



What's News in Tax

Analysis that matters from Washington National Tax

Extended Income Recognition Deferral for “Specified Goods”

February 24, 2020

by [Jessica Blair Theilken](#) and [James Atkinson](#), [Washington National Tax](#)*

Did you know that a special rule for advance payments for specified goods can defer including those payments in gross income for at least two years? Depending on a taxpayer’s circumstances, this could simply be good news or inadvertently affect tax planning in other areas.

Proposed regulations¹ implementing the 2017 codification of Revenue Procedure 2004-34² contain a special rule likely to benefit companies entering into contracts for the future delivery of high-value, customer-configured goods. In brief, the one-year deferral limitation applicable to most advance payments generally will not apply to pre-delivery payments received for goods scheduled to be delivered to customers at least two years in the future, provided the revenue likewise is deferred for book purposes.³ Instead, the taxpayer generally must defer including the pre-delivery payment in gross income until the goods are delivered to the customer.

* *Jessica Blair Theilken is a managing director and James Atkinson is a principal in the Income Tax and Accounting group of Washington National Tax (“WNT”).*

¹ REG-104554-18, 84 Fed. Reg. 47175 (Sept. 9, 2019).

² 2004-1 C.B. 991.

³ Proposed section 1.451-8(b)(1)(ii)(H). Neither the statute nor the proposed regulations use the term “pre-delivery payments.” That term is used herein, however, in light of the fact that key to use of the special rule for “specified goods” is that the payments are not “advance payments” as that term is defined for purposes of section 451(c). 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”).

While beneficial in many cases, in certain circumstances this prolonged income deferral may inadvertently affect the taxpayer’s planning in other areas, such as the BEAT, interest deductibility limitations, and the 50 percent deduction for FDII and GILTI amounts. As such, because the provision as currently proposed would be mandatory once the regulations become effective,⁴ understanding its application as well as its pros and cons is an important part of post-TCJA tax planning.

Codified Advance Payment Rules

The 2017 legislation known informally as the Tax Cuts and Jobs Act (“TCJA”)⁵ added new section 451(c) to the Internal Revenue Code. The legislative history of that provision makes clear that Congress intended to codify the one-year “deferral method” previously available under Revenue Procedure 2004-34 for most types of advance payments, and to eliminate longer deferral periods, such as those previously available for the sale of goods under section 1.451-5.⁶

The deferral method now codified as section 451(c) began as an administrative effort to soften the sometimes harsh effects of the Supreme Court’s so-called Trilogy decisions of the early 1960s. In *Schlude* and two companion cases,⁷ the Supreme Court held that accrual method taxpayers must recognize as gross income payments received during the tax year for services to be provided in a subsequent year.

Later courts narrowed the scope of the Trilogy’s holdings by permitting the deferral of income from advance payments for services that would be provided at reasonably certain times in the future. In these cases, the taxpayer would not be required to include the advance payment in gross income until the occurrence of the specific event to which the advance payment relates. For example, income for ticket sales in December for specific games to be played in the following baseball season may be deferred until the following year when the games are played.⁸

Treasury and the IRS further softened the *Schlude* rule by issuing Revenue Procedure 71-21,⁹ permitting the taxpayer to defer recognizing advance payments for services to be provided by the end of the next tax year. Treasury and the IRS also published section 1.451-5, permitting a longer deferral period for advance payments received in connection with the sale of goods. Each set of rules, however, required that books also defer the revenue.

⁴ The regulations are proposed to be effective for the taxpayer’s first taxable year beginning after the date final regulations are published in the *Federal Register*.

⁵ An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, Pub. L. No. 115-97, §13221 (Dec. 22, 2017).

⁶ H.R. Conf. Rep. No. 115-466 (Dec. 15, 2017); Joint Comm. on Tax’n, General Explanation of Public Law 115-97, JCS-1-18 (Dec. 2018) (the “Blue Book”).

⁷ *Schlude v. Commissioner*, 372 U.S. 128 (1963); *American Automobile Ass’n v. United States*, 367 U.S. 687 (1961); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957).

