American Bar Association Tax Section
Tax Accounting Committee

Proposed regulations under section 451(b) and (c) and related procedural guidance

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Agenda

— Prop. Reg. section 1.451-3 (Income Inclusion-Acceleration Rule)

— Prop. Reg. section 1.451-8 (Advance Payments)

Background: Section 451 (b)

Requires recognition of income of the earlier of:

— When the all events test is met for an item of income; or
— When the taxpayer takes the income into account on its applicable financial statement*

*Applicable Financial Statement ("AFS") includes:

— Certain financial statements that are certified as prepared in accordance with generally accepted accounting principles;
— A financial statement based on international financial reporting standards that is filed by the taxpayer with a foreign governmental agency similar to the SEC; and
— A financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Secretary
Prop. Reg. § 1.451-3

Overview
— Released on Sept. 9, 2019, and taxpayers may early adopt for TYBA 12/31/2017
— AFS income inclusion rule for accrual method taxpayers applying the all events test
— Does not affect characterization (e.g., sale vs. lease) - only timing of income recognition
— Early adoption available for TYBA 12/31/17 (12/31/18 for specified credit card fees)
— No separate rules for foreign taxpayers

Scope (AFS)
— Must have an applicable financial statement for the entire taxable year
— Rules for different tax and financial accounting years
— AFS priority rules
— AFS income inclusion is determined on a year-by-year basis

Exclusions
— Special methods of accounting are not subject to § 451(b) (such as, installment method, § 460 long-term contracts, 467, etc.)
— Mortgage servicing contracts
— OID
  - Specified credit card fees now subject to § 451(b) but adoption deferred (TYBA 12/31/18)
  - Other OID excluded and now treated as special method, departing from the statute
— Non-recognition provisions, (e.g., § 1031 like-kind exchange, corporate reorganization/liquidations, etc.)
Amount realized – preamble discussion

The AFS inclusion rule does not change the treatment of the transaction (for example, sale vs. lease), consistent with Footnote 872.

IRS position is that 451(b) applies to unbilled receivables for both goods and services.

Transaction price

Amount of gross consideration (for AFS purposes) taxpayer expects to become entitled to for providing goods/services/property.

AFS rebuttable presumption.

Transaction price does not include:

Amounts collected as an agent on behalf of unrelated party (e.g., sales tax collected).

Increases in consideration that are contingent at year-end on the occurrence or non-occurrence of future event (e.g., variable consideration such as bonuses contingent on performance).

— An AFS amount is not contingent if amount is actually or constructively received, due/payable, or taxpayer has an enforceable right to all or partial payment.

— Reductions for section § 461 costs (e.g., rebates, chargebacks, rewards, COGS).
Application of Section 451 (b) to Multi-year Contracts

Prop. Reg. 1.451-3(k) provide that a taxpayer with multi-year contracts may apply the all-events test using a cumulative approach rather than an annualized approach.

- For example: a taxpayer who provides engineering services entered into a contract in 2018 with a customer to provide services over four years. The taxpayer received $25 each year beginning in 2018 and reported revenue of $50, $0, $20, and $30 on its AFS for years 2018, 2019, 2020, and 2021, respectively. Under the proposed regulations, the taxpayer must include $50 in its income in 2018: $25 from its receipt of payment under the all events test plus the remaining $25 that it recorded as revenue on its AFS in 2018 but did not recognize under the all events test. In 2019, the taxpayer does not include any amount in its income because the taxpayer had already included the $25 it received in 2019 in its income in 2018 (this is an application of the cumulative approach noted above). In 2019 and 2020, the taxpayer includes $25 in income each year under the all events test.
Allocation of Transaction Price Involving Multiple Performance Obligations

— Prop. Reg. § 1.451-3(c) (3) provides that if a contract has multiple performance obligations, the transaction price is allocated to each performance obligation in a manner similar to how the taxpayer accounts for the income in revenue in its AFS.

— "Performance obligation" is defined as a distinct contractual promise with a customer to transfer either a good or service (or a combination of both) or a series of goods.

