CURRENT DEVELOPMENTS

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The information contained herein is of general nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax advisor. The government panelists did not participate in the preparation of this handout.
Regulations:


On October 15, the IRS released proposed regulations (REG-104872-18) to remove Treas. Reg. §1.451-5 as a result of the changes made to §451 under the Tax Cuts and Jobs Act (TCJA). Treas. Reg. §1.451-5 currently provides rules for recognizing gross income from advance payments for goods and long-term contracts, including the ability for accrual method taxpayers to defer the inclusion in gross income of advance payments for inventorial goods for up to two years. However, these rules are overridden by new §451(c) which permits taxpayers to elect to include the advance payments in gross income or to defer advance payments for at most one year. Accordingly, for tax years beginning after December 31, 2017, affected taxpayers that are presently deferring advance payments longer than one year will need to change their method of accounting to a proper method consistent with the new rules once the proposed regulations are finalized.

Under Treas. Reg. §1.451-1, accrual method taxpayers must include items of income in the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (the “all-events” test). Although neither the Code nor the regulations provide specific rules for determining when a taxpayer has a fixed right to income, the courts and the IRS have generally concluded that the all-events test is met at the earliest of (1) required performance by the taxpayer; (2) the date a payment becomes due; or (3) the date the payment is received by the taxpayer. Thus, under the all-events test, an accrual basis taxpayer generally must include advance payments in income in the year of receipt, even if the amount hasn’t been earned yet and/or is deferred for financial statement purposes.

Treas. Reg. §1.451-5(c) provides an exception to this general rule by permitting an accrual method taxpayer to defer substantial advance payments (as defined in Treas. Reg. §1.451-5(c)(3)) for inventorable goods up to the second taxable year following receipt of the substantial advance payments. Substantial advance payments received under an agreement are recognized for tax purposes as they are included in gross receipts for financial statement purposes. Any remaining advance payment not yet included in taxable income is included in the second taxable year following receipt of the advance payment.

The TCJA added §451(c) to codify the treatment of advance payments for accrual basis taxpayers for years beginning after December 31, 2017. Section 451(c) generally requires a taxpayer to include any advance payment in income in the year of receipt or make an election to (1) include any portion of the advance payment in income in the taxable year of receipt to the extent the amount is taken into account as revenue in a taxpayer’s applicable financial statement, and (2) include the remaining portion of the advance payment in income in the following taxable year. This election to defer advance payments of goods and services under new §451(c) is similar to the one-year deferral method provided in Revenue Procedure 2004-34, which presently remains applicable under IRS Notice 2018-35 issued in April 2018.

In the Joint Explanatory Statement issued with the TCJA, the government explicitly noted that new §451(c) is intended to override any deferral method provided by Treas. Reg. §1.451-5 for advance payments received for goods. Thus, once the proposed regulations are finalized, taxpayers that are currently using the two-year deferral under Treas. Reg. §1.451-5 will be required to change to another proper method (e.g., to include advance payments in income in the year of receipt or to defer advance payments in accordance with books up to one year under Rev. Proc. 2004-34). Presumably, this will necessitate the filing of a Form 3115, Application for Change in Method of Accounting.

As part of the proposed regulations, the Treasury Department and IRS request comments from the public on whether any changes to the existing procedural rules under §446 for changes in methods of accounting are necessary or desirable as a result of removing Treas. Reg. §1.451-5.

On November 18, the IRS released final regulations (TD 9843) modifying Treas. Reg. §§1.263A-1, -2 and -3 to address the allocation of certain costs to property produced or acquired for resale by the taxpayer. The regulations clarify the treatment of negative adjustments related to certain costs (negative §263A costs) required to be capitalized to property produced or acquired for resale and also provide for a new simplified method of accounting, the modified simplified production method (MSPM), for taxpayers that are treated as producers under §263A. Further, the final regulations offer several safe harbors and de minimis rules to reduce the administrative burden and complexities associated with complying with the new rules.

Section 263A requires taxpayers to capitalize direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer, as well as real property and personal property described in §1221(a)(1) acquired by the taxpayer, for resale. Generally, the costs required to be capitalized for tax purposes under §263A exceed the amounts required to be capitalized for financial accounting purposes (§471 costs). Accordingly, many taxpayers must capitalize “additional §263A” costs to property acquired or produced as an unfavorable book/tax adjustment (i.e., an addback to taxable income). The §263A regulations prescribe a variety of methods that taxpayers can use to identify and allocate additional §263A costs, including certain simplified methods for producers and resellers.

Although most additional §263A costs are positive, negative §263A costs may arise when a particular cost is capitalized for book purposes but is not required to be capitalized under §263A. For instance, a taxpayer may have negative §263A costs related to selling and marketing expenses (which are generally not required to be capitalized under §263A) if such amounts are capitalized as §471 costs. Further, negative §263A costs may arise due to unfavorable book-tax differences related to certain expenses such as depreciation, bonuses and rent.

