TIMING OF INCOME RECOGNITION UNDER THE TCJA: PROPOSED REGULATIONS PROVIDE MUCH-NEEDED GUIDANCE

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INTRODUCTION

As part of the Tax Cuts and Jobs Act (TCJA), Congress enacted two new sections that address when revenue is recognized—§§ 451(b) and 451(c). These sections do not determine whether income is realized; instead, they determine the timing of income recognition under the taxpayer’s method of accounting. In general, income is included in gross income at the time of its actual or constructive receipt, unless the taxpayer’s method of accounting requires a different result. The year of receipt is the general rule for cash method taxpayers, while accrual method taxpayers include income in gross income when “when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy” (the “all events test”). If a taxpayer receives payment for goods or services before providing the goods or services, it generally may include the payment as income in the year of its receipt, even if the taxpayer uses the accrual method. Under Revenue Procedure 2004-34, an accrual method taxpayer could elect to recognize in the year of receipt only the amount of the advance payment included in revenue in the taxpayer’s applicable financial statement, with the remaining amount of income deferred to the next taxable year.

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2 Treas. Reg. § 1.61-1(b)(3).
3 I.R.C. § 451(a).
4 Treas. Reg. § 1.451-1(a).
Revised § 451(b) changes the rules for the timing of income recognition under the all events test, and new § 451(c) generally codifies Revenue Procedure 2004-34 to allow certain taxpayers to defer income recognition for advance payments. Proposed reliance regulations implementing these two sections were issued in September 2019 and provide much-needed guidance to accrual method taxpayers. Part I presents Proposed Regulation § 1.451-3, which addresses the timing of gross income recognition under § 451(b), and Part II describes the rules for reporting advance payments as income under § 451(c) in Proposed Regulation § 1.451-8. The article concludes by applauding the increased clarity the proposed regulations provide, while recognizing that a significant issue regarding cost offsets remains that should be addressed in final regulations.

I. Timing of Gross Income Inclusion

To “promote simplification and reduced compliance costs,” Congress enacted a new § 451(b) to conform the timing of income recognition for financial purposes with the timing for tax purposes. Effective for taxable years beginning after 2017, § 451(b) requires that the all events test for any item of gross income be treated as met no later than when income is “taken into account as revenue” in an applicable financial statement (AFS) or other financial statement specified by the IRS (the “AFS income inclusion rule”). For a taxpayer that does not have either type of financial statement, the rule does not apply. A taxpayer that uses a “special method of accounting” under the Internal Revenue Code (the Code) also generally does not follow the AFS income inclusion rule and instead takes income into account as required for that method. The AFS income inclusion rule applies on a

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7 For § 451(b) proposed regulations, see REG-104870-18, 84 Fed. Reg. 47,191 (Sept. 9, 2018); for § 451(c) proposed regulations, see REG-104554-18, 84 Fed. Reg. 47,175 (Sept. 9, 2019).
9 Pub. L. No. 115-97, §§ 13221(a), 13221(c), 131 Stat. 2054 (2017). Proposed regulations to implement § 451(b) were issued in September 2019. The proposed regulations generally are applicable for taxable years beginning on or after the date adopted as final regulations. Prop. Treas. Reg. § 1.451-3(n). Taxpayers generally can rely on the proposed regulations for taxable years beginning after December 31, 2017. See REG-104870-18, 84 Fed. Reg. 47,191 (Sept. 9, 2019).
12 I.R.C. § 451(b)(2); Prop. Treas. Reg. § 1.451-3(b). The AFS income inclusion rule does apply, however, with respect to provisions for capital gains and losses for bonds and other instruments under §§ 1271 through 1288, not including mortgage servicing contracts. See Prop. Treas. Reg. § 1.451-3(i) for special ordering rule for certain items of income with respect to debt instruments. But see Prop. Treas. Reg. §§ 1.451-3(c)(5)(ix) through 1.451-3(c)(5)(xi) for treatment of certain items of bonds and other instruments that are considered special methods of accounting to which the AFS income inclusion rule does not apply.
year-by-year basis and does not apply if the taxpayer does not have an AFS for the entire year.\textsuperscript{12}