— Consistent with the definition of "performance obligation" in International Accounting Standards Board's International Financial Reporting Standard (IFRS) 15.
Generally codified the Deferral Method provided under Rev. Proc. 2004-34 as the exclusive advance payment deferral method

- Provides an election to defer the recognition of certain advance payments to the taxable year following the year of receipt to the extent such income is deferred in the AFS
  - Alternatively, if no AFS, when earned
- Applies generally to most advance payments for provision of goods and services
  - Specifically excludes rent, insurance premiums, financial instruments, others
- Acceleration required if taxpayer’s obligation or taxpayer cease to exist

Notice 2018-35, released on April 12, 2018, permits taxpayers to rely on Rev. Proc. 2004-34 until it issues final regulations

Caused the separate deferral method in Reg. §1.451-5, which provided a longer deferral period for advance payments for goods, including gift cards redeemable for goods, to sunset.

- On July 15, 2019, Reg. § 1.451-5 was withdrawn for tax years ending on or after July 15, 2019
Prop. Reg. § 1.451-8

Released on Sept. 9, 2019, taxpayers may early adopt for TYBA 12/3/2017

Provides additional rules for use of deferral method

Similarities

— Non AFS taxpayer can similarly defer income using an “earned” standard

— 92-day rule for short taxable years: 92 day rule – if advance payment is received in the year before a short taxable year of 92 days or less, follow AFS and recognize remainder in subsequent year

— Acceleration of deferral if taxpayer ceases to exist, or taxpayer’s obligation ends
  - Similar step in shoes for transfers under section 351 in consolidated group or section 381

— Does not provide an accelerated cost offset as under Reg. sec. 1.451-5 when advance payments had to be included in income in the second year after the year of receipt
Prop. Reg. § 1.451-8

Differences

— Must include no later than when “earned” even if AFS, so can no longer rely exclusively on AFS

— Reward points for an eligible item explicitly qualify if a separate performance obligation

— Liabilities treated as contra revenue may not be treated as deferred revenue (e.g., chargeback example)

— Any advance payment not included in year of receipt and written down in the AFS (e.g., as a result of a stock acquisition) is include in the subsequent year
Included in definition of advance payments*

— Services
— the sale of goods;
— the use of intellectual property, (copyrights, patents, trademarks, and similar intangible rights);
— the occupancy or use of property if ancillary to the provision of services;
— the sale, lease, or license of computer software; guaranty or warranty contracts; subscriptions in tangible or intangible format; memberships in an organization; and an eligible gift card sale

Excluded*

— rent;
— insurance premiums;
— payments with respect to financial instruments;
— payments for the sale of real property
— payments received in a tax year earlier than the tax year immediately preceding the tax year of the contractual delivery date for a specified good

* Not an exclusive list and there are more in the NPRM
**Prop. Reg. § 1.451-8**

**Significant exclusion for long-term production contracts**

— Preamble: Advance payments received in connection with commercially significant or high-value goods that take significant amount of time to produce and when the Taxpayer receives an upfront payment but delivery of the finished goods does not occur for at least two taxable years

— Regulation:
  - Contracted delivery month > two years after upfront payment for “specified goods”
  - Specified goods:
    — goods not on hand; and
    — revenue recognized in year of delivery in AFS

**Still subject to section 451(b)?**
Prop. Reg. § 1.451-8

Allocation of advance payment between multiple performance obligations in one contract

— Now required to be consistent with financial accounting for AFS taxpayers
  - Tracking cash payments to performance obligations
  - A performance obligation may no longer have deferred revenue
— Based on how the performance obligations are separately priced or another method provided in the guidance for non-AFS taxpayers
Prop. Reg. §§ 1.451-3 and 1.451-8

Common examples

— **Unbilled services** – recognize when services performed if taxpayer has enforceable right for partially performed services

— **Unbilled goods** – recognize before delivery/acceptance if taxpayer has enforceable right to payment for the goods for work performed to date

— **Variable consideration** – on-time delivery bonus (consideration depends on future event) and returned goods (reduction controlled by section 461)

— **Reductions to transaction price for costs subject to § 461** – reduce transaction price when all events test is met and economic performance occurs

— **Anticipated Chargebacks** - reduce transaction price when all events test is met and economic performance occurs

— **Contract renewals** - do not recognize if amounts are contingent at year-end on the occurrence or non-occurrence of future event (e.g., commissions for future renewals)

— **Advance payments earned before AFS recognition** – recognize when all events test is met and economic performance occurs (i.e., earned when services performed)
# Automatic consent procedures

## Rev. Proc. 2018-29: Changes in timing of income recognition due to ASC 606
Temporary automatic consent procedures for taxpayers changing accounting methods to conform with ASC 606 in the TY of adoption

