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Proposed Regulations Address TCJA Gross Income Acceleration Requirement

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The 2017 tax reform legislation imposed a one-way book-tax conformity requirement that could unexpectedly accelerate gross income for tax purposes. Understanding the new rules is critical, enabling taxpayers to foresee and potentially mitigate potentially adverse tax consequences. This article discusses recently proposed regulations addressing the new requirement, focusing both on positive clarifications proposed by the regulations, as well as on a few less welcome surprises.

The 2017 tax reform legislation commonly referred to as the Tax Cuts and Jobs Act ("TCJA")[1] profoundly changed two bedrock foundations of federal tax accounting: that tax and financial accounting methods have different purposes and need not move in tandem;[2] and that for an accrual method taxpayer, an item of income is incurred when the facts establishing the right to the income have become fixed and the amount to which the taxpayer is entitled is reasonably determinable (the "all

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1 Pub. L. No. 115-97, §13221. The Act is more formally denominated "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018."

2 Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979) (based on differing objectives, rejecting equivalence of GAAP and tax accounting methods).

events test").[3] In enacting section 451(b),[4] the TCJA altered both of these core principles, by "deeming" the all events test to be satisfied for an item of gross income no later than the year in which that amount is taken into account as revenue for book purposes, regardless of the actual underlying facts.

The legislative history explaining this new linkage between book and tax methods touches upon, but does not resolve, a number of central issues. First, the legislative history makes clear that the income acceleration requirement applies only to amounts that already have been *realized* for tax purposes.[5] It provides relatively little guidance, however, regarding the distinction between "realization" and "recognition" beyond traditional sales, exchanges, or other dispositions.[6]

Second, taxpayers and practitioners expressed the need to offset the accelerated income with a commensurate amount of related costs in order to avoid the taxation of gross receipts and to ensure the clear reflection of income.[7] In its "Blue Book," the Joint Committee on Taxation foreshadowed the eventual position of the proposed regulations—that section 451(b) does not alter the timing rules for business expenses, precluding an acceleration of cost offsets unless the separate requirements of sections 263A, 461, and 471, et al., are satisfied.[8]

Treasury and the IRS issued proposed regulations under section 451(b) on September 9, 2019, which, if finalized, would be effective for tax years beginning after the date the final regulations appear in the Federal Register.[9] Assuming the government is unable to finalize the regulations until 2020 (a reasonable assumption), the regulations would not become effective until 2021 tax years. As applied to "specified fees," the proposed regulations would be delayed for an additional year.

Taxpayers may "early adopt" the regulations immediately (via an accounting method change), but must do so on an all-or-nothing-basis. Regardless of whether taxpayers early adopt the proposed

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3 United States v. Anderson, 269 U.S. 422 (1926) (articulating what became the all events test). IRC §451(b)(1)(C); Section 1.446-1(c)(1)(ii).

4 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

5 H.R. Conf. Rep. No. 115-466, at 428 fn. 872 (Dec. 15, 2017); Joint Committee on Taxation, General Explanation of Public Law 115-97, JCS-1-18 (Dec. 2018) (the "Blue Book").

6 *See* James Atkinson, *Section 451(b): Did you Realize the Need to Recognize the Difference*, What's News in Tax (February 11, 2019).

7 Nathan Richman, *Lack of Safe Harbor in Proposed Accounting Regs Chafes Tax Pros*, 164 Tax Notes Federal 1951 (Sept. 16, 2019); *Firm Backs Up Argument on Treatment of Advance Payments*, 2018 TNT 116-17 (June 14, 2018) (comment letter from Ivins, Phillips & Barker); *Treatment of Advance Payment Under Sales Should Remain the Same, Firm Says*, 2018 TNT 94-26 (May 14, 2018) (comment letter from Ivins, Phillips & Barker).

8 *See JCT Opposes Revenue Recognition Cost of Goods Sold Offset Proposal*, 162 Tax Notes 332 (Jan. 21, 2019).

9 The government concurrently issued a separate set of proposed regulations addressing new section 451(c), also added by the TCJA. Proposed section 1.451-8, 84 Fed. Reg. 47175 (Sept. 9, 2019). Section 451(c) governs the tax treatment of advance payments, and in essence codifies the deferral method of accounting under Revenue Procedure 2004-34, 2004-1 C.B. 991. That set of regulations will be discussed separately in a forthcoming publication.

regulations, the accelerated recognition requirement of section 451(b) became effective for tax years beginning after December 31, 2017.

