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New IRS Final Section 451(b) and 451(c) Regulations: Rules for Income Recognition and Advance Payments

All-Events Test for Gross Income, Cost Offset, Multi-Year Contract Issues, Contracts With Multiple Performance Obligations, and More

TUESDAY, JUNE 1, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Agenda

- Overview of Income Recognition Rules
- Timing and Income Recognition under Section 451(b)
- Advance Payments under Section 451(c)
- Impact of Final Regulations
- Change in Accounting Methods
- Best Practices

Overview of Income Recognition Rules

Overview of Income Recognition Rules

- June 2015 → Notice 2015-40
- March 2017 → Notice 2017-17
- December 2017 → TCJA (addition of Section 451 (b)/(c) to IRC)
- December 2018 → JCT Bluebook
- September 2019 → Proposed regulations (with Rev. Proc. 2019-37)
- December 2020 → Final regulations

Timing and Income Recognition under Section 451(b)

Section 451(b)

- Requires recognition of income <u>at the earlier of</u>:
  1. When the all events test is met for an item of income; or
  2. 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

Section 451(b) (cont'd)

- Does not apply with respect to any item of gross income for which a taxpayer uses a special method of accounting
- Transaction price must be allocated between performance obligations in the same manner as AFS
- Legislative history (Conference Report, footnote 872) indicates change in recognition rules does not impact rules associated with when an item is realized for FIT purposes

Advance Payments under Section 451(c)

Section 451(c)

- Essentially codified the Deferral Method provided under Rev. Proc. 2004-34
- Allows TPs to elect to defer the recognition of advance payments to the taxable year following the year of receipt to the extent such income is deferred for book purposes
- Prior to the release of proposed regulations, Notice 2018-35 was released on April 12, 2018, confirming for TPs that until further guidance was released, Rev. Proc. 2004-34 could still be relied upon by TPs
- On July 15, 2019, Treas. Reg. §1.451-5 (and its lengthier income deferral period) was officially repealed

Section 451(c) - Specifically

- Section 451(c) - Treatment of advance payments
- (1) In general - A taxpayer which computes taxable income under the accrual method of accounting, and receives any advance payment during the taxable year, shall—
  - (A) except as provided in subparagraph (B), include such advance payment in gross income for such taxable year, or
  - (B) if the taxpayer elects the application of this subparagraph with respect to the category of advance payments to which such advance payment belongs, the taxpayer shall—
    - (i) to the extent that any portion of such advance payment is required under [section 451(b)] to be included in gross income in the taxable year in which such payment is received, so include such portion, and
    - (ii) include the remaining portion of such advance payment in gross income in the taxable year following the taxable year in which such payment is received

Section 451(c) – Advance Payments

- Any payment in which:
  - The full inclusion in the gross income of the taxpayer for the taxable year of receipt is a permissible method of accounting
  - Any portion of which is included in revenue by the taxpayer in a financial statement in a subsequent yea, and
  - Which is for good, services, or other items identified by Secretary.
- Enumerated list of exclusions, including, rent, insurance premiums, etc.

Impact of Final Regulations

Final Regulations

- Final section 451(b) regulations (T.D. 9941) issued on Dec. 21, 2020
  - Generally, regulations are effective for tax years beginning on or after Jan. 1, 2021
    - For a specified fee that is not a credit card fee, the regulations are applicable for taxable year beginning on or after Jan. 6, 2022
  - In general, taxpayers may apply the final regulations for tax years beginning after Dec. 31, 2017
    - Exceptions for specified credit card fees and specified fees that are not specified credit card fees

Treas. Reg. §1.451-3 – AFS Income Inclusion Rule

- If a taxpayer uses an accrual method of accounting for Federal income tax purposes and has an AFS, the all events test under Treas. Reg. § 1.451– 1(a) for any item of gross income, or portion thereof, is met no later than when that item, or portion thereof, is taken into account as AFS revenue
- Exceptions. The AFS income inclusion rule does not apply to:
  - (i) Any item of gross income, or portion thereof, if the timing of income inclusion for that item, or portion thereof, is determined using a special method of accounting;
  - (ii) Any item of gross income, or portion thereof, in connection with a mortgage servicing contract; or
  - (iii) Any taxable year that is not covered for the entire year by one or more AFS

