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A Tax Practitioner's Guide to Section 451(b) and Specified Fees

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Section 451(b) requires that certain types of income be included in taxable income no later than when it is included in the taxpayer's "applicable financial statement" revenue.[1] In section 1.451-3, Treasury and the IRS delayed the application of this requirement for certain "specified fees." The regulation requires that those fees be included in taxable income when recognized in financial statement revenue, starting in 2023 for calendar year taxpayers. Specified fees are fees that would be treated as original issue discount ("OID") (absent the application of section 451(b)) and are included in revenue currently for financial accounting purposes. Lenders receiving specified fees that presently defer the recognition of those fees for tax purposes are required to file a nonautomatic method change request to transition to the new method of accounting. This article provides an overview of certain issues associated with this accounting method change.

Background

Section 451(b) was amended in 2017 by Pub. L. No. 115-97 (commonly referred to as the Tax Cuts and Jobs Act ("TCJA")).[2] As amended, section 451(b) generally provides that for accrual method taxpayers, the all-events test for an item of gross income is treated as met no later than when the item is taken into account as revenue in an applicable financial statement. For this purpose, the term "applicable financial statement" is broadly defined and includes most audited financial statements.[3]

The legislative history to section 451(b) clearly anticipated that the provision would apply to credit card fees, but it was unclear whether, or to what extent, it would apply to income from debt instruments outside that context.[4]

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[1] 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").

[2] Sec. 13221 of P.L. 115-97, 131 Stat. 2054 (2017).

[3] Section 451(b)(3).

[4] Section 451(b)(2) provides that the general rule in section 451(b) does not apply to any item of gross income for which the taxpayer uses a special method of accounting provided under any provision of Chapter 1, other than any provision of part V of subchapter P (sections 1271–1288). Although the legislative history to section 451(b) implies that the exclusion of part V of subchapter P from the special method of accounting rule was primarily intended to ensure credit card fees were subject to inclusion on a current basis, it was previously unclear whether the provision would affect market discount or OID accruals more broadly.

Under regulations, Treasury and the IRS clarified that in the context of debt instruments, section 451(b) applies only to "specified fees."[5] Specified fees are fees that are not spread over a period of time as discount or as an adjustment to the yield of a debt instrument in the taxpayer's applicable financial statement and would otherwise be treated as creating or increasing OID on a debt instrument in the absence of section 451(b).[6] Thus, if a loan fee is included in revenue in an applicable financial statement when received, it would also be included in taxable income upon receipt under section 451(b). However, fees that are deferred in applicable financial statement revenue (i.e., treated as discount or as an adjustment to the yield of the debt instrument) do not meet the definition of specified fees and would, therefore, not be required to be included in income upon receipt. The regulations provide for a phased-in application of section 451(b) to specified fees. For specified fees that are "specified credit card fees" (i.e., credit card late fees, cash advance fees, and interchange fees), section 451(b) applies to tax years beginning after December 31, 2018.[7] For all other specified fees, section 451(b) applies for tax years beginning on or after January 6, 2022.[8]

Nonautomatic Change

The change to implement section 451(b) for specified fees that are not specified credit card fees is not currently included on the list of automatic method changes.[9] Therefore, barring additional guidance to the contrary, the method change to implement section 451(b) for specified fees is a nonautomatic method change. As such, Form 3115, *Application for Change in Accounting Method*, is required to be filed with the IRS National Office no later than the last day of the year of change. If a calendar year taxpayer with specified fees were to file a method change for the first effective year, Form 3115 is due no later than December 31, 2023.

Consolidated groups may file a single method change request for the entire group and nonconsolidated entities satisfying certain requirements may file a single method change request under a common sponsor.

Section 481(a) Adjustment

Generally, unfavorable section 481(a) adjustments are spread over a four-year period. However, in the context of section 451(b), the TCJA included an off-code provision that allowed for a six-year spread for "qualified changes" in a taxpayer's method of accounting. This provision was intended to provide relief and flexibility to taxpayers affected by the change in tax law. This special six-year spread period appears to apply only to specified credit card fees.[10] Thus, method changes for other types of specified fees will be subject to the usual four-year spread period.

