing book versus tax accounting, application of the all events test has often resulted in favorable book-tax differences for income recognition, whereby income is included for tax purposes in a later year as compared to financial reporting purposes. However, many taxpayers now may encounter increased instances of financial accounting and tax accounting conformity under the new rules provided in the TCJA. In particular, Section 451(b) provides that for an accrual method taxpayer with an Applicable Financial Statement (AFS), income must be recognized upon the earlier of when the all events test is met or when the taxpayer recognizes such income in its AFS. This so-called "AFS income inclusion rule" operates only in one direction, namely to accelerate in timing the recognition of gross income for tax purposes. Thus, an accrual method taxpayer with an AFS that is currently deferring the recognition of income to a tax year later than when books recognize such income may be required to change its method of accounting to comply with Section 451(b).

Section 451(b) also provides that taxpayers on certain special methods of accounting are exempt from the AFS inclusion rule. However, the statute does not define which methods may constitute special methods of accounting.

With respect to contracts that contain multiple performance obligations, Section 451(b)(4) provides that the allocation of the transaction price for tax purposes shall follow the allocation used for the taxpayer's AFS but does not define either transaction price or performance obligation. The proposed Section 451 regulations therefore resolve many of these uncertainties by adding definitional guidance and clarifying the scope of the rules. Some of the key highlights of Prop. Reg. Section 1.451-3 are as follows:

- The proposed regulations define transaction price to mean the gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes in exchange for transferring promised goods, services, or other property, but with certain exclusions, including amounts collected on behalf of third parties and reductions for amounts subject to Section 461 (e.g., allowances, refunds, and rebates).
- Consistent with the examples provided in the Joint Committee of Taxation's Blue Book, variable consideration that is contingent on a future event and included in the transaction price for book purposes under ASC 606 is not included in the taxpayer's transaction price for purposes of Section 451(b) if the taxpayer's entitlement to the amount is contingent on the occurrence or nonoccurrence of a future event or reductions for amounts subject to 461. However, to reduce compliance burden, the proposed regulations provide that amounts included in the transaction price for AFS purposes are presumed to not be contingent unless the taxpayer can establish that the amount is contingent. Thus, if a taxpayer has a significant amount of contingent payments it may be worth looking into establishing that the amounts are contingent. On the other hand, for taxpayers that want to follow their AFS transaction price for tax purposes for administrative ease, this rule essentially amounts to a "safe harbor" allowing them to do so.
- The proposed regulations clarify that the AFS income inclusion rule does not change the treatment of a transaction for federal income tax purposes. For instance, Section 451(b) does not cause a transaction treated as a sale or financing arrangement for AFS purposes to recharacterize a transaction treated as a lease or license for tax purposes. The proposed regulations also list examples of other transactions that would not be affected by the AFS inclusion rule, including certain nonrecognition transactions (e.g., a reorganization under Section 368 or a contribution under Section 721).
- As noted above, taxpayers on a special method of accounting are not subject to the AFS income inclusion rule. The proposed regulations provide a non-exclusive list of methods that constitute a special method of accounting, including Section 453 (installment sales), Section 460 (long-term contracts), Section 467 (certain rental agreements with cumulative rents exceeding $250,000), Section 475 (mark-to-market) and Sections 1276 and 1278(b) (accrued market discount).
- For multi-year contracts, the proposed regulations clarify that Section 451(b) is applied using a cumulative approach, taking into account amounts previously included in income under Section 451, rather than an annualized approach that only compares current year book income versus current year tax income (as determined under the all events test). Under the cumulative approach, a taxpayer must compare the total amounts previously included in income to determine whether it has an additional acceleration of income under Section 451(b). The cumulative approach is generally more favorable than the annualized approach, as the latter may result in a tax acceleration of income relative to the amounts recognized for book purposes.
- If a taxpayer's revenues are restated on an AFS, and the restatement changes the time at which an item of income is taken into account as revenue for book purposes, the proposed regulations specify that the change constitutes a change in method of accounting for tax purposes. Further, a change in the taxpayer's revenue recognition policies for AFS purposes also constitutes a change in method of accounting for tax purposes. Accrual method taxpayers should therefore inquire on an annual basis whether any changes to their book revenue recognition policies occurred, even for years other than the ASC 606 implementation year.
- Proposed guidance is provided for taxpayers with a financial reporting period that is different than the taxable year. Rather than a one size fits all approach, taxpayers have three separate options for applying the AFS income inclusion rule, and a change from one option to another is considered a change in accounting method.
- The preamble to the proposed regulations notes that Treasury and the IRS received multiple comments proposing the allowance of a cost offset when income is accelerated for tax purposes under the AFS income inclusion rule. Citing the economic performance rules under Section 461, as well as the inventory rules under Sections 263A and 471, the proposed regulations clarify that a cost offset is not allowed, as such treatment could result in a potential distortion of income. While this reasoning is in line with the position outlined in the Joint