Early adoption may provide an attractive alternative to some of the analytical uncertainty presented by the statutory language of section 451(b), but particularly for taxpayers outside of certain service industries, it may come at an unacceptably high cost. Those considerations are discussed herein.

Overview

The proposed regulations establish the applicable financial statement (AFS) income inclusion rule, requiring a taxpayer to determine the contract's "transaction price" using a standard largely mirroring that used for financial accounting purposes. From this initial amount the taxpayer subtracts any amounts not constituting gross income for tax purposes as well as any amounts that remain contingent on future events as of the end of the tax year. The resulting amount cannot be further adjusted to reflect any cost offsets, including cost of goods sold or any form of price adjustment. To the extent the company takes the resulting transaction price into revenue for financial accounting purposes during that tax year (regardless of how it is reflected in the company's financials), that amount is potentially subject to accelerated recognition for federal tax purposes under section 451(b) and the proposed regulations.

Importantly, although section 451(b) and the proposed regulations borrow heavily from "Topic 606," which by its terms applies only to certain revenue from contracts with customers,[10] neither section 451(b) nor the proposed regulations are so limited. Instead, the accelerated recognition requirement applies to *any* item of gross income within the scope of section 61, and to *any* item of revenue included in a taxpayer's AFS within a given tax year.

As such, the AFS income inclusion rule now requires close and ongoing coordination between *every* AFS company's tax and financial accounting functions, regardless of the company's earlier determinations regarding the impact of "rev rec" on its tax positions and accounting methods.

State and Local Considerations

Most states now conform to the Code as amended by the TCJA. This conformity results in states generally following the amendments to section 451(b). However, California has not updated its conformity related to revenue recognition. On July 1, 2019, Governor Newsom approved AB 91, which updated California's conformity to a limited set of TCJA provisions. That legislation did not include any changes to the state's conformity with section 451. Also, in Wisconsin, despite conforming to many of the provisions in the TCJA, the legislature opted to exclude the amendments to section 451(b) from that conformity.[11] As a result, in both California and Wisconsin, taxpayers must determine the timing of

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[10] IFRS 15, *Revenue from Contracts with Customers*; FASB ASU 2014-09, *Revenue from Contracts with Customers* ("Topic 606"). This discussion is not intended to address, directly or indirectly, the proper financial accounting treatment of any item of income or expense. Alternative sources should be consulted for the proper application of financial accounting standards, including Topic 606.

[11] *See* Wis. Stat. § 71.22(4)(L).

income recognition for payments under the pre-TCJA version of section 451. For taxpayers with significant exposure to one or both of those states, an examination of the magnitude of those differences is necessary.

Section 451(b): One-Directional Book-Tax Conformity

As enacted by the TCJA, section 451(b) provides that in the case of an accrual method taxpayer, the all events test with respect to an item of gross income (or portion thereof) is deemed to be satisfied no later than the year in which that amount is taken into account as revenue on the taxpayer's AFS for the reporting period.

This new conformity requirement works only to *accelerate* income recognition, however, and may not be relied upon to *defer* the recognition of gross income beyond the tax year in which it is recognized under the traditional all events test.[12] As a result, a particular amount that is otherwise includible in gross income for tax purposes must be recognized upon the earlier of (1) the tax year in which the amount is included in the taxpayer's revenue for book purposes, or (2) the tax year in which it would otherwise have been recognized under the traditional all events test.

Section 451(b)(4) also creates a conformity requirement with respect to contracts containing multiple "performance obligations." Under this rule, if the taxpayer must allocate a contract's transaction price among multiple performance obligations for book purposes, the taxpayer must make the same allocation among the same performance obligations for tax purposes. Mandating the same allocations for tax purposes promotes accuracy in matching the book inclusions for specific items of revenue with the corresponding gross income required to be accelerated for tax.

The nomenclature used by Congress in crafting section 451(b) as well as the preamble to the proposed regulations make clear that the provision is intended to tie the all events test used for tax purposes much more closely to the financial accounting treatment of an item of revenue than has been the case previously.[13] The terms chosen closely mirror those used in the recent changes in the financial accounting standards for revenue from contracts with customers.

During the implementation of Topic 606, many corporate tax departments determined that their federal tax accounting methods operated independently of their financial accounting methods, and that as a result, changes required by Topic 606 to the company's AFS treatment of contract revenue had no effect upon the company's federal tax positions or accounting methods. Many of those tax departments now may be required to change certain methods of accounting due to Congress' "deeming" the all events test to be satisfied if book revenue is accelerated (whether by Topic 606 or otherwise) into a tax year earlier than that in which the amount would have been recognized for tax under the traditional all events test.