Character of Specified Fees

The regulations provide that specified fees are not taken into account in determining the amount (if any) of OID on a debt instrument.[11] The regulations do not specifically address whether specified fees retain their character as interest income, notwithstanding the fact that they are no longer treated as OID. The method of accounting for an item of income normally does not affect its underlying character. Therefore, specified fees are generally expected to continue to be treated as interest, notwithstanding the fact that they are no longer characterized as OID. This may be significant because these fees could create additional interest expense capacity under section 163(j).

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[5] Section 1.451-3(a)(13)(x)-(xiv). Prior to the release of the section 451(b) regulations, the IRS indicated that the recognition of market discount income was not affected by section 451(b). *See* Notice 2018-80, 2018-42 I.R.B. 609.

[6] Section 1.451-3(j)(2).

[7] Sec. 13221(e)(1) of P.L. 115-97, 131 Stat. 2054 (2017). *See also* section 1.451-3(m)(3)(ii).

[8] Section 1.451-3(m)(2).

[9] Rev. Proc. 2023-24. The section 451(b) method change for specified credit card fees is automatic for a taxpayer's first, second, or third tax year beginning after December 31, 2020. *See* Sections 16.08(2)(a)(i) and 16.08(8) of Rev. Proc. 2023-24.

[10] *See* section 1.451-3(l)(2)(ii).

[11] Section 1.1275-2(l).

Reporting Implications

The treatment of an item as interest or non-interest income may also have implications for other purposes. For example, specified fees would presumably no longer be reported on Form 1099-OID, *Original Issue Discount*, and would instead be reported on Form 1099-INT, *Interest Income*.

Borrower Treatment

The regulations do not address whether the borrower's method of accounting is affected by the fact that specified fees are no longer treated as OID. As noted above, the character of specified fees as interest is not expected to be affected by section 451(b). Section 1.446-2(c) provides that interest other than qualified stated interest and OID is generally accrued in the same manner as OID.[12] Because OID principles would continue to apply under this rule, the borrower's method of accounting for specified fees is not expected to be affected by section 451(b).

Special Issues

In situations where OID on a loan is created solely by a specified fee, the calculation of the section 481(a) adjustment and ongoing interest accruals is relatively straightforward because the adjustment amount equals the unamortized portion of the specified fee. However, there are a variety of situations that create greater, and in some cases quite significant, complexity. For example, loans with interest payable in kind ("PIK interest"), loans with de minimis specified fees and no other form of OID, loans that are applicable high yield discount obligations ("AHYDOs"), and foreign currency denominated loans each create unique complexities. These issues are examined in further detail below.

De Minimis OID

The section 451(b) regulations generally carve out various types of debt instrument income accruals (other than specified fees) by creating a list of special methods of accounting that are not overridden by section 451(b). Specifically, sections 1.451-3(a)(13)(ix)-(xiv) provide exclusions for income included under the rules for integrated debt instruments, contingent payment debt instruments (both functional currency and nonfunctional currency), variable rate debt instruments, inflation indexed instruments, debt instruments with market discount, debt instruments with de minimis OID or de minimis market discount, short-term debt instruments, and stripped bonds.

The regulations also include a general exclusion for debt instruments with OID, but qualify this exclusion by stating: "[e]xcept as otherwise provided in [section 1.451-3(j)]…"[13] Section 1.451-3(j) sets forth the general rule that specified fees must be included in income when received. Notably, a similar caveat is not included in the exclusion for de minimis OID.[14] This disparate treatment may be on account of the fact that de minimis OID is generally included in taxable income as gain when realized (i.e., as principal payments are received) and the relevant legislative history indicates that section 451(b) was not intended to result in the recognition of income in situations where a realization event has not occurred.[15]

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[12] This regulation applies to both holders and borrowers. *See* section 1.446-2(a)(2)(ii), (e)(2), (h). Also, although section 1.446-2(a)(2)(i)(G) specifically does not apply to interest that is taken into account under section 1.451-3(j), that is a holder-side rule that should not affect the applicability of section 1.446-2 to specified fees for the borrower. *See* section 1.446-2(a)(1) ("Application of an exception described in [section 1.446-2(a)(2)] to one party to a transaction does not affect the application of this section to any other party to the transaction.").

[13] Section 1.451-3(a)(13)(x).

[14] Section 1.451-3(a)(13)(xi).

