Proposed regulations interpret the all-events test under Section 451(b)

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In brief

The IRS and Treasury have released long-awaited proposed regulations implementing Sections 451(b) and 451(c), added by the 2017 tax reform act (the Act), and Rev. Proc. 2019-37, which provides procedures for a taxpayer to change its method of accounting to comply with the amendments to Section 451, including the proposed regulations. This Insight discusses the Section 451(b) proposed regulations. A forthcoming Insight will discuss the Section 451(c) proposed regulations and Rev. Proc. 2019-37.

Section 451(b) provides rules that apply to a taxpayer using an accrual method of accounting on the timing of recognizing income under the all-events test.

The Section 451(b) regulations, in general, are proposed to apply to tax years beginning after the date final regulations are published in the Federal Register. The proposed regulations on 'specified fees' (other than 'specified credit card fees') are proposed to apply for tax years beginning one year after the date final regulations are published in the Federal Register.

The regulations allow taxpayers to rely on the proposed regulations for tax years beginning after December 31, 2017, if they apply all the proposed rules (other than the rules for specified fees) and consistently apply the proposed regulations to all items of income during the tax year (except specified fees). Taxpayers may rely on the proposed regulations on specified credit card fees for tax years beginning after December 31, 2018, under the same conditions. Taxpayers may not rely on the proposed regulations for specified fees that are not specified credit card fees.

Observation: Based on the proposed effective date, calendar-year taxpayers can expect that the earliest the final regulations will apply is for their 2021 tax year (calendar year 2022 for specified fees other than specified credit card fees). Until then, taxpayers have the option of relying on the proposed regulations (other than specified fees that are not specified credit card fees) or reasonably interpreting Section 451(b).

PwC professionals will discuss the proposed regulations in a Tax Readiness series webcast on Thursday, September 26, 2019, at 1 PM EDT. Registration details for the webcast are available here.

Background

Section 451 governs the timing of including an item in gross income. A taxpayer using an accrual method of accounting includes an item in gross income when all the events have occurred that fix the right to receive the income and the amount is determinable with reasonable accuracy (the all-events test). Before tax reform, an accrual-method taxpayer generally accrued income at the earliest of when an item was due, paid, or earned.

The Act added Section 451(b), which provides that an accrual-method taxpayer meets the all-events test no later than when an item of gross income is taken into account as revenue in the taxpayer's applicable financial statement (AFS) or other statement Treasury identifies (the AFS inclusion rule). Thus, for tax years beginning after December 31, 2017 (or after December 31, 2018, in the case of debt instruments with original issue discount), the Act effectively requires taxpayers to include an item in gross income at the earliest of when the item is due, paid, earned, or taken into account as revenue in its AFS.

Note: Exceptions apply to the general all-events test rule requiring that amounts paid prior to being due or earned (advance payments) must be recognized upon receipt. Section 451(c) provides a one-year deferral method that applies to advance payments.

In general and in descending order of priority, an AFS is a (1) financial statement certified as complying with generally accepted accounting principles, such as a Form 10-K or certified audited financial statement used for credit purposes or reporting to shareholders, (2) financial statement made on the basis of international financial reporting standards (IFRS) and filed with a foreign government agency equivalent to the Securities and Exchange Commission, or (3) financial statement filed with a regulatory or government agency specified by Treasury. The AFS of a group of entities that includes the taxpayer's financial results is treated as the taxpayer's AFS.

The requirement to recognize income no later than when recognized as revenue in applicable financial statements does not apply to special methods of accounting (other than certain rules related to debt instruments) or to income connected to a mortgage servicing contract. Taxpayers that do not have an AFS for a tax year are not subject to the AFS inclusion rule.

Note: Accrual-method taxpayers that do not have an AFS continue to include an item in gross income under the all-events test at the earliest of when the item is due, paid, or earned.

Section 451(b) also requires taxpayers to allocate transaction price to each performance obligation under a contract with multiple performance obligations consistently with the allocation in an AFS.

