# KPMG report: Final regulations on changes to income recognition rules; initial impressions

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# Introduction

Final regulations (T.D. 9941) under sections 451(b) and 451(c) addressing amendments made by the 2017 tax law (Pub. L. No. 115-97), or the legislation commonly referred to as the "Tax Cuts and Jobs Act" (TCJA), were published in today's edition of the Federal Register.

The IRS on December 21, 2020, posted to its website a version of these final regulations, and then the U.S. Treasury Department and IRS on December 30, 2020, released the "official" version of the final regulations for publication in the Federal Register.

The final regulations adopted regulations that were proposed in 2019, but with significant revisions to the proposed regulations.

The **final regulations** [PDF 481 KB] (54 pages as published in the Federal Register on January 6, 2021) include the following major sections:

- The first provides guidance regarding section 451(b), amending the "all events test" to require certain taxpayers to recognize income no later than the tax year in which the amount is included in revenue for financial accounting purposes.
- The second provides guidance regarding section 451(c), codifying the deferral method of accounting for certain advance payments. Section 451(c), as amended, largely codifies Rev. Proc. 2004-34, with which many taxpayers are already familiar, but makes certain changes to those rules as well. The preamble to the final regulations states that Rev. Proc. 2004-34 is now obsolete.

This report provides initial observations and a high-level summary of the final regulations. It is important to note that the final regulations are complex and will likely take some time for taxpayers to properly implement.

**Effective dates**

The final regulations under Reg. §§1.451-3 and 1.451-8 generally apply for tax years beginning on or after January 1, 2021. However, see Reg. §1.451-3(n)(2) for delayed effective dates for certain specified fees that are not specified credit card fees applying for tax years beginning on or after January 6, 2022.

The preamble to the final regulations indicates that, pursuant to section 7805(b)(7), taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may apply the final regulations, in their entirety and in a consistent manner, to a tax year beginning after December 31, 2017, and before January 1, 2021. However, the preamble to the final regulations clarifies that if taxpayers apply the final regulations to a tax year beginning before January 1, 2021, they must follow the rules for changes in method of accounting under section 446 and the applicable procedural guidance.

Concurrently with the publication of the proposed regulations in 2019, Treasury and the IRS issued section 16.12 of Rev. Proc. 2019-43, providing automatic consent to make accounting method changes to comply with section 451(b) and section 451(c) as well as to early adopt the proposed regulations under Prop. Reg. §§ 1.451-3 and 1.451-8. As of the date of this publication, Treasury and the IRS have not issued specific guidance for method changes under the final regulations. However, section 16.12 generally covers changes under sections 451(b) and 451(c) and appears broad enough to cover automatic changes to the final regulations under Reg. § 1.451-3 and 1.451-8. Thus, a taxpayer whose extended due date has not yet passed for a tax year may consider filing an automatic change to use the final regulations for that year. It should be noted that the waiver of the "five-year scope limitation" under

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section 16.12 of Rev. Proc. 2019-43 applies only for a taxpayer's first three tax years beginning after December 31, 2017.

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# Section 451(b): AFS income inclusion rule

## Background

Under section 451(a) and Reg. §1.451-1(a), an accrual basis taxpayer is required to recognize income in the year that all events have occurred that establish the right to receive the income and the amount of the income can be determined with reasonable accuracy. All events that fix the right to receive income generally occur when (1) the required performance occurs; (2) payment is due to the taxpayer; or (3) payment is received by the taxpayer, whichever happens earliest. See, for example, Rev. Rul. 84-31, 1984-1 C.B. 127. The 2017 TCJA modified the all events test by adding section 451(b), which provides that 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 applicable financial statement (AFS) for the reporting period.

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.