[15] Footnote 872 of H.R. Rep. 115-466. "The provision does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred. For example, the provision does not require the recharacterization of a transaction from sale to lease, or vice versa, to conform to how the transaction is reported in the taxpayer's applicable financial statement. Similarly, the provision does not require the recognition of gain or loss from securities that are marked to market for financial reporting purposes if the gain or loss from such investments is not realized for Federal income tax purposes until such time that the taxpayer sells or otherwise disposes of the investment. As a further example, income from investments in corporations or

In light of the difference described above, if a specified fee (and any other OID on the debt) is less than a de minimis amount, the specified fee is not subject to section 451(b).[16] Although this provides a better timing and character result for holders, this may create calculation complexity because taxpayers will need to first determine if a specified fee results in de minimis OID before subjecting it to section 451(b).

Debt with Specified Fees and other types of OID

In the case of debt instruments where upfront fees are combined with other OID, the section 481(a) adjustment cannot be easily determined by looking to the unamortized portion of the upfront fee. Instead, the section 481(a) adjustment must be calculated by comparing the OID accruals under the old method to the OID accruals computed without the upfront fees reducing the issue price of the debt.

This can be illustrated by the following example:

> ***Scenario:*** On January 1, 2021, ABC Inc. acquires at original issuance a debt instrument with a stated principal amount of $1,000,000 due December 31, 2026. Interest on the debt instrument may be paid in cash or in kind. If cash payments are selected, the interest rate is 7.75 percent; if the borrower elects to pay in kind, interest is computed using an 8.00 percent rate. All interest is calculated using a 30/360 convention. The debt instrument was issued for $1,000,000 and ABC Inc. received a fee of $100,000 in connection with making the loan. The $100,000 fee falls within the definition of a specified fee.
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> The borrower elected to pay interest in kind on December 31, 2021, and December 31, 2022.
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> ***Old Method:*** Under ABC Inc.'s old method of accounting, the issue price of the debt was $900,000. When creating a payment schedule for OID amortization purposes, the parties are generally required to assume that the borrower will exercise its options (including the option to pay in kind or pay in cash) in a manner that minimizes the yield of the debt.[17] Deferring payments generally reduces the yield of debt instruments issued with an upfront discount, and in this case the yield reduction caused by greater deferral is larger than the yield increase that results from the higher interest rate that applies if a PIK election is made. As a result, ABC Inc. was required to assume that the borrower would elect to pay all interest in kind.[18] Under this method ABC Inc. recognizes $187,283 of OID through December 31, 2022.
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> ***New Method:*** Under ABC Inc.'s new method of accounting, the issue price of the debt instrument is $1,000,000. Because the debt instrument is issued without upfront discount, cash payments of interest would produce the lowest yield. Thus, under the new method of accounting, ABC Inc. would be required to assume that interest will be paid in cash, regardless of the fact that the taxpayer knows that is not what actually occurred. ABC Inc. would then deem a reissuance on December 31, 2021, and on December 31, 2022, to account for the fact that a PIK election was made by the borrower on that date. Under this method the yield of the debt is initially 7.75 percent and is adjusted on December 31, 2021, to 7.81 and on December 31, 2022, to 7.89 percent. The taxpayer recognizes $155,428 of OID through December 31, 2022.
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> ***Section 481(a) adjustment:*** The section 481(a) adjustment in this example is $68,145 ($100,000 specified fee income inclusion—$187,283 OID accrual under the old method + $155,428 OID accrual under the new method).

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partnerships that are accounted for under the equity method for financial reporting purposes will not result in the recognition of income for Federal income tax purposes until such time that the Federal income tax realization even has occurred (e.g., when the taxpayer receives a dividend from the corporation in which it owns less than a controlling interest or when the taxpayer receives its allocable share of income, deductions, gains, and losses on its Schedule K-1 from the partnership)."

[16] The de minimis threshold is defined in section 1.1273-1(d).

[17] *See* section 1.1272-1(c)(5).

[18] Assuming interest will be paid in kind produces a 9.91 percent yield. Assuming interest will be paid in cash produces a 10.04 percent yield.

AHYDOs

An AHYDO is defined in section 163(i)(1) as any debt instrument issued by a corporation that (1) has a maturity date more than five years from the date of issue, (2) the yield to maturity on such instrument equals or exceeds the applicable federal rate plus five percentage points, and (3) the instrument has significant OID as defined by section 163(i)(2).