⁸ *Tampa Bay Devil Rays, Ltd. v. Commissioner*, T.C. Memo. 2002-248; *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968).

⁹ 1971-2 C.B. 549.

The government restated and slightly broadened Revenue Procedure 71-21 in 2004 through the issuance of Revenue Procedure 2004-34. Revenue Procedure 2004-34 permits a taxpayer to defer advance payments for transactions involving most types of goods and services until the end of the tax year subsequent to the year of receipt, again provided that the revenue is deferred for financial accounting purposes. In issuing Revenue Procedure 2004-34, the government left unchanged the longer deferral period available under the regulations for advance payments for the sale of goods.

As part of the TCJA, Congress codified Revenue Procedure 2004-34 as new section 451(c). Although the language of the new Code provision differs somewhat from that of the existing administrative guidance, the legislative history makes clear that Congress intended to permit the use of the same one-year deferral period for the same categories of advance payments as those available under the existing administrative guidance.¹⁰

At the same time, the legislative history of section 451(c) makes clear that Congress intended to statutorily nullify the longer deferral period previously permitted for sales of goods under section 1.451-5.¹¹ In furtherance of this stated legislative intent, Treasury and the IRS removed section 1.451-5, effective for tax years ending on or after July 15, 2019.¹²

Treasury and IRS issued proposed regulations on September 9, 2019, implementing new section 451(c). For the most part, the proposed regulations are unremarkable, and largely track the language of the new statutory provision, which itself largely restates the standards of a long-standing revenue procedure with which most affected taxpayers are familiar. In many ways, the proposed regulations represent the government’s efforts to align the provisions of section 451(c) more closely with the existing scope and standards of Revenue Procedure 2004-34.¹³

Extended Deferral for Specified Goods

New to the rules, however, is an exception for pre-delivery payments for certain types of goods.¹⁴ Under this exception, the one-year deferral limitation is inapplicable to payments received more than two tax years before the contractual delivery date of “specified goods.” The proposed regulations define “specified goods” as those for which, during the year in which a payment is received, the taxpayer does not have on hand (or available that year through its normal supply chain) goods of a substantially

¹⁰ H.R. Conf. Rep. No. 115-466, at 277; Blue Book, at 167.

¹¹ H.R. Conf. Rep. No. 115-466, at 277 fn. 880; Blue Book, at 168.

¹² T.D. 9870, 84 Fed. Reg. 33691 (July 15, 2019).

¹³ Notice 2018-35, 2018-18 I.R.B. 520, permits taxpayers to continue relying upon Revenue Procedure 2004-34 until the IRS issues further guidance.

¹⁴ The preamble explains that this special rule was added at the request of commenters who raised concerns regarding “pre-delivery payments for the sale of high-value customer-configured equipment that will be delivered to customers at reasonably certain times.” The preamble notes that other commenters requested such an exclusion for “commercially significant goods” having a useful life in excess of 10 years and that is developed, marketed, and sold to customers in the aerospace industry. 84 Fed. Reg. at 47177.

similar kind and in sufficient quantity to satisfy the contract, and all of the revenue from the sale of which will be recognized for financial accounting purposes in the year of delivery.¹⁵

The one-year deferral limitation of section 451(c) and the proposed regulations will not apply to payments for specified goods that are received “earlier than the tax year immediately prior to the tax year of the contractual delivery date of the goods.”¹⁶ In other words, the pre-delivery payment must be for specified goods contractually scheduled to be delivered no earlier than two tax years in the future.

Upon first reading, the special rule is relatively broad. The requirements of section 451(c)—and hence the one-year cap on the deferral period—will not apply if:

- Taxpayer receives a pre-delivery payment;
- The contracted goods are not on hand during the year of receipt and are not available that year through the taxpayer’s normal supply chain;
- The specific, contracted delivery date is after the tax year following the tax year in which the payment is received; and
- All the contract revenue from the sale is recognized in the taxpayer’s applicable financial statement (“AFS”) in the year of delivery.