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[12] 84 Fed. Reg. at 47196.

[13] 84 Fed. Reg. at 47192.

AFS Income Inclusion Rule

The proposed regulations implement this new requirement by creating the "AFS income inclusion rule." As its name indicates, and consistent with the requirements of section 451(b), the new rule applies only to taxpayers having an AFS during the entire tax year.[14] For this purpose, the proposed regulations define an AFS consistently with the manner in which the term has been used for other federal tax purposes (e.g., a Form 10-K or other shareholder statements filed with the SEC, audited financial statements used for specific purposes, or financial statements filed with federal agencies other than the SEC or the IRS).[15]

The preamble indicates that this determination is made on a year-by-year basis, such that a taxpayer may be subject to the AFS income inclusion rule in one year, but not the next, depending upon whether the taxpayer has or ceases to have an AFS for each day of a particular tax year (for example, the taxpayer only prepares financials every other year).[16] While year-to-year changes in a taxpayer's status as having or not having an AFS may not be common, the proposed regulations do not discuss whether any such year-to-year changes in status would be treated as changes in accounting method requiring IRS consent or instead as changes in fact not requiring consent. The government has indicated in public remarks that it continues to consider that question.[17]

In general, the AFS income inclusion rule tracks the basic rule imposed by section 451(b). A few concepts are critical though. First, section 451(b) and the proposed regulations operate only to potentially accelerate an item taken into account in determining the taxpayer's *revenue* during the tax year. Here, the IRS and Treasury make clear they will take the "book-tax conformity" concept only so far. For purposes of the regulations, "revenue" is defined as anything that would be income under section 61 of the Code. It is irrelevant what the item is called for financial accounting purposes, or where it appears in the AFS. For example, the regulations state than an item is "revenue" even if it is reported as "other comprehensive income" on the AFS.[18]

To be revenue for this purpose, however, the item must have been included in the contract's "transaction price" for financial accounting purposes. The proposed regulations define a contract's transaction price as the gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes in exchange for transferring goods, services, or other property.[19]

Here, the company's financial accounting decisions may directly affect the amount of gross income potentially subject to acceleration for tax purposes. Those financial accounting concepts are beyond the

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[14] Section 451(d).

[15] Proposed section 1.451-3(c)(1). *See* section 1.263(a)-1(f)(4) (AFS for *de minimis* election for tangible personal property costs); Rev. Proc. 2004-34, 2004-1 C.B. 991, §4.06 (AFS for deferral method of accounting).

[16] 84 Fed. Reg. at 47192-93.

[17] Nathan Richman, *Treasury Not Dismissing New Tax Accounting Rules Safe Harbor*, 164 Tax Notes Federal 237 (Sept. 23, 2019).

[18] Proposed section 1.451-3(c)(4).

[19] Proposed section 1.451-3(c)(6).

scope of this discussion, but companies should keep in mind that for purposes of section 451(b), the potential gross income accelerated for tax purposes cannot exceed revenue reflected in the AFS, and under the proposed regulations, revenue cannot exceed the contract's transaction price.[20]

As a result, to the extent that for financial accounting purposes the company determines that some amount less than the actual contract price will be treated as the "transaction price" for book purposes, that determination may directly translate into a lower amount potentially subject to acceleration under the proposed regulations. Keep in mind, though, that the entire contract price may still be required to be included in gross income at some point under traditional tax principles (regardless of what is treated as the "transaction price" for book purposes). Section 451(b) simply provides a limited "financial statement override" that may require accelerating the recognition of some portion of the gross income to be earned under a particular contract, affecting the *timing* but not the ultimate *amount* of gross income to be recognized for federal tax purposes.

After determining the base-line transaction price, the proposed regulations next impose three special rules. First, the transaction price does not include any amounts collected on behalf of third parties. This simply restates another basic tax principle—a receipt is not taxable unless it is taken under a claim of right. Because items such as certain sales tax receipts, customer deposits, and amounts collected in the taxpayer's capacity as an agent are not taken under a claim of right, they will never be included in the taxpayer's gross income, and the timing rules are irrelevant.[21]

"Contingencies" in Lieu of "Realization"

Under the proposed regulations, the contract's transaction price also does not include consideration to which the taxpayer's entitlement remains contingent upon the occurrence or non-occurrence of a future event as of the end of the tax year. The proposed regulations posit as examples bonuses contingent on performance and insurance commissions contingent on renewal.[22]

The proposed regulations impose two presumptions upon this "contingency rule." First, they create a *rebuttable* presumption that amounts included in the transaction price for AFS purposes are *not* contingent on the occurrence or nonoccurrence of a future event unless the taxpayer is able to convince the IRS otherwise. This presumption is a bit of a truism, since all tax positions ultimately are subject to potential scrutiny and acceptance by the IRS.