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# Summary and explanation of Reg. §1.451-3

## Realization and recognition

Footnote 872 of the Conference Report to the TCJA states that section 451(b) was not intended to revise the rules associated with when an item is realized for federal income tax purposes and does not require the recognition of income in situations where the federal income tax realization event has not taken place. See H.R. Rep. No. 115-466, at 428 fn. 872 (2017) (Conf. Rep.). The proposed regulations did not explicitly distinguish between the realization and recognition of income, but instead proposed a rule that amounts subject to the occurrence of future contingencies as of the end of the tax year were not subject to inclusion under section 451(b). The final regulations do not include the future contingencies rule as it existed in the proposed regulations and decline to use the amounts realized concept. Instead, the final regulations focus on the appropriate tax year of inclusion under a new standard called the "AFS income inclusion rule."

### AFS income inclusion rule

Under the AFS income inclusion rule, the all events test under §1.451-1(a) is treated as met no later than when that item, or portion thereof, is "taken into account as AFS revenue." In determining when an item of gross income is "taken into account as AFS revenue," AFS revenue is reduced by amounts that the taxpayer **does not have an enforceable right to recover if the customer were to terminate the contract on the last day of the tax year** [emphasis added]. Whether a 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. The AFS income inclusion rule applies only to taxpayers having an AFS for the entire tax year, determined on a year-by-year basis.

To reduce compliance burdens, the final regulations provide for an alternative method to the AFS income inclusion rule that allows a taxpayer to more closely align its tax and AFS methods. Under the "alternative AFS revenue method," a taxpayer does not reduce AFS revenue by amounts that the taxpayer lacks an enforceable right to recover if the customer were to terminate the contract on the last day of the tax year. The alternative AFS revenue method is a method of accounting and must be applied to all items of gross income in the trade or business that are subject to the AFS income inclusion rule.

Whether a taxpayer uses the AFS income inclusion rule or the alternative AFS revenue method, two adjustments must be made to AFS revenue in determining whether an item of gross income is taken in account as AFS revenue.

- The first adjustment requires the taxpayer to disregard any increase in the transaction price as a result of a significant financing component being included on the AFS. Under ASC 606, a significant financing component may be included in the AFS transaction price as a result of delays between payment and the transfer of control criteria and generally require imputed interest income and expense.

- The second adjustment requires the taxpayer to increase the transaction price if the AFS transaction price is reduced by (1) amounts that are cost of goods sold or liabilities that are required to be accounted for under other provisions of the Code, such as section 461, including liabilities for allowances, rebates, chargebacks, rewards issued in credit card and other transactions and other reward programs, and refunds (for example, estimated returns based on historic practice), regardless of when any such amount is incurred (Liability Amounts); or (2) amounts anticipated to be in dispute or anticipated to be uncollectable.

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It is important to note that the AFS income inclusion rule applies to the sale of goods. Under the proposed regulations, a taxpayer may have taken the position that section 451(b) did not apply to inventory sales because there was no amount realized until the sale took place, whether at title transfer, shipment, delivery, or acceptance. The final regulations make it clear that section 451(b) applies to inventory sales and that taxpayer may not rely on the amount realized concept to defer the recognition of revenue until the inventory is treated as sold. A taxpayer that is currently deferring the revenue and related cost of goods sold until the inventory is sold will have to change its method of accounting to comply with the final regulations. However, the final regulations alleviate the potentially harsh results of recognizing revenue from inventory sales prior to the sale date or receipt of payment by providing the "AFS cost offset method," as described below, to reduce the amount of revenue recognized under section 451(b).

### AFS cost offset method

Under the AFS cost offset method, a taxpayer may reduce gross income includible for a year prior to the year in which ownership of inventory transfers to the customer by reducing the amount of revenue it would otherwise be required to include under the AFS income inclusion rule by the "cost of goods in progress offset." The cost of goods in progress offset for each item of inventory for the tax year is calculated as (1) the cost of goods incurred through the last day of the tax year, (2) reduced by the cumulative cost of goods in progress offset amounts attributable to the items of inventory that were taken into account in prior tax years, if any. The cost of goods progress amount is determined for each item of inventory by applying a taxpayer's methods of accounting used for federal income tax purposes, including sections 263A and 471. However, the cost of goods in progress offset cannot reduce the AFS inventory inclusion amount for the item of inventory below zero. A taxpayer that defers revenue prior to the sale under the AFS cost offset method will generally include that revenue in the tax year in which ownership of the item of inventory is transferred to the customer.