### Timing:
- Only for taxpayer’s first, second, or third taxable year ending on or after 5/10/18

### Manner of making the change: DCN 231
- May be implemented with either a § 481(a) adjustment or on a cutoff basis
- 5-year scope limitation waived

### Applies to early adopters (Rev. Proc. 2018-49)

### Possible book conformity for:
- Allocation of contract price
- Acceleration of variable consideration
- Timing of recognizing unbilled revenue for partially performed services

## Rev. Proc. 2018-60: Changes in timing of income recognition under new § 451(b)
Applies to accrual method taxpayers with AFS changing methods to comply with §§ 451(b)(1)(A) or 451(b)(4)

### Timing:
- For tax years beginning after 12/31/17
- TYBA 12/31/18 for OID
- First TYBA 12/31/17 for streamlined procedures

### Manner of making the change: DCN 239
- Must describe where § 481(a) adj. is reflected on the return (6 year spread for OID changes)
- Cutoff basis or § 481(a) adj. (AFS taxpayer changing under § 451(b)(1)(A), if filing concurrent change 231)
- Short form permitted; duplicate copy filing waived
- 5 year scope limitation waived in first, second, or third year (first year for streamlined procedures)
- Audit protection (if not using streamlined procedures)
- May make concurrent changes on same 3115 for DCN 231 (ASC 606 conformity)

### Streamlined procedures:
- No 3115 for first TYBA 12/31/17 for small business taxpayers or if zero § 481(a) adjustment
### Changes in timing of income recognition

**Prop. Reg. § 1.451-3**

Applies to accrual method taxpayers with AFS adopting Prop. Reg. § 1.451-3 (including specified credit card fees)

**Timing:**
- TYBA 12/31/17
- TYBA 12/31/18 for specified credit card (“CC”) fees

**Manner of making the change:** DCN 242
- § 481(a) adjustment or on a cutoff basis, if making concurrent change DCN 231
- § 481(a) adj. (6 year spread for specified CC fees; 2 year spread if under exam)
- 5-year scope limitation waived for first, second, or third TYBA 12/31/17 (TYBA 12/31/18 for specified CC fees)
- Audit protection for taxpayers under exam in first, second, or third TYBA 12/31/17 (if not using streamlined procedures)

**Streamlined procedures:**
- No 3115 for first TYBA 12/31/17 for small business taxpayers or if zero § 481(a) adjustment
- No audit protection; 5-year scope limit waived in first or second TYBA 12/31/17

### Changes in timing of Advance Payments

**Prop. Reg. § 1.451-8**

Applies to accrual method taxpayers with AFS adopting Prop. Reg. § 1.451-8(c) or without AFS adopting Prop. Reg. § 1.451-8(d)

**Timing:**
- TYBA 12/31/17

**Manner of making the change:** DCN 242
- § 481(a) adjustment or on a cutoff basis
- 2-year § 481(a) adj. spread if under exam
- 5-year scope limitation waived for first, second, or third TYBA 12/31/17
- Audit protection for taxpayers under exam in first, second, or third TYBA 12/31/17 (if not using streamlined procedures)

**Streamlined procedures:**
- No 3115 for first TYBA 12/31/17 for small business taxpayers or if zero § 481(a) adjustment
- No audit protection; 5-year scope limit waived in first or second TYBA 12/31/17
## Automatic consent procedures – AFS Changes

### Change in AFS timing for Advance Payments

Appplies to AFS changes for taxpayers currently using the 1-year deferral method under Rev. Proc. 2004-34 or Prop. Treas. Reg. § 1.451-8(c)

**Timing:**
- Advance payments received on or after the beginning of the year of change

**Manner of making the change:** DCN 153
- Cut-off method required
- 5 year scope limitation waived
- No audit protection
- Attach statement to return in lieu of filing Form 3115

### Changes in AFS timing of income recognition under § 451(b) and Prop. Reg. § 1.451-3

Appplies to AFS changes for taxpayers including amounts in income under § 451(b) or Prop. Reg. § 1.451-3, including allocating the transaction price to POs under § 451(b)(4) or Prop. Reg. § 1.451-3(g)

**Timing:**
- TYBA 12/31/17

**Manner of making the change:** DCN 153
- Section 481(a) adjustment
- 5 year scope limitation waived
- No audit protection
- Attach statement to return in lieu of filing Form 3115

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Thank you