AFS Income Inclusion Rule - Adjustments

Increased to…

- For inventory, remove reductions for costs of goods sold
- Liabilities that are required to be accounted for under other Code provisions, i.e., Section 461 (e.g., rebates, chargebacks, rewards)
- Amounts anticipated to be in dispute or anticipated to be uncollectable

Decreased for…

- An amount the taxpayer does not have an enforceable right to recover if the customer were to terminate the contract on the last day of the taxable year
- A significant financing component recorded for AFS purposes

Treas. Reg. §1.451-3 – AFS Income Inclusion Rule

- Enforceable right standard
  - Amounts the taxpayer would have a right to recover if the customer were to terminate the contract on the last day of the taxable year
  - Includes any right under contract terms or applicable law (e.g., liquidated damages, equitable relief)
- Alternative AFS revenue method
  - Taxpayer takes into account revenue recognized in AFS, but does not adjust for enforceable right (only increases to add back future liabilities and decreases for significant financing component)
  - Optional at trade or business level
  - Taxpayer can also utilize AFS cost offset method if using the alternative AFS revenue method

Treas. Reg. §1.451-3 – AFS Income Inclusion Rule

- Enforceable right – example
  - *Facts.* In 2021, E, a manufacturer, enters into a contract with Fire Department for the manufacture and delivery of a fire truck. The fire truck takes 10 months to manufacture at an estimated cost of $60,000. The contract provides E with an enforceable right to recover costs incurred in manufacturing the fire truck regardless of whether the Fire Department accepts delivery of the fire truck or terminates the contract, and an enforceable right to an additional $20,000 if the fire truck is accepted by the Fire Department. E does not have an enforceable right to recover any portion of the additional $20,000 if the Fire Department were to terminate the contract before it accepts the fire truck. E has an obligation to cure any defects if the customer rejects the fire truck.
  - In August 2021, E begins manufacturing the fire truck ordered by Fire Department and incurs $30,000 of costs for materials and labor for the contract. For its AFS, E reports $40,000 of AFS revenue for 2021 ($30,000 costs plus $10,000 expected profit on the sale of the fire truck).

Treas. Reg. §1.451-3 – AFS Income Inclusion Rule

- Enforceable right – example
  - Under the all events test in Treas. Reg. § 1.451–1(a), E is required to include $30,000 in gross income in 2021 as E has a fixed right to receive $30,000 as of the end of 2021. Although E reports $40,000 of AFS revenue for 2021, E has an enforceable right to recover only $30,000 if the Fire Department were to terminate the contract on the last day of 2021.
  - Accordingly, pursuant to Treas. Reg. §1.451-3, of the $40,000 of AFS revenue reported for 2021, only $30,000 is treated as ''taken into account as AFS revenue'' under the AFS income inclusion rule. As a result, E is required to include only $30,000 in gross income in 2021.

Treas. Reg. §1.451-3 – Cost Offsets

- An optional method of accounting that may be used to determine the AFS income inclusion amount for an item of gross income from the sale of inventory
- Taxpayer must first determine the AFS inventory inclusion amount and then reduce such amount by the cost of goods in progress offset for the taxable year
- During the year of sale, a taxpayer must determine the appropriate gross income to take into account

Treas. Reg. §1.451-3 – Cost Offsets

- Qualifiers
  - A taxpayer that uses the AFS cost offset method for a trade or business must apply this method to all items of gross income in the trade or business that meet the AFS cost offset criteria
  - A taxpayer that uses the AFS cost offset method must also use the advance payment cost offset method
  - The cost of goods in progress offset is determined separately for each item of inventory
  - The cost of goods in progress offset attributable to one item of inventory cannot reduce the AFS inventory inclusion amount attributable to a separate item of inventory
  - The cost of goods in progress offset cannot reduce the AFS inventory inclusion amount for the taxable year below zero