Example. Taxpayer E, a manufacturer of automobile parts, is a calendar-year accrual method taxpayer with an AFS. E normally sells parts for $10 per part with a two percent bonus if the parts are delivered

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[20] Revenue means "all transaction price amounts includible in gross income under section 61." Proposed section 1.451-3(c)(4) (emphasis added).

[21] Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). *See, e.g.*, Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203 (1990) (customer deposits); Seven-Up Co. v. Commissioner, 14 T.C. 965 (1950) (company had no income when it received payments as an agent on behalf of others).

[22] Proposed section 1.451-5(c)(6)(ii).

on time. In 2018, E enters a contract to sell 1,000 parts to a customer for $10 per part, for a total of $10,000. The contract also provides that E will receive a two percent bonus if it delivers all the parts to the customer by February 1, 2019. E delivers 500 parts to the customer on December 31, 2018. On December 31, 2018, the additional 500 parts were scheduled for shipment to the customer on January 4, 2019. For AFS purposes, E expects to earn the two percent bonus. In its 2018 AFS, E reports $5,100 of revenue from the contract, including a $100 adjustment for the expected bonus. Under proposed section 1.451-3(c)(6)(ii), the performance bonus is presumed *not* to be contingent on the occurrence or nonoccurrence of a future event since E included it in revenue on its 2018 AFS. As of year-end, however, all parts have yet to be delivered within the February 1, 2019, deadline. Under the contract, E has no right to payment of the bonus at the end of the year. Therefore, the presumption is rebutted.[23]

The proposed regulations appear to have adopted this contingency rule in lieu of wrestling with the more difficult distinction between realization and recognition of income, as the legislative history suggested would be necessary in applying section 451(b).

This approach is likely to disappoint some (but not all) taxpayers and practitioners. The TCJA legislative history discusses the distinction between the realization and recognition concepts firmly embedded in federal tax law and emphasizes that section 451(b) has no impact upon amounts that have not yet been realized.[24] Decades of case law reflects the distinction between these core concepts, and various provisions of the Code likewise operate to defer recognizing previously realized amounts, highlighting the distinction. Nonetheless, outside the context of transactions involving gains and losses upon the sale, exchange, or other disposition of property, clearly articulating the realization concept in a way that does not essentially mirror the first prong of the all events test (all facts having occurred that establish entitlement to the income) proved elusive for many practitioners, as it apparently also did for the regulations' drafters.

As such, while some practitioners and taxpayers may be disappointed by the proposed regulations' articulating a contingency rule in lieu of broader standards distinguishing realization and recognition for this purpose, as a practical matter the government may have had few options. Alternative approaches or definitions may surface during the proposed regulations' "notice and comment" period, but otherwise, the "contingency rule" likely is here to stay.

Unbilled Receivables

The proposed regulations also create an *irrebutable* presumption that an amount included in the AFS transaction price is *not* contingent if it is actually or constructively received, is due and payable, or if the taxpayer has an enforceable right to payment for performance completed to date. In other words, there is no contingency if either the taxpayer already has been paid, or if the taxpayer has an enforceable right to demand payment for partial performance.

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[23] Proposed section 1.451-5(m), Example 6.

[24] *See supra* note 6.

Example. Taxpayer C is a calendar-year accrual method taxpayer with an AFS. In 2018, C enters into a contract with a customer to provide 50 customized computers for $80,000. Under the contract, C can bill $80,000 after the customer accepts delivery of the computers. However, because of the customization, the contract allows C to be paid for work performed to date, even if the contract is not completed for reasons other than C's failure to perform. C delivers all the computers in 2018. Customer accepts delivery of the computers and C bills the customer in 2019. C includes all $80,000 in revenue in its 2018 AFS. Under the AFS income inclusion rule, because $80,000 of revenue from the provision of goods is included in C's 2018 AFS, the all events test for that $80,000 of income is met in C's 2018 tax year. Under proposed section 1.451-5(c)(6)(ii), the limitation on C's ability to bill until after the customer accepts delivery of the computers is not a future event that restricts C's enforceable right to payment for the goods.[25]