In recent years, the IRS has expressed concerns related to the potential distortion of income resulting from taxpayers including negative §263A costs in their simplified methods of accounting for allocating §263A costs to ending inventory. To address this issue, the IRS and the Treasury released proposed negative §263A regulations in 2012 generally prohibiting the inclusion of negative §263A costs in a taxpayer's computation, with certain exceptions. The final regulations largely conform to the proposed regulations, and retain the general rule that disallows taxpayers using the simplified production method from including negative §263A costs in their computations. Resellers using the simplified resale method to allocate additional §263A costs to ending inventory may continue to include negative §263A in their computation to the extent the capitalization of such costs is either optional or not permitted under tax law.

Consistent with the proposed regulations, the final regulations contain several simplifying conventions and exceptions from the general rule, including the following:

- A safe harbor for producers with average annual gross receipts of $50 million or less for three previous tax years.
- Several de minimis rules for certain direct materials and direct labor costs that are not capitalized in the taxpayer’s financial statement.
- A safe harbor for variances and under- or over-applied burdens.
- A new modified simplified production method (MSPM) for allocating negative §263A costs to ending inventory.

The MSPM allows larger producers (i.e., taxpayers with average annual gross receipts exceeding $50 million) to take into account negative §263A costs by computing two new absorption ratios, rather than the one absorption ratio required under the simplified production method. Under the MSPM, taxpayers will compute a pre-production absorption ratio and a production absorption ratio, and then apply each ratio to separate categories of costs in ending inventory to determine the total
amount of additional §263A costs to capitalize for tax purposes. As the MSPM is generally more complicated than the simplified production method, larger producers must weigh the benefit of changing to the MSPM (e.g., the tax savings from being able to include negative §263A costs in the computation) against the additional compliance costs associated with using the new method.

The final regulations apply for taxable years beginning on or after November 20, 2018. For any taxable year that both begins before November 20, 2018, and ends after November 20, 2018 (e.g., the 2018 tax year for calendar year taxpayers), the IRS will not challenge return positions consistent with the final regulations.

Released concurrently with the final regulations, Rev. Proc. 2018-56 modifies Rev. Proc. 2018-31, the existing guidance governing automatic accounting method changes, to assist taxpayers with complying with the new rules. Specifically, Rev. Proc. 2018-56 expands the existing automatic method changes under Sections 12.01 and 12.02 of Rev. Proc. 2018-31 to include UNICAP methods specifically described in the final regulations, and adds two new sections, Sections 12.17 and 12.18. Section 12.17 provides a new automatic change in method of accounting for taxpayers using a simplified method or changing to a simplified method to recharacterize costs in accordance with the final regulations, and Section 12.18 temporarily permits taxpayers to make an automatic change to revoke a taxpayer’s historical absorption ratio election. Certain eligibility rules that would normally preclude a taxpayer from filing an automatic method change are waived for a limited time (e.g., for the taxpayer’s first, second or third taxable year ending on or after November 20, 2018).

c. REG-106089-18 – Limitation on Deduction for Business Interest Expense

Treasury and the IRS have issued proposed regulations (the “Proposed Regulations”) addressing the broadly applicable business interest expense deduction limitation contained in section 163(j) of the Internal Revenue Code (the “Code”) and enacted in December 2017 as part of the Tax Cuts and Jobs Act. Section 163(j) generally limits business interest deductions to the sum of (i) 30 percent of a taxpayer’s adjusted taxable income (ATI), plus (ii) business interest income.

Although that deduction limitation formula may seem simple, the Code and the Proposed Regulations set out a very complex set of rules. Many are particular to specific provisions of section 163(j), such as a broad definition of interest, methods for allocating items within groups of related entities, and defining the scope of the exceptions from section 163(j). Many of the rules apply differently to different entity types, adding to the complexity. The rules for partnerships and their partners are both complex and unusual. Taxpayers with significant business interest expense will want to consider these rules when engaging in merger and acquisition activity, incurring debt, planning internal restructurings, reporting financial results, and preparing tax returns. The Proposed Regulations will affect most taxpayers, foreign and domestic, that engage in business activity and are subject to federal income tax.

Broad definition of interest

Some items not treated as interest under prior federal income tax rules would be treated as interest for section 163(j) purposes by the Proposed Regulations. Treasury and the IRS consider these items closely related to interest such as substitute interest payments under securities loan or repo arrangements, debt issuance costs, loan commitment fees and certain interest rate hedging income or expense items.

Generally, compensation for the use of money (or other property) under a debt obligation represents interest for federal income tax purposes. Compensation for the use of money is treated as interest under tax rules even where no debt instrument is present. For section 163(j) purposes, the proposed regulations expand the definition of interest to include more items representing compensation for use of money in the absence of a formal debt instrument. Under an anti-abuse
rule, other amounts predominantly associated with the time value of money may be characterized as interest for purposes of section 163(j).

Surprisingly, the proposed regulations would treat as interest some costs that economically do not represent compensation for the use of funds. As a result, the proposed regulations would subject these costs to the 163(j) limitation.