An instrument has significant OID if the aggregate amount that would be includible in gross income with respect to the instrument for periods before the close of any accrual period ending after the date five years from the date of issue exceeds the sum of the aggregate amount of interest to be paid under the instrument before the close of the accrual period and the product of the issue price of the instrument and its yield to maturity. (Stated another way, if the total amount of accrued and unpaid interest, including OID (for the note, PIK and the amount of initial discount that has been accrued), as of the end of any accrual period that ends after the fifth anniversary of the debt instrument, exceeds an amount equal to the debt instrument's issue price and yield, then the debt instrument has significant OID). Importantly, section 163(i)(3) states that any payment in the form of another obligation of the issuer (a PIK payment) is assumed to be made when the payment is required to be made in cash. Section 163(i)(3) also requires that for purposes of determining if significant OID exists, all payments are assumed to be made on the last date permitted. Thus, if an issuer has the right to pay interest in the form of PIK, the AHYDO rules require that the issuer be treated as paying interest in PIK to determine if there is significant OID. Thus, the ability to issue a PIK instrument in lieu of requiring interest to be paid in money can cause an obligation to be an AHYDO.

A debt instrument has a single yield and a single amount of OID.[19] The AHYDO limitations only apply to OID—they do not apply to other forms of interest.[20] As noted previously, the section 451(b) rules specifically provide that specified fees are not included when calculating the amount of OID on a debt instrument.[21] Therefore, if an instrument is classified as an AHYDO, the amount of interest subject to disallowance or deferral should arguably not include any interest classified as a specified fee.[22]

Frequently, taxpayers seek to avoid AHYDO classification by including an "AHYDO savers clause" that requires payments to be made in a manner that prevents the debt instrument from having significant OID. As described above, whether a debt instrument has significant OID depends on the yield of the debt and the amount of accrued but unpaid OID. Could the holder's treatment of a fee as a specified fee affect the amount of payments contractually required to be made under an AHYDO saver's clause? This was probably not a result contemplated by the drafters of the section 451(b) regulations, but it could potentially be the case under a very literal interpretation of the mechanics and interplay of section 451(b), the OID rules, and the AHYDO statute.

Foreign Currency Denominated Loans

When a loan is denominated in a foreign currency, an accrual method holder generally determines interest in units of nonfunctional currency and then translates that nonfunctional currency amount into functional currency terms using the average exchange rate for the accrual period.[23] The holder recognizes foreign currency gain or loss for the difference between this functional currency accrual and the amount ultimately paid in functional currency.[24] The holder also recognizes foreign currency gain or loss for principal equal to the difference between

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19 *See generally* section 1.1275-1(b)-(d), (f).

20 *See* section 163(e)(5). See also H.R. Conf. Rep. No. 101-386 at 554 (1989) ("[D]eductions will not be disallowed for amounts that qualify as qualified periodic interest payments."). At the time of the AHYDO rules' enactment, qualified stated interest was referred to as "qualified periodic interest." *See* 51 Fed. Reg. 12022 (Apr. 8, 1986).

21 Section 1.1275-2(l).

22 Admittedly, it may be difficult for borrowers to determine whether a fee is a specified fee, because such a determination is contingent upon the holder's financial statement method of accounting.

23 Section 1.988-2(b)(2)(ii)(C). Holders may also elect to use a spot rate accrual convention. *See* section 1.988-2(b)(2)(iii)(B).

24 Section 1.988-2(b)(3).

the taxpayer's functional currency basis in the principal amount and the amount received in functional currency terms.[25]

Under the new section 451(b) method of accounting, specified fees should presumably be included in income upon receipt (and should be translated into functional currency terms using the spot rate on the date of payment). As a result of this change, the amount of OID accrued in any particular period will change, which will affect the amount of foreign currency gain or loss recognized in connection with payments on the debt.