The preamble to the proposed regulations makes clear that the *per se* requirement to recognize as gross income any amounts included in an AFS under a partially performed contract is intended to require recognizing any "unbilled receivables" for either goods or services. Treasury and the IRS disagreed with commenters that applying section 451(b) to unbilled receivables conflicts with the intent to not change the treatment of a transaction to match the taxpayer's AFS treatment.[26]

Cost Offsets

The proposed regulations reject commenters' concerns regarding the need to accelerate a commensurate amount of the costs associated with the accelerated income in order to clearly reflect the taxpayer's income and also to avoid taxing gross receipts rather than gross income.[27] Instead, proposed section 1.451-3(c)(6)(iii) imposes a blanket prohibition against adjusting the contract's transaction price for amounts subject to section 461 (including allowances for adjustments, rebates, chargebacks, refunds, rewards (for example, estimated redemption costs associated with loyalty programs), or for costs of goods sold.

In doing so, Treasury and the IRS take the position that section 451(b) affects only the application of the all events test in recognizing income, but has no effect upon the application of section 461 (specifically including the economic performance requirement), the uniform capitalization rules of section 263A, or the inventory rules under sections 471 and 472 for purposes of recovering costs incurred in producing the income.[28]

Exclusions

Determining that a particular amount is potentially subject to accelerated recognition under the AFS income inclusion rule is not the end of the analysis. Instead, more specific accounting rules permitted or required by another provision of the tax law will render section 451(b) inapplicable.

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[25] Proposed section 1.451-5(m), Example 3.

[26] 84 Fed. Reg. at 47193.

[27] *See supra* note 8.

[28] 84 Fed. Reg. at 47195-96; Blue Book, at 164-165.

First, the AFS income inclusion rule does not affect the tax treatment of an income item for which the taxpayer uses a "special method of accounting."[29] For this purpose, a special method of accounting is a method permitted or required by any provision of the Code, regulations, or other guidance published in the Internal Revenue Bulletin under which an item of income is taken into account in a tax year other than the tax year in which the all events test is met.

The proposed regulations provide a non-exclusive list of 12 special methods, including:

- The installment method under section 453
- Long-term contract methods under section 460
- Mark-to-market method of accounting under section 475
- Timing rules for original issue discount (OID) under section 811(b)(3) or section 1272 (except as otherwise provided in the proposed regulations)
- Timing rules for accrued market discount under sections 1276 and 1278(b)
- Methods of accounting provided in sections 1502 and 1503 and the regulations thereunder, including the method of accounting relating to intercompany transactions under regulation section 1.1502-13[30]

Second, the timing rules of section 451(b) do not apply to any item excluded from gross income under a specific provision of the Code.[31] This again simply reflects the fact that section 451(b) affects only the *timing* of an item that is otherwise properly included in gross income under section 61 or section 1001.

Third, the AFS income inclusion rule does not apply if recognition is deferred by another specific provision of the Code. Thus, for example, an amount deferred under the like-kind exchange rules of section 1031 or the involuntary conversion rules of section 1033 is not accelerated by reason of the AFS income inclusion rule.

Similarly, the AFS income inclusion rule does not affect the tax treatment of any non-recognition transaction within the meaning of section 7701(a)(45). This includes, for example, a liquidation described in sections 332 and 337, an exchange described in section 351, a distribution described in section 355, a reorganization described in section 368, and a contribution described in section 721. The specific tax treatment provided for those transactions remains applicable regardless of the financial accounting treatment.[32]

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[29] Proposed section 1.451-3(b).

[30] Proposed section 1.451-3(c)(5).

[31] Proposed section 1.451-3(f)(2).

[32] Proposed section 1.451-3(f)

Finally, section 451(b) has no application in determining the "treatment" of an item for federal tax purposes. It is just a timing provision, governing how the all events test might apply to an otherwise taxable item of gross income. It does not, for example, change the tax treatment of the following:

- A transaction treated as a lease, license, or similar transaction for tax purposes that is treated as a sale or financing for AFS purposes, and vice versa;
- A transaction that is not required to be marked-to-market for tax purposes but that is marked-to-market for AFS purposes;
- A distribution of previously taxed earnings and profits of a foreign corporation; and
- A deposit or conduit payment for tax purposes that is treated as revenue for AFS purposes.[33]

Original Issue Discount

The proposed regulations do not alter the treatment of OID in general and do not apply to market discount. Favorably, however, the proposed regulations narrowly apply the AFS income inclusion rule to OID. As proposed, the AFS income inclusion rule would apply only to credit card late fees, credit card cash advance fees, and interchange fees, and not to OID (*e.g.*, points) treated as discount or an adjustment to the yield of a debt instrument in the AFS.[34]