Treas. Reg. §1.451-3 – Cost Offsets

- Treatment of inventory
  - The cost of goods in progress offset does not reduce the costs that are capitalized to the items of inventory produced or items of inventory acquired for resale by the taxpayer
  - There must be consistency between the inventory methods of a taxpayer and the AFS cost offset method

Treas. Reg. §1.451-3 – Cost Offsets

- Example
  - *Facts.* In 2021, E, a manufacturer, enters into a contract with Fire Department for the manufacture and delivery of a fire truck. The fire truck takes 10 months to manufacture at an estimated cost of $60,000. The contract provides E with an enforceable right to recover costs incurred in manufacturing the fire truck regardless of whether the Fire Department accepts delivery of the fire truck or terminates the contract, and an enforceable right to an additional $20,000 if the fire truck is accepted by the Fire Department. E does not have an enforceable right to recover any portion of the additional $20,000 if the Fire Department were to terminate the contract before it accepts the fire truck. E has an obligation to cure any defects if the customer rejects the fire truck.
  - In August 2021, E begins manufacturing the fire truck ordered by Fire Department and incurs $30,000 of costs for materials and labor for the contract. For its AFS, E reports $40,000 of AFS revenue for 2021 ($30,000 costs plus $10,000 expected profit on the sale of the fire truck).
  - Ownership of the fire truck transfers upon delivery in 2022

Treas. Reg. §1.451-3 – Cost Offsets

- Example
  - In 2021 E determines its AFS inventory inclusion amount is $30,000. E incurs $30,000 of costs in 2021 and $30,000 of costs in 2022. E has a fixed right to receive $80,000 upon acceptance of the fire truck and an enforceable right for costs of performance to date should the contract be terminated.
  - For 2021, E's AFS Income inclusion amount under the AFS cost offset method is $0 ($30,000 AFS inventory inclusion amount less $30,000 cost of goods in progress offset)

Treas. Reg. §1.451-3 – Contracts with Multiple Performance Obligations

- *In general.* Each performance obligation generally yields a corresponding item of gross income that must be accounted for separately under the AFS income inclusion rule. If a contract contains more than one performance obligation, and thus yields more than one corresponding item of gross income, the transaction price amount shall be allocated to each corresponding item of gross income in accordance with the transaction price amount allocated to each performance obligation for AFS purposes, subject to the adjustments to the transaction price amount and special allocation rules.

- *Single performance obligation with more than one item of gross income.* If a single performance obligation yields more than one corresponding item of gross income, the transaction price amount allocated to the single performance obligation for AFS purposes must be further allocated among the corresponding items of gross income using any reasonable method.

Treas. Reg. §1.451-8 - Advance payments

- Optional methods for qualifying advance payments
  - Current inclusion method
  - 1-year deferral method
    - Include the amount taken into account as AFS revenue under Reg. § 1.451-3
    - Remainder is recognized in the year immediately following the year of receipt
- An advance payment is a payment received by a taxpayer if
  - Full inclusion in gross income for the taxable year of receipt is a permissible method of accounting,
  - Any portion of the payment is taken into account as AFS revenue (under the same rules as the AFS income inclusion rule) for a subsequent taxable year
    - Amount taken into account as AFS revenue determined under Reg. § 1.451-3, but is NOT adjusted for amounts for which the taxpayer does not have an enforceable right
  - The payment is for one or more qualifying items
- Advance payment includes amounts received or due

Treas. Reg. §1.451-8 - Advance payments

Qualifying advance payments

- Services
- Sale of goods
- Use of certain intellectual property
- Occupancy or use of space ancillary to services
- Sale, lease or license of computer software
- Ancillary guaranty or warranty contracts
- Subscriptions
- Membership fees
- Eligible gift card sale
- Any combination of the above