So long as the pre-delivery payment satisfies these criteria, it is not an “advance payment” for purposes of section 451(c) and the proposed regulations. As such, neither the full-inclusion default rule of section 451(c)(1) and proposed section 1.451-8(a), nor the elective deferral method of section 451(c)(2) and proposed section 1.451-8(c) are applicable. By their terms, those rules only apply to “advance payments.” Instead, an accrual method taxpayer will apply the traditional all-events test of section 451(b)(1)(C) to determine the year in which to recognize the pre-delivery payment as income, without regard to the elective one-year deferral otherwise available for “advance payments.”

In falling outside the scope of the elective deferral method, it is important that the pre-delivery payment relates to the sale of goods that will be delivered on a specific date sufficiently far in the future. Absent this tie to a specific performance date, excluding the pre-delivery payment from the scope of the deferral method may simply require including it in gross income in the year of receipt under the general rule of *Schlude*. If the pre-delivery payment can be tied to a specific performance date in the future, however, cases such as *Artnell* and *Tampa Bay Devil Rays* permit deferring the recognition of that income until that future performance (e.g., delivery).

Ideally, the regulations when finalized would specifically allow recognition of pre-delivery payments for specified goods upon delivery to the customer (at the taxpayer’s election, rather than mandatorily), rather than leaving the taxpayer and potentially an IRS exam team to wrestle with the applicability of

¹⁵ Proposed section 1.451-8(b)(9).

¹⁶ Proposed section 1.451-8(b)(1)(ii)(H).

common law principles such as those in *Artnell* and *Tampa Bay Devil Rays*.¹⁷ If that is the drafters’ intended application of the special rule, prudence would suggest explicitly saying so in the final regulations.

Interaction with Long-Term Contract Rules

By definition, contracts for specified goods within the scope of this rule are those not otherwise required to be treated as long-term contracts under section 460. Briefly, in the context of the manufacture of goods, section 460 applies if the goods are either (1) a “unique” item of a type not normally carried in the taxpayer’s finished goods inventory; or (2) an item that normally requires more than 12 calendar months to complete (regardless of the duration of the contract or the time to complete a deliverable quantity of the item). Section 1.460-1 provides detailed rules for determining whether a contract falls within one of these two categories of long-term contracts.

If an agreement falls within the definition of a long-term contract, the accounting method prescribed by section 460 and its regulations (such as the percentage completion method) is mandatory. Through exclusion from the definition of “advance payments,” pre-delivery payments for specified goods are subject to the general standards for determining when to recognize an item of income, including applying the long term contract rules when the facts require doing so.¹⁸

Potential Application

Depending on the contract terms, the extended deferral period for specified goods might benefit manufacturers of (for example):

- Airframes, engines, and other critical components of an aircraft
- Power plant turbines, nuclear fuel assemblies, and other critical long-lead time power plant components
- Railroad locomotives and rolling stock (including commuter rail cars) ordered several years in advance of delivery

As currently drafted, the specified-goods exception applies more narrowly than perhaps its drafters intended. Because the extended deferral period is available only if the entire contract revenue is included in the taxpayer’s AFS in the year of delivery, the revenue recognition timing pattern for book

¹⁷ Income deferral for pre-delivery payments also should be elective rather than mandatory in light of the general rule that income is recognized under the all events test upon the earlier of an item having been earned, due, or received. Rev. Rul. 84-31, 1984-1 C.B. 127. By definition pre-delivery payments have been received, rendering moot the consideration as to whether the amounts have been “realized.” For an earlier discussion, please see J. Atkinson, *Section 451(b): Did You Realize the Need to Recognize the Difference?*, What’s News in Tax (Feb. 11, 2019).

¹⁸ Section 460 likewise is applicable to amounts that would otherwise qualify as “advance payments” under the proposed regulations.

purposes must be “point-in-time” rather than over time. This may inadvertently exclude many transactions that presumably were intended to fall within the scope of the special rule.