Other Special Rules

Multi-year contracts

The proposed regulations apply to multi-year contracts (those spanning more than one tax year) using a "cumulative" rather than an "annual" approach. Under this approach, the taxpayer takes into account the cumulative amounts included in income in prior tax years on the contract, if any, in order to determine the amount to be included under section 451(b) for the tax years remaining on the contract.[35]

The preamble explains the distinction between the two approaches. An annualized approach would look at payments received in each tax year in isolation and compare the amounts included in the taxpayer's AFS and under the all events test to determine whether an amount should be included for federal tax purposes for that year. In contrast, under a cumulative approach, the taxpayer takes into account amounts previously included in prior tax years to determine the extent to which income must be accelerated in the current tax year by reason of the AFS income inclusion rule.[36] The taxpayer effectively receives "credit" for prior year inclusions.

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[33] Proposed section 1.451-3(e).

[34] This topic will be developed more fully in a separate *What's News in Tax* article.

[35] Proposed section 1.451-3(k).

[36] 84 Fed. Reg. at 47194.

As a result, the total amount of gross income recognized on the contract can never exceed the total contract price, and the amount recognized as gross income as of the current tax year will never exceed the greater of (1) the cumulative amount of contract revenue taken into account for book purposes, or (2) the cumulative amount that would have been recognized as gross income to date under the traditional all events test.

Example. Taxpayer D, an engineering services provider, is a calendar-year accrual method taxpayer with an AFS. In 2018, D enters into a contract with a customer to provide services for four years for a total of $100x. Under the contract, D receives $25x each year of the contract. For AFS purposes, D reports $50x, $0, $20x, and $30x of revenue from the contract in 2018, 2019, 2020, and 2021 respectively. In 2018, D recognizes all of the $25x payment in income from the contract under the all events test. In addition, under section 451(b), because $50x of revenue from the provision of services is included in D's 2018 AFS, the all events test for that portion of the provision of services is not met later than D's 2018 tax year. Therefore, D must recognize as gross income the additional $25x ($50x - $25x = $25x) reported on the AFS in 2018. In 2019, D includes $0 of the $25x payment in gross income from the contract because the payment received in 2019 relates to income included in 2018. In 2020, D recognizes all of the $25x payment in income from the contract under the all events test. In 2021, D recognizes the remaining $25x payment in income under the contract under the all events test.[37]

	2018	2019	2020	2021	Total
Payments	$25x	$25x	$25x	$25x	$100x
AFS Revenue	50x	0	20x	30x	100x
Income	50x	0	25x	25x	100x

If the taxpayer has elected to use the deferral method permitted by section 451(c) and proposed section 1.451-8 (or Revenue Procedure 2004-34, as applicable), the deferral of amounts otherwise recognized under the all events test will remain eligible for deferral (i.e., so long as they are not yet included in revenue for book purposes and the other requirements of that method are satisfied).

The following example reconciles the interaction of one statutory method that accelerates income recognition based on the book treatment, and a second statutory method that defers income recognition with respect to the same contract.

Example. The facts are the same as in the prior example, except that Taxpayer D elects to defer advance payments under section 451(c)(1)(B). In 2018, D recognizes all of the $25x payment in income from the contract under the all events test, as well as the additional $25x that is included in revenue on its AFS, for a total of $50x recognized for tax purposes in 2018. As in the prior example, D does not include any amount in gross income in 2019 for tax purposes because the payment received in that

[37] Proposed section, 1.451-3(m), Example 4.

year related to income included in 2018. In 2020, D recognizes $20x of the $25x payment in income from the contract under the deferral method for advance payments under section 451(c)(1)(B). In 2021, D recognizes the $5x that was deferred in 2020 under the deferral method plus the remaining $25x payment in income under the contract under the all events test.

	2018	2019	2020	2021	Total
Payments	$25x	$25x	$25x	$25x	$100x
AFS Revenue	50x	0	20x	30x	100x
Income	50x	0	20x	30x	100x

Mismatches in Reportable Periods

Proposed section 1.451-3(h)(4) provides guidance for taxpayers having a financial reporting period that differs from the taxpayer's tax year. The proposed regulations offer three permissible methods to address this situation. Under the first method, the taxpayer uses the accounting principles used to create its AFS to determine the items of income to be reported in revenue as if its financial reporting period coincided with its tax year.[38]

Example: Taxpayer A is a calendar-year accrual method taxpayer with an AFS. For AFS purposes, A's financial results are reported on a June 30 fiscal year. Using the method described in proposed section 1.451-3(h)(4)(ii)(A), for the tax year 2018, A uses the financial results reported on its June 30, 2018, AFS to determine whether an item of income was taken into account as revenue in its AFS from January 1, 2018 through June 30, 2018, and uses its June 30, 2019, AFS to determine whether an item of income is taken into account as revenue in A's AFS from July 1, 2018, through December 31, 2018.[39]

Under the second method, the taxpayer makes a reasonable estimate of revenue for the pro rata portion of the tax year for which the financial statement and tax year do not align.