The AFS cost offset method does not modify the rules for determining when costs are allocated to and included in inventory under sections 461, 471, and 263A. Thus, the AFS cost offset method applies only to reduce the amount of income included under the AFS income inclusion rule. Costs allocated to inventory will continue to be recovered through COGS in the year they are treated as sold in accordance with the taxpayer's inventory cost flow assumption. The AFS cost offset method is a method of accounting that must be applied to all items of income eligible for the AFS cost offset method in the taxpayer's trade or business. In addition, a taxpayer using the AFS cost offset method must also use the AFS cost offset method for advance payments under Reg. §1.451-8(e).

## Other considerations

**Special methods of accounting**—The AFS income inclusion rule is inapplicable to any item of income for which the taxpayer uses a "special method of accounting." The proposed regulations provided a non-exclusive list of examples of special methods of accounting, including the installment method, long-term contract methods, the treatment of certain rental agreements under section 467, or specific methods of accounting for market discount and OID, other than certain specified fees. The final regulations retain the methods and add items to the list of special methods: (1) methods of accounting for notional principal contracts under Reg. §1.446-3, and (2) the timing rules for stripped bonds under section 1286.

**OID special methods of accounting**—Under the statute, the AFS income inclusion rule trumped the special accounting method rules for all forms of OID, including credit card fees and other types of loan fees. Unlike credit card fees, for which current recognition is generally required for financial reporting purposes, the AFS accounting methods generally treat other types of loan fees and discount as a yield adjustment that is recognized over time over the life of the debt instrument rather than upfront at the

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time the loan closes. In recognition of the complexities that would result from differences in timing for fees that are recognized over time for both financial and tax purposes, the proposed and final regulations limit the AFS income inclusion rule to specified fees, which includes credit card fees and other fees that are not treated as a yield adjustment. As a result, taxpayers may continue to use a different OID method for tax purposes that may in some cases result in a longer deferral than the AFS method in the case of fees that are treated as a yield adjustment in the AFS.

The final regulations expand the scope of the OID exclusion to fees that may not be treated as a yield adjustment over the life of the instrument, but over a shorter period, such as a promotional discount, since these fees are still deferred in the AFS. Consistent with the delayed statutory effective date, the mandatory change to the current inclusion method for specified credit card fees applies for tax years beginning after December 31, 2018, with a six-year rather than four-year section 481(a) adjustment period, and for specified fees other than credit card fees the final regulations require the change to the current inclusion method for tax years beginning after the date that is one year after the date of publication of the final regulations in the Federal Register.

**Allocation of transaction price for special methods of accounting**—To determine the transaction price allocated to a performance obligation subject to a special method of accounting, the final regulations provide that the transaction price is first allocated to items of gross income subject to a special method of accounting, as determined under the special method of accounting. Prior to allocating the transaction price the taxpayer must reduce the transaction price in the amount of a significant financing component, if any, and increase the transaction price in the amount of any liability amounts or COGS adjustment made for AFS purposes. The residual amount is allocated to each performance obligation in accordance with Reg. §1.451-3.

**Definition of AFS**—The final regulations apply only to taxpayers having an AFS for the entire tax year. For this purpose, "AFS" is defined in order of priority to include such documents as Forms 10-K or other annual shareholder statements filed with the U.S. Securities and Exchange Commission (SEC); audited financial statements used for specific purposes; and financial statements other than tax returns filed with federal agencies other than the SEC or the IRS. AFS definitions are provided for both GAAP and IFRS taxpayers.