By its terms, the exception applies only to goods that the taxpayer does not hold in its inventory, cannot obtain that year through its normal supply channels, and whose delivery (and presumably production) will require a substantial period of time. Applicable financial accounting standards generally will require the taxpayer to recognize the contract revenue over time if either:

- The customer receives and consumes the benefits as the taxpayer performs;
- The taxpayer’s performance creates or enhances an asset that the customer controls as the taxpayer performs; or
- The taxpayer’s performance does not create an asset with an alternative use to the taxpayer, and the taxpayer has an enforceable right to payment for performance completed to date.¹⁹

The book revenue will be recognized at a point in time—for example, delivery—only if none of these three criteria is met.²⁰

As such, the proposed regulations’ dual requirements that the goods not be held in inventory nor be readily available (i.e., generally must be produced upon customer demand and to its specification) *and* that the entire contract revenue must be deferred for book purposes until delivery constricts the potential scope of the special rule perhaps more than the drafters intended. Hopefully the regulations, when finalized, will relax these strictures so as to broaden the scope of “specified goods” eligible for the extended deferral period.

For most contracts, the extended deferral likely will not apply to progress payments received during the course of contract performance. Payments received within two tax years of the delivery date would remain within the general definition of an “advance payment,” and as such subject to either the full-inclusion method or the general one-year deferral period (depending upon the taxpayer’s accounting method). Some progress payments made on contracts with exceptionally long performance periods, however, might be eligible for the extended deferral, depending on the facts.

When applicable, this special rule offers a number of potential benefits. Most fundamentally, the taxpayer will defer recognizing pre-delivery payments as gross income until the year in which the goods are delivered to the customer.

A less obvious but nonetheless important benefit is ensuring that the taxpayer can offset the taxable receipt by the related costs of performance. In many cases, the taxpayer’s inventory method of

¹⁹ Paragraphs 25-27 through 25-29 of ASC Subtopic 606-10.

²⁰ 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.

accounting will take the sale into account only upon delivery.²¹ If so, the taxpayer generally would be unable to recognize a deduction for those expenditures—in particular its cost of goods sold (COGS)—prior to that delivery date. Deferring the recognition of the related income until that same year avoids the potential mismatch that might otherwise occur.

Post-TCJA tax planning requires carefully balancing a multitude of potential ripple effects. For example, in some situations, taxpayers might benefit from accelerating rather than deferring the recognition of income. Doing so might assist (for example) the company’s efforts to mitigate BEAT liability;²² to manage the adjusted taxable income limitation on interest deductibility;²³ or to manage the taxable income limitation on the deduction for GILTI and FDII amounts.²⁴ Even though the proposed specified goods rule would be mandatory, in some cases taxpayers may be able to plan around its application to derive a more beneficial overall tax position. In all cases, taxpayers faced with these interacting considerations should model the potential tax consequences of each position that is otherwise “just timing.”

As a final caveat, this special rule currently is available only by “early adopting” the proposed regulations through an accounting method change. The IRS has provided automatic consent for taxpayers wishing to do so.²⁵ Early adoption of proposed section 1.451-8 is on an all-or-nothing basis, and certain elements of the proposed regulations may be broadly unattractive to manufacturers and others with significant production costs. Once the regulations become final and effective, however, that consideration becomes moot, and all taxpayers receiving advance payments will need to assess whether the longer deferral period for specified goods applies, and if so, how it interacts with the taxpayer’s overall tax planning under the TCJA.

□ □ □ □

The information in this article is not intended to be “written advice concerning one or more federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230 because the content is issued for general informational purposes only. The information contained in this article is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author or authors only, and does not necessarily represent the views or professional advice of KPMG LLP.

²¹ See section 1.446-1(c)(1)(ii)(C).

²² Section 59A.

²³ Section 163(j).

²⁴ Section 250.

²⁵ Section 16.12 of Rev. Proc. 2019-43, 2019-48 I.R.B. 1107.