Under the third method, if a taxpayer's financial accounting year ends five or more months after the end of its tax year, the taxpayer computes revenue based on the revenue reported on the AFS prepared for the financial accounting year ending within its tax year.

While the taxpayer has the option to use any of these three methods, changing from one methodology to another is a change of accounting method requiring IRS consent.

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[38] Proposed section 1.451-3(h)(4).

[39] Proposed section 1.451-3(m), Example 1.

Foreign Entities

The proposed regulations provide no special rules for foreign persons, including controlled foreign corporations. The preamble acknowledges that applying the AFS income inclusion rule to a CFC may

create mismatches between the CFC's taxable income for U.S. federal and foreign tax purposes. The preamble explains that, "As a result, certain taxpayers may lose the ability to credit foreign taxes imposed on a CFC's income, particularly where such taxes relate to amounts includible in gross income under section 951A and are therefore ineligible to be carried back or forward under section 904(c)."[40]

Treasury and the IRS have requested comments regarding whether special rules are needed to address the applicability of the AFS income inclusion rule to foreign persons, including whether and how the rules for determining the taxable income of a CFC can be adjusted to better align the U.S. federal and foreign income tax bases.

Effective Date

The regulations are proposed to be effective for tax years beginning after the date the final regulations are published in the Federal Register.[41] As applied to "specified fees",[42] the proposed regulations would be delayed for an additional year. Assuming the government is unable to finalize the regulations until 2020 (a reasonable assumption), the AFS income inclusion rule would not be mandatory until 2021 for calendar year taxpayers (with an additional one-year deferral for specified fees).

Importantly, however, the effective date of the regulations has no bearing upon the fact that the acceleration requirement of section 451(b) is already mandatory. The statutory provision became effective for tax years beginning on or after December 31, 2017.

Even though the proposed regulations likely will not be mandatory until 2021 for calendar year taxpayers, taxpayers generally may early-adopt the regulations immediately. Taxpayers early-adopting the proposed regulations generally may rely on them for tax years beginning after December 31, 2017.[43]

Early adoption of the proposed regulations is accomplished by filing an accounting method change using the procedures published in Revenue Procedure 2019-37, discussed below. The proposed regulations may be early adopted only on an all-or-nothing basis, however. As a consequence, being able to trade the uncertainty of the "realization" concept for the more concrete contingency rules contained in proposed section 1.451-3(c)(6) comes at the price of losing the potential ability to claim a cost offset for any of the items identified in the proposed regulations, including cost of goods sold.[44]

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[40] 84 Fed. Reg. at 47192.

[41] Proposed section 1.451-3(n).

[42] Proposed section 1.451-3(i)(2).

[43] Special rules are provided for specified fees, including specified credit card fees. *See* proposed section 1.451-3(n)(3)(ii).

[44] In actuality, the taxpayer is ceding the ability to debate the IRS regarding the right to claim a cost offset under the law applicable prior to the eventual effective date of the regulations. The preamble's discussion of this point provides a good barometer of the IRS's likely position even prior to the regulations' becoming final.

For taxpayers in some industries, this may be an attractive trade off. For many others, however, particularly those in the manufacturing, retail, mining, or similar industries, it likely will not be.

Accounting Method Changes

Concurrently with the publication of the proposed regulations, Treasury and the IRS issued Revenue Procedure 2019-37,[45] providing automatic consent to make accounting method changes to comply with either section 451(b) (designated change number ("DCN") 239) or proposed section 1.451-3 (DCN 242, only for "early adopters" of the proposed regulations). Taxpayers doing so concurrently with making a separate change in accounting method to align tax with the financial accounting standards under Topic 606 may choose to do so using either a section 481(a) adjustment or on a cut-off basis.[46] A single Form 3115 may be filed for both method changes,[47] subject to various procedural requirements.