# Section 451(c): Advance payments

The TCJA amended section 451 to add subsection (c), which essentially codified the deferral method of accounting for advance payments for goods and services under Rev. Proc. 2004-34, which is now obsolete. This rule permitted a one-year deferral beyond the year of receipt of certain advance payments. Treasury and the IRS have issued Reg. § 1.451-8 concerning advance payments for goods, services, and other items, which generally incorporates the language and rules as described in Rev. Proc. 2004-34.

## Summary and explanation of Reg. §1.451-8

### Deferral method—definition of advance payment

The final regulations—consistent with section 451(c)(1)(B)—provide that an accrual method taxpayer with an AFS who receives an advance payment may use the one-year deferral method. Under the deferral method, the taxpayer must include an advance payment in income in the year of receipt to the extent that it is included in revenue in its AFS, or to the extent the advance payment is earned in the case of a taxpayer without an AFS. Any remaining amount of the advance payment must be included in income in

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the next tax year. If a taxpayer does not use the deferral method for an advance payment, the payment must be included in income in the year it is received or becomes due.

No changes were made to the definition of an advance payment in the final regulations. Note that if a type of payment is not an "advance payment" under the final regulations, the payment is subject to the default rules under section 451(b), and may be subject to inclusion upon receipt, or a later year in certain cases. For example, an advance payment of rental income is not an advance payment, but if the rental agreement is subject to the special method of accounting under section 467, the advance payment may be subject to inclusion in a later year based on a the rent allocation schedule in the rental agreement.

Section 451(c)(4) defines an advance payment as a payment for which (1) the full inclusion method in the year of receipt is a permissible method of accounting; (2) a portion of the advance payment is included in AFS revenues in a year subsequent to the year of receipt, and (3) the advance payment is for services, goods, or other items identified by the Secretary. The proposed and final regulations largely mirror the list of eligible items in Rev. Proc. 2004-34, with a few additions, and includes a payment for:

- Services;
- The sale of goods;
- The use, including by license or lease, of intellectual property;
- The occupancy or use of property if the occupancy or use is ancillary to the provision of services;
- The sale, lease, or license of computer software;
- Guaranty or warranty contracts ancillary to an item described above;
- Subscriptions in tangible or intangible format;
- Memberships in an organization;
- An eligible gift card sale;
- Any other payment identified by the Secretary of the Treasury or his delegate in published guidance; and
- Any combination of items described above.

## Adjustments to the determination of the amount included in AFS revenue

The final regulations coordinate the determination of the amount of an advance payment deemed to be included in the AFS revenues under the deferral method with the determination of the transaction price for purposes of applying the AFS income inclusion rule under section 451(b). As a result, adjustments are required to add to AFS revenues amounts that reduced AFS revenues for anticipated liabilities (e.g., rebates and chargebacks), and subtract from AFS revenues amounts that increase AFS revenue for a significant financing component. This provision likely adds additional complexity to the deferral method in requiring taxpayers to make tax adjustments to the amount recognized on the taxpayer's AFS in the year of receipt.

## Specified goods exception

An important exclusion from the definition of advance payment in the proposed and final regulations is the exception for advance payments for "specified goods" that are received two years or more before the tax year of the contractual delivery date. The final regulations define the "contractual delivery date" as the month and year of delivery listed in the written contract and "specified good" as a good for which: (1) the taxpayer does not have the goods of a substantially similar kind and in a sufficient quantity at the end of the tax year the upfront payment is received; and (2) the taxpayer recognizes all of the revenue from the sale of the good in its AFS in the year of delivery. Thus, a taxpayer that receives advance payments for specified goods must analyze the proper year for inclusion under the general principles of sections 451(a) and 451(b), unless, as discussed below, the taxpayer chooses to not apply the specified goods exception.