“Revenue” for these purposes includes only “transaction price” amounts includible in gross income under § 61;\textsuperscript{13} the “transaction price” is the “gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes.”\textsuperscript{14} Section 451(b) does not change the timing of gross income realization and does not require income recognition until the realization event has occurred.\textsuperscript{15} In particular, amounts “contingent on the occurrence or nonoccurrence of a future event” are not part of the transaction price that is includible in gross income during the period in which the amount is contingent.\textsuperscript{16} Section 451(b) also does not change the treatment of a transaction,\textsuperscript{17} the applicability of provisions that exclude items from income, or the treatment of nonrecognition transactions.\textsuperscript{18} Unbilled receivables for partially performed services, however, must be recognized when taken into income on an AFS.\textsuperscript{19} Despite the possibility of the acceleration of income inclusion under § 451(b), the proposed regulations do not provide a corresponding offset for cost of goods sold, primarily because the statute does not address the timing of deductions.\textsuperscript{20}

For purposes of § 451(b), an AFS is a financial statement that is certified as prepared in accordance with generally accepted accounting principles (GAAP statement) or International Financial Reporting Standards (IFRS statement), with the GAAP statement taking priority over the IFRS statement.\textsuperscript{21} The GAAP statement or IFRS statement additionally must be either, in order of descending priority, (1) a 10-K or successor form, or annual shareholder statement, filed with the U.S. Securities and Exchange Commission (SEC) for the GAAP statement, or,
for an IFRS statement, filed with a foreign government agency equivalent to the SEC that has reporting standards “not less stringent” than those of the SEC, (2) an audited financial statement used, in order of priority, for credit purposes, reporting to owners or beneficiaries, or any “substantial nontax purpose,” or (3) a financial statement, other than a tax return, filed with the federal government or any of its agencies (other than the SEC or IRS), and additionally for an IFRS statement, filed with a foreign government or agency other than an agency equivalent to the SEC or the IRS. In the absence of either a GAAP statement or an IFRS statement, an AFS is a financial statement, other than a tax return, filed by the taxpayer with the federal government or a federal agency, state government or state agency, self-regulatory organization, or as provided in guidance in the Internal Revenue Bulletin.22

A financial statement for a group of entities is used as the AFS for the member entities unless a member also reports its financial results on a separate AFS of equal or higher priority to the group’s AFS.23 For example, if the financial results of an accrual method taxpayer are included on its parent corporation’s consolidated Form 10-K filed with the SEC and the taxpayer files a separate tax return but no other financial statement, the group’s Form 10-K must be used as the taxpayer’s AFS. For a group statement that lists revenue separately for each member taxpayer, the separately stated amount is the amount of revenue attributable to a taxpayer. If revenue is instead aggregated, source documents used to compute the group amounts determine the amount of revenue allocated to a taxpayer.

If a taxpayer has a different year for its AFS than its taxable year, revenue for purposes of the AFS income inclusion rule is computed under one of three “permissible methods.”24 One permissible method is to compute revenue as if the year for the taxpayer’s AFS is the same as its taxable year, using the accounting principles that created the AFS. To illustrate, assume an accrual method taxpayer uses the calendar year for tax purposes and a June 30 year-end for financial purposes. In 2018, the taxpayer will use the financial results on its June 30, 2018, AFS to determine whether an income item was taken into account as revenue in the taxpayer’s AFS from January 1, 2018, through June 30, 2018. The taxpayer will use its June 30, 2019, AFS to determine whether an income item is treated as revenue in the taxpayer’s AFS from July 1, 2018, through December 31, 2018.25 Alternatively, the taxpayer can include a pro rata amount of revenue for each financial accounting year that includes the taxable year.26 If the taxpayer’s financial accounting year ends five or more months after the end of its taxable year, the taxpayer can compute tax revenue based on the revenue reported on the AFS for the accounting year ending within its taxable year.