Taxpayers making *only* an accounting method change to comply with Topic 606, however, are ineligible to use the procedures of Revenue Procedure 2019-37. Instead, those method changes continue to be governed by §16.11 of Revenue Procedure 2017-30, as added by Revenue Procedure 2018-29 (DCN 231).[48]

In the context of an affiliated group, the "concurrent change" requirement applies at the member level, rather than at the group level. In other words, an election to make the method change on a cut-off basis will apply only if the same entity is making both a change that complies with either section 451(b) or proposed section 1.451-3 *and* a method change in the same year to conform tax to certain financial accounting changes driven by Topic 606.

Although this will be a short-term consideration as AFS companies complete their implementation of the Topic 606 financial accounting standards, distinguishing between changes to conform to Topic 606 and changes to conform with section 451(b) or the proposed regulations (and thus which "DCN" to use) is conceptually difficult. The difficulty is particularly acute when the need to comply with section 451(b) is driven by accelerations in book revenue resulting from the implementation of Topic 606 in the same year. The distinction should be clearer in the context of book revenue from sources outside the scope of Topic 606.

Revenue Procedure 2019-37 applies to changes with respect to specified credit card fees, but not to changes with respect to other types of specified fees. An expanded six-year recovery period is permitted for positive section 481(a) adjustments (additions to income) for "qualified changes" made for income from specified credit card fees, but only for the taxpayer's first tax year beginning after

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[45] 2019-39 I.R.B. 731. Revenue Procedure 2019-37 also applies to method changes for advance payments permitted or required by section 451(c) and proposed section 1.451-8. Those provisions will be discussed separately.

[46] Section 16.12(4)(b) of Rev. Proc. 2018-31, as amended by Rev. Proc. 2019-37.

[47] Section 16.12(8)(b) of Rev. Proc. 2018-31, as amended by Rev. Proc. 2019-37.

[48] 2018-22 I.R.B. 634.

December 31, 2018. Changes in the treatment of specified credit card fees also are ineligible for the election to make the method change on a cut-off basis.

Similar to existing procedures, a "streamlined procedure" is available in limited circumstances. Under the streamlined procedure, a Form 3115 is not required in order to change to the new method of accounting. The streamlined procedure is available to a taxpayer who either (1) is a "small business taxpayer" with average annual gross receipts of $25 million or less for the prior three years or (2) is making one or more changes under §16.12(2)(a) of Revenue Procedure 2018-31 (e.g., to comply with either section 451(b) or the proposed regulations) *and* the section 481(a) adjustment required by each change is zero (without netting the adjustments for individual method changes). Taxpayers employing the simplified procedure, however, do not receive audit protection for the change, and may not elect to make the method change on a cut-off basis.

For taxpayers making a change to early adopt the proposed regulations, the streamlined procedure is available for the first or second tax year beginning after December 31, 2017. Taxpayers making a change to comply with section 451(b) but not early adopting the regulations may use the streamlined procedure only for their first tax year beginning after December 31, 2017.

For a taxpayer's first three tax years beginning after December 31, 2017, the government has waived the "five-year scope limitation," under which automatic consent generally is unavailable if the taxpayer has requested a change for the same item during any of the five tax years ending with the year of change.[49] For method changes involving specified credit card fees, this five-year scope limitation instead is waived for the taxpayer's first three tax years beginning after December 31, 2018. Taxpayers using the streamlined method have a smaller window of opportunity to avoid the scope limitation, depending upon whether they are early adopting the proposed regulations.[50]

The government also waives the general rule denying audit protection if the taxpayer is under IRS examination for the year of change. That waiver is available, however, only if the taxpayer is making a change to early adopt the proposed regulations (DCN 242), and does not appear to be available if the taxpayer is changing to a method to comply only with section 451(b) itself (DCN 239). This waiver is available for the taxpayer's first three tax years beginning after December 31, 2017. The generally applicable adjustment periods will continue to apply, however (e.g., a two-year recovery period for a positive section 481(a) adjustment).[51] As elsewhere in the revenue procedure, slightly different implementation dates apply in the case of specified credit card fees.

Given that many taxpayers will not early adopt the regulations, hopefully the IRS will extend the waiver period for these restrictions following finalization of the proposed regulations. Doing so would provide the same three-year waiver for all taxpayers required or permitted to use the AFS income inclusion rule.

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[49] Section 16.12(5)(a) of Rev. Proc. 2018-31, as amended by Rev. Proc. 2018-60.

[50] Section 16.12(5)(b) and (c) of Rev. Proc. 2018-31, as amended by Rev. Proc. 2019-37.

[51] Section 16.12(6)(b) of Rev. Proc. 2018-31, as amended by Rev. Proc. 2019-37.

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