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The specified goods exception is expected to provide taxpayers an avenue to obtain a longer deferral period for advance payments subject to the rule, based on case law interpreting the all-events test. Many commentators considered the exception in the proposed regulations to be too narrowly drafted in comparison to prior authority and therefore requested that the contractual delivery date requirement be based on whether a contractual delivery date could be reasonably determined from the contract based on facts and circumstances or based on whether it is reasonably certain that the taxpayer's performance will in fact take place. The Treasury Department and IRS declined to broaden the rule in response to the comments and also declined to modify the rule to accommodate situations where the AFS inclusion for the goods is based on an over-time reporting method rather than reporting at the point in time of delivery. Requests to include in the exception payments for services that are integral to the sale of the specified goods was also rejected on the basis that it would lead to audit controversy and would be inconsistent with Congress's intent to override Reg. § 1.451-5.

The Treasury and IRS also declined commentator requests to illustrate the specified goods exception with additional examples, stating only that the effect of the exception is to subject the advance payments to the general accrual method of accounting rules including the all events test. Because the regulations implementing section 451(b) do not provide guidance on how the all events test applies in this instance, there will continue to be no regulatory guidance addressing the proper method of accounting and taxpayers will need to rely on the case law addressing the treatment of advance payments, which may lead to continued controversy.

## Specified goods exception made optional

In response to comments, the final regulations reverse the rule in the proposed regulations and make the specified goods exception optional. The revised rule permits a taxpayer to opt out and use a new "specified good section 451(c) method" which provides the option to use the current inclusion method or a modified one-year deferral method. If the taxpayer uses the specified good section 451(c) method, the prepayment is generally deferred for one year; however, if a taxpayer also uses the advance payment cost offset method under Reg. §1.451-8(e) to account for such prepayments, a portion of the prepayment may be deferred until the year in which ownership of the good is transferred to the customer.

## Acceleration rule for advance payments under the one-year deferral method

If a taxpayer uses the deferral method for advance payments, both the proposed and final regulations include a rule (identical to the rules in Rev. Proc. 2004-34) requiring acceleration of the income into the year of receipt under a specified number of circumstances, including: (1) if, in that tax year, the taxpayer either dies or ceases to exist in a transaction other than a transaction to which section 381(a) applies, or (2) if, and to the extent that, in that tax year, the taxpayer's obligation for the advance payments is satisfied or otherwise ends other than in a transaction to which section 381(a) applies or in a section 351(a) transfer between members of a consolidated group and the transferee adopts the deferral method. With respect to the requirement to accelerate when "the taxpayer's obligation for the advance payment is satisfied," the intent is to prevent the possibility that income from the advance payment is deferred until a tax year later than when the income otherwise would have been earned and recognized in the absence of an advance payment, notwithstanding that the revenue from the advance payment is deferred in the AFS. The regulations illustrate this with an example in which a travel agent receives and thus fully earns a commission in the tax year when a customer purchases and airline ticket but includes the commission in its AFS in the subsequent year when the customer uses the ticket for a flight.

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## Contracts with multiple components

Section 451(c)(4) provides that rules similar to those in section 451(b)(4), which allocate transaction price among multiple performance obligations, apply in the advance payment context. The final regulations clarify that advance payments received under a contract with multiple performance obligations are allocated to the corresponding items of gross income in the same manner that the payments are allocated to the performance obligations in the taxpayer's AFS. The rule for taxpayers without an AFS remains unchanged from the proposed regulations, i.e., allocation based on objective criteria.

Similarly, the final regulations provide that if a contract with a customer includes items of gross income subject to a special method of accounting (e.g., long term contracts under section 460) and items of gross income subject to the advance payment rules, and the taxpayer receives an allocable payment, then the taxpayer must determine the portion of the payment allocable to the various items of gross income based on objective criteria; an allocation is first to the items subject to the special method of accounting, with the residual amount treated as subject to section 451. A similar allocation rule applies to taxpayers using the non-AFS deferral method.