Contracts that span more than one taxable year (multi-year contracts) use a cumulative approach instead of an annualized approach.27 Under this procedure,

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23 I.R.C. § 451(b)(5); Prop. Treas. Reg. § 1.451-3(h).
the taxpayer takes into account the cumulative amounts included in income in prior years to determine the amount included for the remaining contract years. If a contract has multiple performance obligations, the transaction price allocated to each performance obligation must equal the amount so allocated on the AFS of the taxpayer. A “performance obligation” is a contractual promise to transfer a good or service to a customer, or a combination of both, that is “distinct.” If an item of income is treated as deferred revenue and adjusted or written down in a subsequent year, the amount of the adjustment or write down is treated as revenue in the subsequent year. For example, consider a taxpayer that contracts with a customer in 2018 to remanufacture equipment in 2019 and 2020 for $100. The $100 is treated as deferred revenue on the taxpayer’s 2018 AFS. In 2019, the taxpayer adjusts the deferred revenue to $90 and reports $50 of the $90 adjusted deferred revenue in revenue on its AFS. The taxpayer must report $60 of revenue under the AFS income inclusion rule in 2019 ($50 AFS revenue, plus $10 adjustment).

II. Advance Payments

Effective for taxable years beginning after 2017, § 451(c) generally codifies the one-year deferral method of accounting for advance payments provided in Revenue Procedure 2004-34. Section 451(c) provides that an accrual basis taxpayer can either include an advance payment in income in the year of receipt or elect to defer the recognition of income for the “category of advance payments to which such advance payment belongs” for one tax year, if certain conditions are met. The election is effective for the first taxable year for which it is made and for all subsequent years unless the election is revoked with IRS consent. Section 451(c) applies only to timing of income inclusion and

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28 I.R.C. § 451(b)(4); Prop. Treas. Reg. § 1.451-3(g).
29 Prop. Treas. Reg. § 1.451-3(c)(3). A “performance obligation” also includes a series of distinct goods or services that are “substantially the same and that have the same pattern of transfer to the customer.”

Proposed regulations to implement § 451(c) were issued in September 2019, applicable for taxable years beginning on or after the date adopted as final regulations. Prop. Treas. Reg. § 1.451-8(f). Taxpayers can rely on the proposed regulations for taxable years beginning after December 31, 2017. See REG-104554-18, 84 Fed. Reg. 47,175 (Sept. 9, 2019).

With the enactment of § 451(c), Regulation § 1.451-5, which allowed for multi-year deferral for advance payments for goods and certain construction and manufacturing contracts, was removed, effective for tax years ending on or after July 15, 2019. T.D. 9870, 84 Fed. Reg. 33,691 (July 15, 2019).

33 “Receipt” includes actual or constructive receipt and income “due and payable to the taxpayer.” I.R.C. § 451(c)(4)(C).
34 I.R.C. § 451(c)(1).
not timing of liabilities and deductions. The proposed regulations therefore do not include an accelerated cost offset for cost of goods sold for advance payments included in income prior to the completion of the sale of goods.\(^{36}\)

An advance payment is a payment that can be included in gross income in the taxable year of receipt under a permissible method of accounting (determined without regard to § 451(c)) if any portion of the payment is included in revenue in an AFS\(^{37}\) or other specified financial statement in a year subsequent to receipt.\(^{38}\) In addition, the payment must be for an item identified by the IRS (“identified item”): (1) sale of goods, (2) services, (3) use of intellectual property,\(^{39}\) (4) occupancy or use of property if ancillary to providing services,\(^{40}\) (5) sale, lease, or license of computer software, (6) guaranty or warranty contracts ancillary to items (1) through (5), (7) “subscriptions in tangible or intangible format,”\(^{41}\) (8) memberships in an organization,\(^{42}\) (9) an “eligible gift card sale,”\(^{43}\) (10) any other item specified by the IRS in the Internal Revenue Bulletin, or (11) any combination of items (1) through (10).\(^{44}\)