Committee of Taxation's Blue Book, this rule will likely be ill-received by taxpayers, as it may result in more income being recognized for tax purposes as compared to financial statement purposes. However, Treasury and the IRS continue to consider whether any exceptions may be possible to allow for a cost offset (e.g., through allowing taxpayers to elect into the percentage-of-completion method used for book purposes), and specifically seek detailed comments to facilitate further consideration.

Highlights of Proposed Section 451(c) Regulations

Section 451(c) generally permits a taxpayer using an accrual method of accounting that has an AFS to use the deferral method of accounting for advance payments for goods, services, and other specified items. Under this "AFS deferral method," a taxpayer includes in its gross income any portion of an advance payment that is recognized in its AFS in the year of receipt, and includes the remaining portion of the advance payment in gross income in the following taxable year. Although Congress intended Section 451(c) to generally codify the existing one-year deferral method under Rev. Proc. 2004-34, the statutory language does not contain some of the special rules prescribed by the revenue procedure and excludes from its scope accrual taxpayers without an AFS. The provisions under Prop. Reg. Section 1.451-8 are now substantially similar to those outlined under Rev. Proc. 2004-34, and in some cases expand beyond what was offered by the revenue procedure.

Under the proposed regulations, the statutory language under Section 451(c) has been expanded to include provisions permitted under Rev. Proc. 2004-34, as follows:

- The definition of an advance payment is consistent with the definition in Rev. Proc. 2004-34 as modified by Rev. Proc. 2011-18 and Rev. Proc. 2013-29. The definition of an advance payment may be expanded in the future as the proposed regulations give the Treasury the authority to specify any other payment in the Internal Revenue Bulletin.
- Although Section 451(c) limits advance payments to taxpayers with an AFS, the preamble to the proposed regulations indicates that the Treasury Department and IRS have concluded that Section 451(c) does not prohibit a deferral method for taxpayers without an AFS. Therefore, the proposed regulations provide a deferral method for non-AFS taxpayers using an "earned" standard, as in Rev. Proc. 2004-34, referred to as the "non-AFS deferral method." The deferral method for a taxpayer with an AFS and a taxpayer without an AFS has been broken out into two separate sections of the proposed regulations instead of interwoven together as in Rev. Proc. 2004-34. This is a welcome development as it permits taxpayers without an AFS to continue to use the deferral method.
- Although Section 451(c)(3) states that the deferral method does not apply to an advance payment received by a taxpayer during a taxable year if such taxpayer ceases to exist during, or with the close of, the taxable year, the proposed regulations provide more detailed acceleration rules, similar to Rev. Proc. 2004-34. The Treasury Department and IRS determined that these acceleration rules are appropriate for proper application of the deferral method. The same provisions for handling short taxable years and accelerating advance payments that are in Rev. Proc. 2004-34 are now incorporated into the proposed regulations.

Significant Changes from Rev. Proc. 2004-34 that Are in the Proposed Regulations are:

- As noted in the preamble to the proposed regulations, the deferral method under Section 451(c) is an exception to the requirement to include an amount in income when it is received, but is not an exception to the requirement to include an amount in income when it is earned through performance under the all events test. Amounts that are earned in the year of receipt, but not included in revenue in the taxpayer's AFS, must be included in income in the year earned. Prop. Reg. Section 1.451-8(c)(8) illustrates how this rule applies in Example 11.
- The definition of an AFS in Section 451(b)(3), which also applies for purposes of using the deferral method for advance payments, is generally consistent with the definition under Rev. Proc. 2004-34. The proposed regulations expand an AFS to include International Financial Reporting Standards (IFRS) statements, and the acceptable IFRS statements parallel the same types of GAAP financial statements that are considered an AFS. There are additional rules for determining priority where there is a restated AFS, and for a taxpayer that has different financial accounting and taxable years that is required to file both annual and periodic financial statements covering less than a year with a government agency. The proposed regulations also expand the AFS for a taxpayer from one that includes members of a group filing a consolidated return (in Rev. Proc. 2004-34) to a taxpayer's financial results that are reported on the AFS for a group of entities. While the expanded definition of an AFS will subject more taxpayers to the AFS income inclusion rule, it also permits those taxpayers