This can be illustrated by the following example:

> ***Scenario:*** On January 1, 2021, ABC Inc. acquires at original issuance a debt instrument with a stated principal amount of €1,000,000 due December 31, 2026. The debt instrument requires payments of €100,000 per year, with the remainder due at maturity. All interest accrues at a rate of 8.00 percent and is calculated using a 30/360 convention. The debt instrument was issued for €1,000,000 and ABC Inc. received a fee of €100,000 in connection with making the loan. The €100,000 fee falls within the definition of a specified fee. ABC Inc. is a U.S. dollar functional currency taxpayer.
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> At the time of issuance, the exchange rate is 1.20 USD/1 EURO. The average exchange rate for the 2021 and 2022 calendar years is 1.15 USD/1 EURO and 1.10 USD/1 EURO (respectively). The spot rate was 1.14 USD/1 EURO and 1.07 USD/1 EURO on December 31, 2021, and December 31, 2022 (respectively).
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> ***Old Method:*** Under ABC Inc.'s old method of accounting, the issue price of the debt was €900,000 and its yield to maturity was 10.45 percent.
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> For calendar year 2021, ABC Inc. accrued €94,013 of interest, which translates into $108,115. ABC Inc. recognized $940 of foreign currency loss in connection with the payment of this interest. The remaining portion of the €100,000 payment (€5,987) was treated as a payment of principal. ABC Inc. realized a $359 loss in connection with this principal payment.
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> For calendar year 2022, ABC Inc. accrued €93,387 of interest, which translates into $102,726. ABC Inc. recognized $2,802 of foreign currency loss in connection with the payment of this interest. The remaining portion of the €100,000 payment (€6,613) was treated as a payment of principal. ABC Inc. realized a $860 loss in connection with this principal payment.
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> In total, the amount of income, deduction, gain, or loss recognized in 2021 and 2022 was $205,880.
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> ***New Method:*** Under ABC Inc.'s new method of accounting, the issue price of the debt instrument is €1,000,000 and its yield is 8.00 percent.
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> For calendar year 2021, ABC Inc. accrued €80,000 of interest, which translates into $92,000. ABC Inc. recognized $800 of foreign currency loss in connection with the payment of this interest. The remaining portion of the €100,000 payment (€20,000) was treated as a payment of principal. ABC Inc. realized a $1,200 loss in connection with this payment.
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> For calendar year 2022, ABC Inc. accrued €78,400 of interest, which translates into $86,240. ABC Inc. recognized $2,352 of foreign currency loss in connection with the payment of this interest. The remaining portion of the €100,000 payment (€21,600) was treated as a payment of principal. ABC Inc. realized a $2,808 loss in connection with this payment.
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> In total, the amount of income, deduction, gain, or loss recognized in 2021 and 2022 (excluding specified fees) was $171,080.

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[25] Section 1.988-2(b)(5).

Section 481(a) adjustment: The section 481(a) adjustment in this example is $85,200 ($120,000 specified fee income inclusion—$205,880 interest accrual under the old method + $171,080 interest accrual under the new method).

Forward looking considerations: Going forward, the character of income recognized by ABC Inc. will, to some extent, be different than under the old method because the loan is treated as having a higher principal amount for foreign currency gain or loss purposes and ABC Inc. is treated as having a higher basis in such principal.

Implications for Withholding

Generally, payments of interest are subject to backup withholding at the time of payment unless an exception applies. Under the OID rules in effect before section 451(b), specified fees were essentially treated as an adjustment to the net amount loaned rather than a payment of an income item from the borrower to the lender. Thus, in a situation where a borrower paid a specified fee to the lender and there was no other OID on the debt, the borrower would historically withhold on the fee on the maturity date of the debt instrument—i.e., the time at which the OID was paid or redeemed.[26]

Under the new section 451(b) rules, a specified fee is not treated as an adjustment of the issue price of the debt and is instead immediately includable in income by the holder. Under this construct, the payment of a specified fee by the borrower to the lender at the outset of a lending transaction is a payment of interest. Presumably, a borrower must withhold at the time of payment—the outset of the loan—rather than the time at which the borrower is treated as paying the interest under its method of accounting.

With that said, it is not entirely clear how issuers will know whether a particular fee is a "specified fee" because that determination requires knowledge as to whether the holder has included the fee in income upon receipt on an applicable financial statement.

Conclusion

In situations where OID on a loan is created solely by a specified fee, the section 481(a) adjustment calculation is relatively straightforward because the adjustment amount equals the unamortized portion of the specified fee. However, there are a variety of situations that create greater, and in some cases quite significant, complexity. Taxpayers are therefore well advised to begin preparing for the transition to a section 451(b) method of accounting well in advance of year-end.

[26] Section 1.1441-2(b)(3).