Advance payments generally do not include rent, insurance premiums governed by subchapter L, payments with respect to financial instruments,\(^{45}\) payments for service warranty contracts for which the taxpayer uses the accounting method in Revenue Procedure 97-38,\(^{46}\) payments for warranty and guaranty contracts under which a third party is the primary obligor, certain payments for

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\(^{36}\) REG-104554-18, 84 Fed. Reg. 47,175, 47,179 (Sept. 9, 2019).

\(^{37}\) An AFS is defined in Proposed Regulation § 1.451-3(c)(1) and discussed supra in Part I. Prop. Treas. Reg. § 1.451-8(b)(2).

\(^{38}\) I.R.C. § 451(c)(4)(A); Prop. Treas. Reg. § 1.451-8(b)(1)(i). The definition of “advance payment” is intended to be consistent with its definition in Revenue Procedure 2004-34. REG-104554-18, 84 Fed. Reg. 47,175, 47,177 (Sept. 9, 2019).

\(^{39}\) Intellectual property includes “copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights, such as franchise rights and arena naming rights.” Prop. Treas. Reg. § 1.451-8(b)(1)(i)(C)(3).

\(^{40}\) Examples include advance payments for hotel rooms, booth space at a trade show, campsite at mobile home park, and recreational or banquet facilities. Prop. Treas. Reg. § 1.451-8(b)(1)(i)(C)(4).

\(^{41}\) Subscriptions for which an election under § 456 is in effect are not within this category. Prop. Treas. Reg. § 1.451-8(b)(1)(i)(C)(7).

\(^{42}\) Memberships for which an election under § 455 is in effect are not within this category. Prop. Treas. Reg. § 1.451-8(b)(1)(i)(C)(8).

\(^{43}\) An “eligible gift card sale” is a sale of a gift card or gift certificate if (1) the taxpayer is “primarily liable” to the customer or card holder for the value of the card until it is redeemed or it expires and (2) the gift card is redeemable by the taxpayer or “any other entity” that is legally obligated to the taxpayer to accept the card as payment for any of the identified items. Prop. Treas. Reg. § 1.451-8(b)(3).


\(^{45}\) Financial instruments include debt instruments, deposits, letters of credit, notional principal contracts, options, forward contracts, futures contracts, foreign currency contracts, credit card agreements including rewards or loyalty points, and financial derivatives. Prop. Treas. Reg. § 1.451-8(b)(1)(ii)(C). Rewards points not related to a credit card, however, that are treated as a separate performance obligation are treated as advance payments. See Prop. Treas. Reg. § 1.451-(8)(c)(8)(xxii) Ex. 22.

nonbusiness income of a foreign person, and payments in property subject to § 83. Advance payments also do not include payments received in a taxable year earlier than the year immediately preceding the year of the contractual delivery date for a “specified good.” A “specified good” is a good for which the taxpayer receives a payment during the taxable year, the taxpayer does not generally have “on hand” substantially similar goods in a sufficient quantity to be able to transfer the good to the customer, and the taxpayer recognizes all revenue from the sale of the good in the taxpayer’s AFS in the year of delivery. For example, in a four-year contract where payments are received each year and delivery is in the fourth year, the payments in the first two years would not be advance payments and would be governed by § 451(b) and generally included as income in the year of delivery. The final two payments would be taxable in the year of delivery under the advance payment rules.