to qualify for automatic changes to comply with Section 451(b), including changes from impermissible income recognition methods, and to change to defer advance payments.

- Certain payments have been added to the list of payments excluded from the definition of advance payments, specifically "payments received in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery date for a specified good." This is an upfront payment under the contract if (i) the contracted delivery month and year of the good occurs at least two taxable years after an upfront payment, (ii) the taxpayer does not have the good or a substantially similar good on hand at the end of the year the upfront payment is received, and (iii) the taxpayer recognizes all of the revenue from the sale of the good in its AFS in the delivery year. The preamble indicates that this was added in response to comments received by the Treasury Department and IRS. The preamble to the proposed regulations also requests detailed comments on other payments, that would otherwise be advance payments, that are potentially excludible as advance payments.
- For the use of both the deferral method with an AFS and without an AFS, the proposed regulations incorporate and expand on guidance previously set forth by IRS in CCA 201619009, which addressed the treatment of financial statement adjustments that cause amounts to not be included in income. The proposed regulations provide that the full amount of an advance payment must be included for tax purposes, even if a portion of the taxpayer's deferred revenue liability is written down or adjusted for financial accounting purposes in a subsequent year.
- The proposed regulations for a taxpayer using the deferral method with an AFS require that the same financial statement that is used to apply the rules in Section 451(b) be used to apply the deferral method under Section 451(c) and require the transaction price be allocated to performance obligations as it is allocated in the AFS.
- The proposed regulations contain 25 examples applying the proposed regulations to the deferral method for taxpayers with an AFS. Most of these are updated examples that were in Rev. Proc. 2004-34. However, five new examples have been added to illustrate the fact that the transaction price of advance payments are not reduced for amounts that are subject to Section 461 (for example, deductions and offsets for rebates, refunds, and cost of goods sold prior to when the liability for such items in incurred under Section 461), as discussed above. The proposed regulations request detailed comments on whether any such offsets are appropriate to prevent mismatching of income and associated expenses. Taxpayers will need to maintain records to be able to properly report the liabilities subject to Section 461 for tax purposes.
- Advance payments that involve reward points must be analyzed to determine whether the reward points qualify as advance payments and whether they are separate performance obligations in order to determine whether they may qualify to be deferred. See examples 22, 23 and 24 under Prop. Reg. Section 1.451-8(c)(8).
- In addition to comments the IRS has requested that are noted above, comments are also requested for taxpayers with an AFS on allocation of the transaction price (i) to performance obligations that are not contractually based, (ii) for arrangements that include both income subject to Section 451 and long-term contracts subject to Section 460, and (iii) when the income realization event for federal income tax purposes differs from the income realization event for AFS purposes.

New Automatic Method Change Procedures

Concurrent with the release of the proposed Sections 451(b) and 451(c) regulations, as discussed above, the IRS issued Rev. Proc. 2019-37 to provide additional automatic accounting method changes for taxpayers requesting IRS consent to make changes permitted under those proposed regulations. Rev. Proc. 2019-37 is generally effective for taxable years beginning after December 31, 2017.

In late 2018, the IRS issued Rev. Proc. 2018-60, which adds a new automatic change #239 under Section 16.12 to Rev. Proc. 2018-31 for accrual method taxpayers with an AFS wishing to change their method of accounting for the timing of income recognition to comply with the AFS income inclusion rule under Section 451(b). Furthermore, taxpayers not adopting the new standards for the year of change but wanting to allocate the transaction price to performance obligations under Section 451(b)(4) can also file request IRS consent by filing automatic change #239. Rev. Proc. 2018-60 required that these changes be implemented with a Section 481(a) adjustment and did not provide the alternative of implementing the change on a cut-off basis.