Business interest versus investment interest

Section 163(j) disallows only business interest expense. Business interest is interest allocable to a trade or business, other than 'investment interest' within the meaning of section 163(d). Rules under section 163(d) characterize interest as investment interest to the extent the interest relates to assets held for investment. To characterize interest expense, section 163(d) generally requires tracing borrowing proceeds and characterizing the interest depending on how the proceeds are used. These are longstanding rules under section 163(d) and the proposed regulations would not revise them.

Calculating adjusted taxable income

The proposed regulations generally adhere closely to the statutory definition enacted in 2017 closely, but make some adjustments. For example, a taxpayer selling an asset that generated depreciation, amortization, or depletion that previously adjusted ATI upward would be required to adjust ATI downward by the lesser of (i) the same depreciation, amortization, or depletion amount used to adjust ATI upward, or (ii) the gain recognized on the property’s sale.

Certain other adjustments would be required under the proposed regulations based on the taxpayer’s tax status. For example, U.S. shareholders of controlled foreign corporations (CFCs) that include in their federal taxable income amounts of subpart F income or global intangible low-taxed income (GILTI) with respect to a CFC do not include that subpart F income or GILTI in their own ATI (and similarly do not include in ATI certain deductions allowed under section 250 in respect of their subpart F income or GILTI). As another example, regulated investment companies (RICs, generally mutual funds) and real estate investment trusts (REITs) do not include the dividends paid deduction when calculating ATI. This special ATI rule for RICs and REITs is intended to maintain RICs’ and REITs’ ability to rely on the dividends paid deduction to attain single level tax on their earnings at the shareholder level.

Small business taxpayer exception

Small business taxpayers are exempt from the business interest expense limitation rules of §163(j). To qualify, the taxpayer must have average annual gross receipts of $25 million or less for the 3 years preceding the current taxable year. The $25 million threshold will be indexed for inflation.

The entity aggregation rules of sections 52 and 414 are applied for purposes of the annual gross receipts test. “Tax shelters” as defined under section 448(a)(3) cannot qualify for the small business exception. We note that the applicable tax shelter definition has some complexity, and can encompass business entities that do not meet a common sense concept of a “tax shelter.”

A taxpayer’s status as a small business taxpayer is an annual determination that can change from year to year. If a taxpayer with a section 163(j) carryforward becomes eligible for the small business exception in a later year, the Proposed Regulations include a favorable rule providing a that section 163(j) cannot apply to limit deduction of the carryforward in that later year.

Under the Proposed Regulations, a partner’s (or an S corporation shareholder’s) allocation of business interest expense from a partnership (or S corporation) that is a small business taxpayer will be subject to the partner’s own section 163(j) limitation, provided that the partner is not also a small business taxpayer or otherwise exempt. The partner must include its allocable share of
income, gain, loss, or deduction from the partnership that is a small business taxpayer in its own section 163(j) limitation computation. This approach—testing the business interest deduction at the owner (or S corporation level)—would stand in contrast to the general rule for non-exempt businesses, which requires testing at the partnership (or S corporation) level.

Cases

a. Thrasys, Inc. et al. v. Commissioner, T.C. Memo 2018-199

The Tax Court denied the Service’s motion for summary judgment that the taxpayer’s use of a deposit method of accounting was an impermissible change in method of accounting. The taxpayer provided certain software products and services to its customer under various contracts. The taxpayer had originally accounted for payments received from the customer under Revenue Procedure 2004-34, i.e., the taxpayer had included the payments in gross income for tax purposes in the taxable year following the year in which it received the payments, consistent with its financial reporting treatment of the payments. Specifically, the taxpayer would increase “other current liabilities” by the amount of such receipts, in the year of receipt. (The taxpayer titled such entries “deferred revenue” or “unearned revenue”.) The taxpayer would generally include such “deferred revenue” in income for both financial and tax purposes in the following year. The amounts received in the years 2005 through 2007 that were subject to this treatment totaled less than $2.5 million.

In 2008, the taxpayer received from the customer a payment of approximately $15 million. For financial reporting purposes, the taxpayer’s independent financial auditor concluded that the entire amount was potentially refundable as of the end of the year of receipt, on the basis that the taxpayer was in technical breach of its agreement with the customer. In that year, the taxpayer’s books showed the amount as a “deposit” among “other assets,” and as a “deposit obligation” among its “other liabilities. The taxpayer concluded that the risk of having to refund the $15 million was eliminated in 2009. In 2009, the taxpayer moved the $15 million from “deposit” to “deferred revenue.” The taxpayer included the amount in income in 2010 as long-term capital gain, and disclosed the treatment on Form 8275, which cited Revenue Procedure 2004-34.