## Cost offsets with respect to advance payments

The proposed regulations did not provide for an offset for costs attributable to advance payments. Under prior law, there was such a cost offset only in limited circumstances under Reg. §1.451-5 and not at all under Rev. Proc. 2004-34. Treasury and IRS considered comments on the proposed regulations and determined that a cost offset based on estimates of future costs would be inappropriate, but agreed with comments suggesting that taxpayers should be afforded the flexibility of applying an offset for costs incurred against advance payments for the future sale of inventory. The final regulations accordingly provide that a taxpayer determines the amount of an advance payment that is included in gross income for the tax year by reducing the amount that would otherwise be included in gross income for such tax year under the taxpayer's full inclusion method or deferral method by the cost of goods related to the item of inventory, the "cost of goods in progress offset." The portion of any advance payment that is so offset is deferred and generally included in gross income in the tax year in which ownership of the item of inventory is transferred to the customer.

Specifically, the final regulations provide that the cost of goods in progress offset is calculated as the cost of goods incurred through the last day of the tax year, reduced by the cumulative offset amounts in prior tax years, if any. However, the offset cannot reduce the advance payment inventory inclusion amount for the tax year below zero. Furthermore, the offset attributable to one item of inventory cannot reduce the inclusion amount attributable to a separate item of inventory. Any incurred costs that are not used to offset an advance payment because they are subject to limitation are considered when the taxpayer determines the offset in a subsequent tax year. In addition, the offset does not apply to an inclusion resulting from the acceleration rules concerning cessation of the trade or business or cessation of the taxpayer's deferred revenue obligation, while any advance payments previously deferred by way of an offset in a prior year are accelerated under such rules.

A taxpayer must calculate its cost of goods in progress offset by reference to all costs that the taxpayer has permissibly incurred, capitalized, and allocated to items of inventory under its methods of accounting, but may not consider costs that are not properly capitalized under such method. Sections 461, 471, and 263A are given full effect; thus, estimates of future costs are not permitted, and any incurred costs that are properly allocable to the inventory at issue must be so allocated. For a sale of a gift card or customer reward program points, no offset is permitted. The advance payment cost offset method is a method of accounting that applies to all advance payments received by a trade or business for items of inventory that satisfy the regulatory criteria. If a taxpayer chooses to use the advance payment cost offset method

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for a trade or business, it must also use the AFS cost offset method (discussed above), and coordination between these methods is provided in the preamble to today's final regulations (T.D. 9941).

## Continued application of Rev. Proc. 2004-32 and Rev. Proc. 79-38

Rev. Proc. 2004-32, 2004-1 C.B. 988, allows an accrual method taxpayer to account for income from credit card annual fees ratably over the period covered by the fees. Rev. Proc. 79-38, 1979-2 C.B. 501, generally allows accrual method manufacturers, wholesalers, and retailers of motor vehicles or other durable goods to include a portion of an advance payment related to the sale of a multi-year service warranty contract in gross income over the life of the service warranty obligation. The preamble to T.D. 9941 clarifies that both of these revenue procedures remain effective after the enactment of section 451(c) and may be relied upon after promulgation of the final regulations.

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# Contact us

**For more information, contact a tax professional with KPMG's Washington National Tax:**

**Eric Lucas**
**T:** +1 202 533 3023
**E:** ejlucas@kpmg.com

**Colleen O'Connor**
**T:** +1 202 533 8049
**E:** colleenmoconnor@kpmg.com

**Carol Conjura**
**T:** +1 202 533 3040
**E:** cconjura@kpmg.com

**Scott Vance**
**T:** +1 202 533 6398
**E:** scottvance@kpmg.com

**Catherine Fitzpatrick**
**T:** +1 202 533 3168
**E:** cfitzpatrick@kpmg.com

**Melissa Abel**
**T:** +1 949 885 5794
**E:** mabel@kpmg.com

**www.kpmg.com**

**kpmg.com/socialmedia**

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