Rev. Proc. 2019-37 Modifies Section 16.12 of Rev. Proc. 2018-31 in Several Key Areas:

- A new automatic change #242 is added for taxpayers with an AFS to request IRS consent to change the method of accounting for revenue recognition to comply with Prop. Reg. Sections 1.451-3 or 1.451-8, as discussed in the above sections of this article.
- Notably, a taxpayer that does not have an AFS and wishes to change to defer advance payments based on when the payment is earned under the non-AFS deferral method may also file automatic change #242. However, if a taxpayer without an AFS cannot determine the extent to which a payment is earned in the year of receipt and instead uses a statistical basis, straight-line ratable basis, or any other basis accepted by the IRS, then the change to defer the advance payment must be filed on a nonautomatic Form 3115.
- Changes made under automatic change #239 or #242 to comply with Section 451(b)(1)(A) and Prop. Reg. Section 1.451-3, respectively, must be implemented with a Section 481(a) adjustment. However, if either of those changes are paired with a concurrent automatic method change #231 under Section 16.11 of Rev. Proc. 2018-31 (relating to changes in the timing of income recognition due to the New ASC 606 and IFRS 15 Standards), then such combined change can be implemented with either a Section 481(a) adjustment or on a cut-off basis.
- For the first or second taxable year beginning after December 31, 2017, Rev. Proc. 2019-37 extends the streamlined method change procedures offered by Rev. Proc. 2018-60 to certain taxpayers with an AFS requesting to change the method of accounting for revenue recognition to comply with Prop. Reg. Sections 1.451-3 or 1.451-8 and to taxpayers without an AFS changing to the non-AFS deferral method. The streamlined approach waives the requirement to file a Form 3115 or to attach a separate statement and is only available to a taxpayer that meets one of the following requirements:
  - (i) The taxpayer, other than a tax shelter, qualifies as a small business taxpayer under Section 448(c) by having average annual gross receipts for the three prior taxable years of $25 million or less (adjusted for inflation).
  - (ii) The taxpayer is making one or more changes under Section 16.12 and the total Section 481(a) adjustment required by each of the changes is zero.
  - Audit protection is unavailable under this streamlined procedure. Notwithstanding, it affords qualifying taxpayers the administrative convenience of being able to comply with Section 451(b) or the proposed regulations simply by filing their federal income tax return. Qualifying taxpayers may, however, still choose to file a Form 3115 for the purposes of retaining a clear record of a method change, making permissible concurrent changes on the same Form 3115, or making a method change with audit protection.
- In general, a taxpayer that is under IRS examination at the time of filing a Form 3115 cannot obtain audit protection for the item being changed unless it meets one of several exceptions. For the first, second, or third taxable year beginning after December 31, 2017, the no-audit protection rule is temporarily inapplicable for taxpayers with an AFS requesting to change the method of accounting for revenue recognition to comply with Prop. Reg. Sections 1.451-3 or 1.451-8. Because audit protection prevents the IRS from making an adjustment for the item(s) being changed in the year under exam, this is beneficial for those taxpayers currently under IRS exam that are changing from potentially impermissible methods of accounting for revenue recognition and advance payments. This temporary rule is similarly afforded under Rev. Proc. 2019-37 to automatic change #231 under Section 16.11 of Rev. Proc. 2018-31.
- Rev. Proc. 2019-37 also modifies Section 16.10 of Rev. Proc. 2018-31 to provide an additional automatic change for a taxpayer that changes the manner in which it recognizes amounts in revenue in an AFS and that wants to change its accounting method for tax purposes. Lastly, the IRS will return any nonautomatic Form 3115 application requesting a change in accounting method impacted by Rev. Proc. 2019-37 that was filed on or before September 9, 2019, and remains pending as of that date.

Although the proposed regulations and Rev. Proc. 2018-37 contain some favorable provisions for taxpayers, the relatively short time frame between the issuance dates and the extended due date for calendar year 2018 federal tax returns means that there is not much reaction time to evaluate the taxpayer's revenue recognition methods and "early adopt" the proposed rules for the 2018 tax year. Accordingly, taxpayers should familiarize themselves with the guidance to determine whether any immediate action items may be necessary for their 2018 tax year and take appropriate action.