The Service argued that the taxpayer incorrectly adopted and applied a “deposit” method of accounting for the $15 million. The Tax Court denied the Service’s motion for summary judgment. First, the court observed that only one customer payment was treated as a “deposit,” and that a question of material fact existed regarding whether this satisfied the “consistency” requirement. Second, the court observed that a change in underlying facts does not constitute a change in method of accounting, and that with respect to the $15 million payment, the taxpayer and its auditor believed the taxpayer may be required to refund the amount. Thus, the Court found that there was a genuine disputes of material fact as to whether the taxpayer adopted the “deposit” method of accounting in 2008.

b. Patients Mutual Assistance Collective Corp. v. Commissioner, 151 T.C. No. 11

The Tax Court held that the taxpayer, which was engaged in the business of selling marijuana, may not apply section 263A for the purposes of determining its cost of goods sold (COGS), but instead should use the section 471 rules applicable to resellers. The Court also held that the taxpayer was not engaged in any other trade or business, because over 99.5 percent of the taxpayer’s revenue were from the sales of marijuana and marijuana products, and the taxpayer’s other activities were neither economically separate nor substantially different.

With respect to COGS, the taxpayer would have preferred to classify its expenditures as COGS rather than deductions, because COGS are used to offset gross receipts in determining gross income, but deductions reduce gross income in determining taxable income. Section 280E prohibits drug traffickers from claiming deductions, and it applies to marijuana businesses like the one operated by the taxpayer because marijuana is a controlled substance under Federal law.
However, section 280E generally does not preclude taxpayers from using COGS to reduce their gross receipts in determining gross income.

The Tax Court held that the taxpayer must follow section 471 in determining COGS, and not section 263A. Taxpayer would have preferred to apply 263A, because it would generally result in a greater amount of expenditures allocated to COGS, including certain indirect costs. The Court observed that section 263A by its terms does not apply to any costs that could not otherwise be taken into account in computing taxable income (citing section 263A(a)(2)). The Court disagreed with the taxpayer's argument that the taxpayer was permitted to determine COGS under section 263A under the Sixteenth Amendment. Thus, the Court held that section 263A does not apply to drug traffickers, and that they should determine COGS under section 471.

In addition, the Court held that the taxpayer was a reseller, and not a producer, for purposes of section 471. The Court observed that producers must exercise a certain amount of control over the manufacturing process, and retain title to the item throughout the contract-production process, citing Suzy's Zoo v. Commissioner, 273 F.3d 875 (9th Cir. 2001). The taxpayer argued that it exercised a high degree of control over the growers who sold it the marijuana, pointing out that it only purchased the marijuana from its members, who used the taxpayer's clones, took the taxpayer's growing class, followed the taxpayer's best practices, and met the taxpayer's quality-control standards. The Court observed that in Suzy's Zoo, the contractors couldn't sell, copy, or use the products without breaching the license. By contrast, the taxpayer merely sold or gave members clones that it had purchased from nurseries and bought back bud if and when it wanted. The taxpayer had no ownership interest in the marijuana plants in between these two steps, and could not prevent the growers from selling to others.

c. Alternative Health Care Advocates v. Commissioner, 151 T.C. No. 13

In this case involving a marijuana business, the facts, issues, and ultimate holdings were very similar to those of Patients Mutual, to which the court cited frequently. However, in Alternative Health Care the corporation that engaged in the business of selling marijuana (the "Seller") retained the services of a management company to handle daily operations for the Seller, including paying employee wages and salaries. The management company was organized as an S corporation whose shareholders were also the organizers of the Seller. The shareholders argued that section 280E did not apply to limit the deductions of the separate management company, because it did not engage in the purchase and sale of marijuana. The shareholders argued that the Seller, not the management company, at all times held legal title to the marijuana products. The Tax Court, however, held that section 280E nevertheless applied to disallow the management company's deductions. The court noted that although the management company and the Seller were legally separate, the management company's employees were engaged in the purchase and sale of marijuana (albeit on behalf of the Seller). The court refused to read the term "trafficking" to require the management company to have had title to the marijuana that its employees were purchasing and selling.

Revenue Rulings, Revenue Procedures, Notices and Announcements


Notice 2018-80 announces that the IRS and Treasury Department intend to issue proposed regulations providing that accrued market discount is not includible in income under new section 451(b). Thus, the notice effectively provides that market discount will continue to be taken into account solely under the rules of section 1276, and that new section 451(b) will not serve to accelerate the recognition of market discount in income as it potentially can original issue discount ("OID").
As background, Congress enacted new section 451(b) as part of the TCJA, applicable to taxable years beginning after December 31, 2017. New section 451(b) generally provides that the all events test applicable to an accrual method taxpayer shall be treated as met with respect to an item of income no later than when the item of income is taken into account as revenue in an "applicable financial statement" ("AFS"), or such other statement as is specified by the Commissioner in regulations, of the taxpayer. The stated purpose for linking tax and book reporting of income in this manner was to promote simplification, reduce compliance costs, and create a "healthy tension" between a taxpayer’s desire to have both high book income and low tax income. Sen. Fin. Comm. Explanation of H.R. 1 (Nov. 19, 2017), p. 161. Section 451(b) is to be applied before applying certain timing rules under subchapter P, including the OID rules. See IRC 451(b)(2). Through new section 451(b), Congress intended to effectively overturn the result in Capital One Financial Corp. and Subs v. Commissioner, 133 T.C. 136 (2009), in which the Tax Court held that interchange fees charged by a credit card company could be recognized and reported for tax purposes over time as OID. See H.R. Conf. Rep. No. 115-466, 115th Cong., 1st Sess. p. 427. Generally, such fees are not treated as discount under generally accepted accounting principles.