A taxpayer can make a deferral election under § 451(c) if it has an AFS and can determine the amount of advance payments included in revenue in its AFS (AFS deferral method). If the election is made, the taxpayer recognizes that portion of the income required to be recognized in the year of receipt under the AFS income inclusion rule of § 451(b) and defers the balance to the following taxable year. For example, Corporation A receives a payment for a one-year subscription to an online service on September 1, 2019, and includes one third of the revenue on its AFS for 2019 and two thirds in 2020. Corporation A must recognize one third of the gross income for tax purposes in 2019 and two thirds in 2020. If, however, the payment is not “earned” in a subsequent taxable year, the AFS deferral method cannot be used. To illustrate, consider a travel agent who is paid by a customer for an airline ticket in 2018 for travel in 2019. In 2018, the agent purchases the airline ticket, delivers it to the customer, and retains the excess of the customer’s payment over the price of the airline ticket as its commission. The agent is not required to perform any additional services after delivery of the ticket and thus earns its commission in 2018. Even if the travel agent includes the commission in income in 2019 in its AFS, no part of the commission is an advance payment because it is not earned in a subsequent taxable year.

If a taxpayer does not have an AFS, it may nevertheless defer income recognition for an advance payment if it can determine “the extent to which advance payments are earned in the taxable year of receipt” (non-AFS deferral method). A taxpayer using the non-AFS deferral method includes in gross income the amount

50 I.R.C. § 451(c)(1)(B).
52 See Prop. Treas. Reg. § 1.451-8(c)(8)(xi) Ex. 11.
53 Prop. Treas. Reg. §§ 1.451-8(d)(1), 1.451-8(d)(2). “Advance payments” for these purposes are the same as defined for the AFS deferral method, except that instead of the advance payment being that portion of the payment included in revenue in an AFS in a year subsequent to its receipt, it is the portion of the payment that is “earned” by the taxpayer in a year subsequent to its receipt. Prop. Treas. Reg. § 1.451-8(d)(3).
that is “earned” in the year the advance payment is received and includes the remaining amount in gross income in the succeeding year.\footnote{Prop. Treas. Reg. § 1.451-8(d)(4)(i).} A payment is “earned” when the all events test is met,\footnote{For the all events test, see Treas. Reg. § 1.451-1(a).} regardless of when it is received.\footnote{Prop. Treas. Reg. § 1.451-8(d)(4)(ii).} If a taxpayer cannot determine how much of a payment is earned in the year of receipt, it can determine that amount under one of the following methods: (1) a “statistical basis” if there is adequate available data, (2) a “straight line ratable basis” over the agreement’s term if the agreement has a fixed term and “it is not unreasonable to anticipate” at the end of the year of receipt that the payment will be earned ratably over the term, or (3) any other method that the IRS determines clearly reflects income. For example, if Corporation $B$ receives an advance payment of $100 for subscription services over a two-year term, does not have an AFS, and is not able to determine how much of the payment is earned in the year of receipt, Corporation $B$ can recognize the income earned on a straight line ratable basis over two years if it is not unreasonable to anticipate that the payment will be earned ratably over the agreement’s term.\footnote{Prop. Treas. Reg. § 1.451-8(d)(10)(ii) Ex. 2.}