Advance payments exclude

- Rent
- Insurance premiums
- Payments with respect to financial instruments
- Payments for the sale of real property
- Payments for "specified goods" where contracted delivery month at least two years after year of receipt

- **Income inclusion rules determined under section 451(b) instead**

Treas. Reg. §1.451-8 - Advance payment cost offset method

- In general, mechanics and limitations are similar to the AFS cost offset method
  - Cost offset equals lesser of cumulative costs incurred or advance payment
  - Consistency required: Must be used for both section 1.451-3 and -8
  - Method not permitted for gift card sales or payments received for customer reward program points
- Advance payment cost offset method available to taxpayers using AFS deferral method as well as taxpayers without an AFS that receive advance payment (non-AFS deferral method)

Treas. Reg. §1.451-8 - Specified goods

- Exclusion from the definition of an advance payment
- No change in definition / applicability from the proposed regulations
- A taxpayer can make an election to treat all prepayments that qualify for the specified goods exception as advance payments subject to section 451(c)
- Unless election made, payments received for specified goods are not advance payments
  - Specified good is good generally not on hand or available through normal supply and for which all revenue from the sale of the good is recognized in the taxpayer's AFS in the year of delivery

Change in Accounting Methods

Initial Accounting Methods Guidance

- Rev. Proc. 2019-37, issued with the release of the proposed regulations under Sections 451(b) and (c), modified Rev. Proc. 2018-31 to provide automatic method changes for:
  - Change in the treatment of an item of gross income as meeting the All Events Test no later than when such item is taken into account as revenue in its AFS under §451(b)(1)(A);
  - Change to allocate the transaction price to performance obligations under §451(b)(4), but is not adopting the new revenue recognition standards for financial accounting purposes;
  - Change its method of accounting to comply with proposed Treas. Reg. §1.451-3; or
  - Change its method of accounting to comply with proposed Treas. Reg. §1.451-8(c).
- Available section 481(a) adjustment; or on cut-off basis.
- Audit protection is available, even if TP is under Examination.
- Ability to file concurrent method changes on same Form 3115.

Transition and Accounting Method Changes

- Final Regulations are generally effective for tax years beginning on or after January 1, 2021
  - Three year transition period with options for reliance
    - Interpretation of statute
    - Proposed regulations
    - Final regulations
- Implementation is generally a voluntary and automatic accounting method change with section 481(a) adjustment
- For OID methods
  - Statute effective for all OID beginning in 2019 (one-year delay)
  - Proposed regulations: Specified fees only, with fees other than credit card fees delayed for two year after final regulations
  - 6-year instead of 4-year section 481(a) adjustment period

Automatic Accounting Method Changes

- **DCN 83 and 84**: Advance payments
  - Taxpayer changing to full inclusion or deferral method for advance payments
  - under Rev. Proc. 2004-34
  - Section481(a)adjustment
- **DCN 153:** Change in AFS timing of advance payments and amounts under section 451(b)
  - Attach statement to return in lieu of filing Form 3115
  - Cut-off or section 481(a) adjustment depending on the particular change
- **DCN 231:** ASC 606 changes
  - Cut-offor481(a)adjustment
- **DCN 239:** Change to comply with statute
  - Cut-off or section 481(a) adjustment depending on the particular change
- **DCN: 242:** Change to comply with proposed regulations
  - Cutoff or section 481(a) adjustment depending on particular change

Best Practices

Best Practices

- Gather relevant internal information regarding revenue recognition for financial accounting purposes
- Confirm current company practices are aligned with new AFS income inclusion rule, and, where relevant, available advance payment methods
  - If not, review accounting method changes to consider implementing with TY20 return
  - If aligned, evaluate whether business could change to more optimal income recognition method
- Work with financial accounting team to evaluate revenue recognition and whether changes could be made to improve tax position
- Stay vigilant – IRS guidance is pending

Thank You

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