Almost immediately after new section 451(b) was enacted, questions arose about whether the new financial statement "backstop" rule was intended to trump the regime in place under Subchapter P for accrued market discount. On the one hand, the Conference Report expressly provided that the backstop rule is to be applied before applying the special rules under Part V of Subchapter P, "which, in addition to the OID rules, also includes rules regarding the treatment of market discount on bonds, discounts on short-term obligations, OID on tax-exempt bonds, and stripped bonds and stripped coupons." H.R. Conf. Rep. No. 115-466, 115th Cong., 1st Sess. p. 429. On the other hand, the market discount rules generally function on the principle of realization events, i.e., generally, a taxpayer does not recognize market discount as income until the instrument is disposed of by the taxpayer or partial principal payments are made by the debtor. A footnote in the legislative history of section 451(b) stated that the backstop rule "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 . . . realization event has not yet occurred." H.R. Conf. Rep. No. 115-466, 115th Cong., 1st Sess. p. 428, fn. 872. Hence the confusion.

Notice 2018-80 addresses the taxpayers’ concerns about the backstop rule and market discount by stating that the IRS and Treasury intend to issue proposed regulations providing that accrued market discount is not includible in income under section 451(b). The guidance described in Notice 2018-80 is applicable retroactively as of January 1, 2018. Since Notice 2018-80 was issued, Congress released the General Explanation of Public Law 115-97 ("Blue Book"). The Blue Book confirms that the financial statement backstop rule does not apply to the character of bond disposition gain where realization does not occur until the bond has been sold or otherwise disposed of by reason of section 1276. Joint Committee on Taxation, General Explanation of Public Law 115-97 (Dec. 2018), pp. 165-66. The Blue Book further confirms, however, that Congress intended for the backstop rule to apply to market discount where the taxpayer has made the election under section 1278(b) to include such discount in income ratably as it accrues. Id. at p. 166.


Rev. Proc. 2018-60 provides procedures for taxpayers to change various methods of accounting to comply with the amendments to section 451(b) by the TCJA. Depending on the circumstances, certain taxpayers may opt to use a "streamlined" procedure to effect the method change in lieu of filing a Form 3115, but only for their first taxable year beginning after December 31, 2017. The revenue procedure confirms that taxpayers generally receive audit protection in connection with these method changes, but only if they implement the method change with a Form 3115. The streamlined procedure offers administrative convenience, but no audit protection.
A. Background

Prior to the TCJA, the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") had jointly announced new financial accounting standards for revenue recognition (called the "New Standards" by the IRS). For entities other than certain not-for-profit entities and certain employee benefit plans, the New Standards become mandatory for taxable years beginning after December 15, 2018, but such entities are permitted to adopt them for reporting periods beginning after December 15, 2016. Generally, under the New Standards, a taxpayer satisfies a performance obligation when it transfers a promised good or service to a customer.

In Rev. Proc. 2018-29, modified by Rev. Proc. 2018-49, the IRS and Treasury amended the "mass automatic" revenue procedure (currently Rev. Proc. 2018-31, 2018-22 I.R.B. 637) to include a new automatic method change to recognize income for tax purposes under section 451 consistent with the New Standards. This was done in response to comments from taxpayers concerned with the increasing book-tax disparities that were expected to result from use of the New Standards for financial reporting purposes. Under new section 16.11 of Rev. Proc. 2018-31, taxpayers may request automatic consent to change their method of accounting for income recognition to a method under the New Standards for: (i) identifying performance obligations, (ii) allocating transaction price to performance obligations, and/or (iii) considering performance obligations to be satisfied. Under Rev. Proc. 2018-29, taxpayers are generally permitted to implement the change either using a section 481(a) adjustment, or on a cut-off basis. Consolidated group members, however, must implement the change with respect to intercompany transactions on a cut-off basis. Rev. Proc. 2018-29 does not apply to changes in methods of accounting to comply with the amendments to section 451(b) by the TCJA.

Subsequent to the adoption of the New Standards by FASB and IASB, the TCJA was enacted, making several changes to section 451, including:

- Adding new section 451(b)(1)(A), which provides that the all events test applicable to an accrual method taxpayer shall be treated as met with respect to an item of income no later than when the item of income is taken into account as revenue in an "applicable financial statement" ("AFS"), or such other statement as is specified by the Commissioner in regulations, of the taxpayer. This rule applies before application of the rules of Subchapter P, including the rules relating to original issue discount ("OID");

- Adding new section 451(b)(4), which provides that in the case of a contract that contains multiple performance obligations, the allocation of the transaction price to each performance obligation shall be equal to the amount allocated to each performance obligation for purposes of including the item in revenue on the taxpayer’s AFS.