If an advance payment is received under a contract that provides for a combination of services, goods, or other identified items, a taxpayer must allocate the payment among the items. A taxpayer using the AFS deferral method that has a contract with multiple “performance obligations” allocates the “transaction price” to each performance obligation in the same amounts as used on the taxpayer’s AFS.\footnote{I.R.C. §§ 451(b)(4), 451(c)(4)(D); Prop. Treas. Reg. § 1.451-3(g)(2). For the definition of “performance obligation,” see Prop. Treas. Reg. § 1.451-3(c)(3), and for the definition of “transaction price,” see Prop. Treas. Reg. § 1.451-3(c)(6). Prop. Treas. Reg. §§ 1.451-8(b)(4), 1.451-8(b)(7).} For a taxpayer without an AFS, the payment is allocated among identified items based on “objective criteria.”\footnote{Prop. Treas. Reg. § 1.451-8(d)(5).} An allocation method is based on objective criteria if it is based on payments the taxpayer regularly receives for an item it regularly sells or provides separately, or is a method published in IRS guidance. A taxpayer that writes down or adjusts an advance payment on its financial statements (e.g., after an equity acquisition under purchase accounting rules) is nevertheless required to follow the AFS or non-AFS deferral method, as applicable.\footnote{Prop. Treas. Reg. §§ 1.451-8(c)(3), 1.451-8(d)(7).} In such a case, taxable revenue for the subsequent year includes the amount written down or adjusted, so that the write down or adjustment is not permanently excluded from income for tax purposes. Consider Corporation $C$, a calendar-year taxpayer, which received $100 for an advance payment for a two-year service contract.\footnote{Prop. Treas. Reg. § 1.451-8(c)(3)(ii)(A) Ex. 1.} The corporation recorded $100 as a deferred revenue liability in its financial statement and planned to report one fourth of the payment in 2019, one half in 2020, and one fourth in 2021. Corporation $D$, an unrelated calendar-year taxpayer, acquired all the stock of Corporation $C$ on August 31, 2019, and Corporation $C$ became part of Corporation $D$’s consolidated group. Corporation $C$’s short taxable year ended

\footnotesize{55 For the all events test, see Treas. Reg. § 1.451-1(a).
\footnotesize{59 Prop. Treas. Reg. § 1.451-8(d)(5).
\footnotesize{61 Prop. Treas. Reg. § 1.451-8(c)(3)(ii)(A) Ex. 1.}
August 31, 2019, and it included $25 of the advance payment in revenue in its financial statement. Corporation D wrote down by $65 the deferred revenue liability to its fair market value of $10 as of September 1, 2019. If Corporation C uses the AFS deferral method for the advance payment, it will report $25 of income for the year ended August 31, 2019, and will include the remaining amount of $75 ($65 write-down, plus $10 future financial statement revenue) in income in Corporation C’s financial statement for the next taxable year.

Recognition of income from an advance payment is accelerated if a taxpayer using either the AFS or the non-AFS deferral method dies or ceases to exist in the year it receives an advance payment.62 The taxpayer must recognize all the revenue from the advance payment that has not previously been included in gross income in the year it ceases to exist. This acceleration also applies if the taxpayer’s obligation with respect to the advance payment is satisfied or “otherwise ends,” not including a § 381(a) transaction or a § 351(a) transaction in which substantially all assets of the trade or business are transferred, the transferee adopts or uses the AFS or non-AFS deferral method in the year of transfer, and the transferor and transferee are members of the same consolidated group.

CONCLUSION

Proposed Regulations issued to implement §§ 451(b) and 451(c) provide much-needed guidance to accrual method taxpayers concerned about the acceleration of income recognition for tax purposes. By generally tying the timing of income inclusion for tax purposes to that used on certain financial statements, the determination of when income is recognized is simplified and a taxpayer’s compliance costs should be reduced. For advance payments, taxpayers can be reassured that the details included in Revenue Procedure 2004-34 generally still apply, and authorities interpreting the procedure can assist in interpretation of the new statute. The most concerning aspect of both the § 451(b) and the § 451(c) proposed regulations is the lack of a cost offset to income inclusion, which can result in a mismatch of income and expenses. The preambles to both sets of proposed regulations specifically request comments as to “whether any such exceptions are an appropriate use of the Secretary’s authority.”63 The Treasury and the IRS should provide some form of relief to the mismatch issue in final regulations.

62 Prop. Treas. Reg. §§ 1.451-8(c)(2), 1.451-8(d)(6). This rule does not cover a transaction to which § 381(a) applies.
63 REG-104870-18, 84 Fed. Reg. 47,191, 47,196 (Sept. 9, 2019); REG-104554-18, 84 Fed. Reg. 47,175, 47,179 (Sept. 9, 2019).