The TCJA amendments are generally effective for taxable years beginning after December 31, 2017 (i.e., earlier than the mandatory effective date of the New Standards for most entities). However, in the case of income from a debt instrument having OID, the amendments to section 451(b) apply to taxable years beginning after December 31, 2018. Taxpayers without AFS are not affected by these changes.

The TCJA provides that any change in method of accounting that either: (i) is required by the amendments to section 451(b), or (ii) was prohibited prior the amendments, but is permissible after the amendments, will, for the first taxable year of the taxpayer beginning after December 31, 2017, be treated as initiated by the taxpayer and made with the consent of the Secretary. Although the statute is not explicit on this point, presumably the same treatment is deemed to apply to method changes in the case of income from a debt instrument having OID for the first taxable year of the taxpayer beginning after December 31, 2018. The TCJA specifies that the spread period for the section 481(a) adjustment for a method change in the case of income from a debt instrument having
OID is to be six years. Apart from these specific rules, the statute itself, and the legislative history, are silent as to the procedures for, and terms and conditions of, the method changes necessitated by the new provisions, including the applicable section 481(a) spread period and the availability of audit protection for prior tax years.

B. New Automatic Method Changes to Comply with the TCJA Amendments

Rev. Proc. 2018-60 modifies Rev. Proc. 2018-31 to include new section 16.12, which applies to a taxpayer with AFS that wants to change its method of accounting for income to one that complies with new section 451(b)(1)(A), and/or change its method of accounting for income to one that complies with new section 451(b)(4). Taxpayers can implement the change in one of two ways (depending on their circumstances): (i) filing a Form 3115; or (ii) using certain "streamlined" procedures. The streamlined procedures apply if either: (i) the taxpayer has average annual gross receipts for the prior three taxable years equal to or less than $25 million; or (ii) has a $0 section 481(a) adjustment with respect to each of the changes the taxpayer is making to comply with new sections 451(b)(1)(A) and/or 451(b)(4). The streamlined procedures simply involve reporting the item on the new method on the taxpayer's return; no Form 3115 is required. Although the streamlined procedures are provided for administrative convenience, the IRS and Treasury caution that taxpayers may wish to file a Form 3115 "in order to retain a clear record of a change in method of accounting." Rev. Proc. 2018-60, section 2.08. Also, a change made with a Form 3115 will be given audit protection (subject to the normal caveats of Rev. Proc. 2015-13), but no audit protection is afforded in respect of changes made under the streamlined procedures.

The four-year spread period provided under Rev. Proc. 2015-13 generally applies to positive section 481(a) adjustments in connection with these new automatic method changes. However, the spread period is six years for changes involving income from a debt instrument having OID, but only if the change is made for the taxpayer's first taxable year ending after December 31, 2018. Finally, taxpayers may make method changes under both section 16.11 (to be consistent with the New Standards) and 16.12 (to comply with new section 451(b)) for the same taxable year on a single Form 3115. However, if they do so, they must make the change under section 16.11 before making the change under section 16.12. The streamlined procedures are not available for a taxpayer that wants to make both of these changes for the same taxable year.

The new automatic method changes are available for taxable years beginning after December 31, 2017 (December 31, 2018 in the case of changes involving income from a debt instrument having OID). The streamlined procedures, however, are available only for the taxpayer's first taxable year ending after December 31, 2017.


Revenue Procedure 2019-10 provides procedures for insurance companies to change the basis of computing reserves under section 807(f), as amended by Section 13513 of the Tax Cuts and Jobs Act, Pub. L. No. 115-97. The revenue procedure provides an automatic method change effective for taxable years beginning after December 31, 2017.

Prior to amendment, section 807(f) required insurance companies to account for any changes in the basis of computing reserves by taking the amount of income or deduction into account over 10 years. Amended section 807(f) provides instead that such amounts are subject to the rules under IRC §481.

Revenue Procedure 2019-10 modifies Rev. Proc. 2018-31 to add new section 26.04 to the list of automatic changes as designated automatic change number 240. The change applies to life insurance and non-life insurance companies changing the basis of computing reserves as described in section 807(f). Audit protection is available for prior taxable years, but ruling protection is not provided for the new basis of computing reserves.
A negative section 481(a) adjustment (resulting from an increase in reserves) is taken into account in the year of change and a positive section 481(a) adjustment (resulting from a decrease in reserves) is taken into account ratably over four taxable years. The section 481(a) adjustment is computed as of the end of the year of change and is only with respect to contracts issued before the year of change.

The revenue procedure provides that multiple changes during the same taxable year in methods, assumptions, or factors, each of which alone would constitute a change in basis of computing reserves for the same type of contract, are considered a single change in basis. The effects of such multiple changes are netted and treated as a single net negative section 481(a) adjustment or net positive section 481(a) adjustment. However, a change in computing the basis of the reserve for each type of contract is considered a separate change requiring a separate section 481(a) adjustment for each type of contract.

Taxpayers are permitted to include multiple changes in basis for a particular year on a single Form 3115. A single Form 3115 may also be filed for members of a consolidated group.

The eligibility rule in Section 5.01(1)(f) of Rev. Proc. 2015-13 (generally prohibiting a taxpayer from changing or requesting to change the method of accounting for the same item during any of the prior five taxable years ending with the year of change) does not apply to this change.

The revenue procedure specifies certain information that is required to be provided in the Form 3115, including a description of the types of insurance contracts subject to the change, the applicable tax reserve method, the change in basis being made and the reason for the change in basis.

d. Rev. Proc. 2019-12 (Dec. 28, 2018) – Safe harbor rules under which amounts that C corporations or certain pass-through entities pay to a section 170(c) entity with the expectation of receiving a tax credit will be considered ordinary and necessary business expenses under section 162.

Rev. Proc. 2019-12 provides safe harbor rules under which amounts that C corporations or certain pass-through entities pay to a section 170(c) entity with the expectation of receiving a tax credit will be considered ordinary and necessary business expenses under section 162.

As background, the TCJA added new section 164(b)(6), which denies deductions for foreign real property taxes and generally limits the aggregate deduction for income, real property, personal property, and sales taxes to $10,000 per individual ($5,000 in the case of married individuals filing separately). Section 164(b)(6)’s limitation does not apply, however, to taxes (other than sales taxes) paid or accrued in carrying on a trade or business or an activity described in section 212. The provision applies to individuals for taxable years beginning after December 31, 2017, and before January 1, 2026.

Section 164(b)(6)’s deduction limitation has been highly controversial. Some state and local governments, and taxpayers sought to avoid the deduction limits of section 164(b)(6) through the use of tax credit programs. Under these programs, a taxpayer making a contribution to an entity described in section 170(c) would receive a credit against taxes otherwise owed to a state or local taxing authority. Thus, the idea was for the taxpayer to deduct under section 170 amounts that he or she otherwise would have paid in taxes and for which a deduction would be limited by section 164(b)(6). In response to these efforts, the IRS issued guidance (including proposed regulations) providing that a tax credit under these types of programs is a quid pro quo that reduces accordingly the amount of any section 170 deduction otherwise allowable.

The revenue procedure provides that if a C corporation makes a payment to or for the use of a section 170(c) entity, and in return for that payment, the corporation receives a credit against state
or local tax imposed on the corporation, the corporation may treat the payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162 to the extent of the credit received.

Similarly, the same safe harbor is provided for certain “specified” pass-through entities. A “specified” pass-through entity is one that meets all of the following requirements:

- It is a business entity other than a C corporation that is regarded for all federal income tax purposes;
- It operates a trade or business within the meaning of section 162;
- The credited state or local tax is incurred by the pass-through entity in carrying on its trade or business, and the tax is imposed directly on the entity itself; and
- In return for the payment to the section 170(c) entity, the pass-through entity receives or expects to receive a state or local tax credit that it applies or expects to apply to offset that state or local tax, other than a state or local income tax.


e. **LTR 201844006 – IRS grants taxpayer revocation of election out of bonus depreciation**

The IRS granted a limited partnership permission to revoke its election under section 168(k) not to deduct the additional first-year depreciation for qualified property.

Taxpayer is a limited partnership whose sole general partner is a real estate investment trust (REIT) under section 856. In Year 1, the taxpayer placed in service qualified property as defined in section 168(k)(2) and filed Form 1065, *Return of Partnership Income*. Taxpayer made an election under section 168(k)(7) not to claim the 50% additional first year depreciation deduction for all classes of property, including 7-year property, 10-year property, and qualified improvement property.

Taxpayer made the election based on erroneous advice provided by a Preparer that the undepreciated basis of a building that was demolished during Year 1 is deductible. The Preparer prepared the taxpayer’s Form 1065 and included the deduction. The REIT decided to have Taxpayer make the election under section 168(k)(7) because claiming the additional first year depreciation deduction for Year 1 would have reduced the REIT’s share of taxable income from Taxpayer below its expected distributions, and would have required Taxpayer to undertake complex recordkeeping and state tax modifications.

Preparer assigned a new engagement team for Year 2 who then realized the error upon review of the Year 1 Form 1065. Preparer advised that the REIT’s share of Taxpayer’s taxable income in Year 1 was greater than had been reported on Taxpayer’s Year 1 Form 1065, and thus the REIT would be liable for income tax on this amount. The magnitude of this adjustment would put the REIT close to failing the REIT requirements to distribute out 90% of its REIT taxable income. Had Taxpayer know the demolition costs were not deductible in Year 1, Taxpayer would not have made the election under section 168(k)(7).

Based on the facts presented, the IRS concluded that a revocation of Taxpayer’s election not to deduct any additional first year depreciation under 168(k)(1) for 7-year, 10-year, and qualified improvement property eligible classes of qualified property that were placed in service in Year 1 by Taxpayer was permitted under Treas. Reg. 1.168(k)-1(e)(7)(i).

f. **LTR 201848012 – Taxpayer properly applied the simplified production method**

PLR 201848012 addresses a taxpayer that is a producer subject to section 263A, that uses the simplified production method and the FIFO method. The taxpayer develops and commercializes certain products using complex manufacturing processes, and produces its products in large batches. The taxpayer’s inventory did not completely turn over during the taxable year, and the
taxpayer asked whether it could properly include (i) only the additional section 263A costs that it incurred during the second taxable year in the numerator of the absorption ratio of the simplified production method formula, (ii) only the section 471 costs that it incurred during the second taxable year in the denominator of the absorption ratio of the simplified production method formula, and (iii) only the section 471 costs that it incurred during the second taxable year and that remained in its inventory at the end of such year in the section 471 costs on hand at year end for purposes of the simplified production method formula.

In addition, the taxpayer asked whether, notwithstanding the fact that a portion of the taxpayer's first year's ending inventory remained on hand in its second year's ending inventory, the taxpayer, using the FIFO method and the simplified production method, could determine the additional section 263A costs capitalized to ending inventory in the second year by only using the portion of additional section 263A costs incurred during the second year that are allocable to ending inventory in the second year under the simplified production method, and whether the taxpayer could properly recover as COGS in the second year the additional section 263A costs that were allocated to ending year in the first year using the simplified production method.

The IRS granted the taxpayer's requested rulings.

g. General Explanation of Public Law 115-97, Joint Committee on Taxation (Dec. 2018) (Blue Book)

The Blue Book addressed, among other things, changes to section 451. The Blue Book summarized prior law, including the concepts of realization and recognition, treatment of advance payments, and certain special methods of accounting, such as original issue discount. The Blue Book also explained the changes to section 451.

With respect to revision of the all events test for income recognition, the Blue Book stated that the revised section 451 requires accrual method taxpayers with applicable financial statements ("AFS") to include items in gross income no later than the taxable year in which such income is taken into account as revenue in the AFS. The provision does not apply to taxpayers without AFS. In the case of a contract which contains multiple performance obligations, the provision requires taxpayers to allocate the transaction price to each performance obligation in accordance with the allocation made in the AFS. The Blue Book also explained the codification of Revenue Procedure 2004-34, with respect to treatment of advance payments, and the impact on Treasury regulations section 1.451-5.

The Blue Book clarified that certain principles were not modified by the new law. Thus, the all events test remains unchanged. The Blue Book also described how cost of goods sold reduces total sales, and the impact of the economic performance requirement. The Blue Book also addressed the impact of the new provision on special methods of accounting, and clarified that, for example, the new provision may require taxpayers with AFS to take items into income sooner than they would be taken in account under the original issue discount rules.

h. PGP Items 2018-2019 Priority Guidance Plan

On November 8, 2018, the Assistance Secretary for Tax Policy and U.S. Department of the Treasury (Treasury) released a joint statement announcing the 2018-2019 Priority Guidance Plan (PGP), which sets forth the guidance priorities for the Treasury and the Internal Revenue Service (IRS).

The statement indicates that guidance for the following tax accounting issues will be prioritized during the twelve-month period from July 1, 2018 through June 30, 2019 (the plan year). The Treasury and IRS may further update the 2018-2019 plan during the plan year.
• Guidance on qualified equity grants under new Section 83(i), as added by Section 13603 of the TCJA.
• Guidance under amended Section 162(f) and new Section 6050X.
• Computational, definitional, and other guidance under new Section 163(j) (released 8/8/2018).
• Guidance on applying the state and local deduction cap under Section 164(b)(6) to passthrough entities.
• Guidance under Sections 168(f)(2) and (i)(9) addressing excess deferred income taxes and public utility companies.
• Guidance under Section 382(h)(6) in response to the TCJA.
• Definitional and other guidance under new Section 451(b) and (c) (published 10/15/18 in IRB 2018-42 as Notice 2018-80, released 9/27/18, published 10/15/18 as REG-104872-18, released 10/12/18).
• Guidance under Section 807(f) as amended by Section 13513 of the TCJA, regarding adjustments for changes in the basis of computing reserves.
• Regulations under new Section 59A concerning the base-erosion and anti-abuse tax.
• Regulations under new Section 250 regarding the deduction for foreign derived intangible income and global intangible low-taxed income.
• Revenue procedure under Sections 168(g) and 179 concerning elections and computation of depreciation.
• Guidance under Sections 167 and 168 for determining whether certain assets used by a wireline telecommunication service provider are primarily used for providing one-way or two-way communication services.
• Revenue procedure under Section 263(a) regarding the capitalization of nature gas transmission and distribution property.
• Guidance regarding the treatment of deferred revenue in stock acquisitions.
• Regulations under Section 453A regarding contingent payment sales.
• Final regulations under Section 453B regarding the nonrecognition of gain or loss on the disposition of certain installment obligations.
• Regulations under Section 472 regarding dollar-value last-in, first-out (LIFO) inventories, including rules for combining pools as a result of a change in method of accounting, certain corporate acquisitions, and certain nonrecognition transactions.
• Final regulations amending Treas. Reg. §1.472-8 regarding the inventory price index computation (IPIC) method.