Proposed regulations

General scope of the AFS inclusion rule

The proposed regulations clarify that the AFS inclusion rule applies only to accrual methods of accounting that employ the all-events test. That is, the AFS inclusion rule does not apply to any item of gross income when the timing of that income is determined using a special method of accounting.

The proposed regulations define 'special method of accounting' as a method of accounting that is permitted or required under any provision of the Code, Treasury Regulations, or published guidance that requires a taxpayer to include an item in income in a tax year other than the applicable tax year under the all-events test. The proposed regulations provide a non-exclusive list of special methods of accounting that includes methods of accounting for installment sales under Section 453, prepaid subscription income under Section 455, qualified returns under Section 458, long-term contracts under Section 460, certain rental payments under Section 467, mark-to-market method under Section 475, hedging transactions under Reg. sec. 1.446-4, and integrated transactions under Reg. sec. 1.988-5.

Differing characterization of transactions for AFS and tax

The proposed regulations provide that a taxpayer is not required to change the characterization of a transaction for consistency with the characterization in an AFS. That is, the AFS inclusion rule does not change the treatment of a transaction for federal income tax (tax) purposes. The proposed regulations identify examples of transactions that are not recharacterized under this rule, including a transaction characterized as a lease, license, or similar transaction for tax purposes and as a sale for AFS purposes, a transaction characterized as a non-taxable deposit or conduit payment for tax purposes that is treated as revenue for AFS purposes, or a transaction that is not required to be marked-to-market for federal income tax purposes but that is marked-to-market for AFS purposes.

Observation: The examples of transactions treated differently for book and tax do not include transactions involving unbilled receivables for partially performed

services or sales of goods. The preamble to the proposed regulations states that the taxpayer is not changing the treatment of the transaction when it includes in income unbilled receivables for either services or sales of goods that are included in revenue in its AFS, for example by using an overtime percentage of completion method.

Observation: The proposed regulations expand the lease-versus-sale exception noted in the conference report accompanying the Act to include licenses. Companies should review the treatment of unbilled receivables licenses – such as licenses of software, entertainment content, or other intellectual property – to determine whether the book characterization of the transaction is a sale as opposed to a license.

The proposed regulations also provide that treating an item as revenue in an AFS does not change the item's exclusion from income or nonrecognition treatment for tax purposes. The proposed regulations provide, as an example, that a transaction under Section 351, Section 368, or Section 721 is not required to be recognized merely because revenue from the transaction is recognized in the taxpayer's AFS.

Rules relating to a AFS

The AFS inclusion rule applies only to taxpayers that have an AFS for the full tax year. This rule applies tax year to tax year. Thus, a taxpayer may be subject to the rule in a year when it has an AFS and not in the next year when it does not have an AFS.

Observation: A taxpayer that applies the AFS inclusion rule in one year when it has an AFS but not in the next year when it lacks an AFS arguably has a change in facts and not a change in method of accounting.

The proposed regulations expand the Section 451(b) definition of an AFS, for example by listing additional statements that qualify as IFRS statements.

Under the proposed regulations, when a taxpayer's information is reported on a consolidated AFS that does not provide separate information for each member, the taxpayer must determine its share of revenue based on the source documents used to create the AFS.

A taxpayer with a different financial accounting year than its tax year must use one of three methods to determine if an item is included in revenue on the AFS:

(1) Apply the accounting principles used to create its AFS as if the reporting periods coincided, for example by conducting an interim closing of the books;

(2) Include a pro rata portion of revenue for each financial accounting year that includes part of a taxpayer's tax year, making a reasonable estimate if the taxpayer's AFS for a part of its tax year is not available by the taxpayer's extended federal income tax return filing date; or

(3) Use the revenue reported on the AFS for the financial accounting year ending within the taxpayer's tax year, if the financial accounting year ends five or more months after the tax year.

Rules relating to amount of revenue

The proposed regulations define 'revenue' recognized in an AFS as all transaction price amounts includible in gross income under Section 61.

Observation: At the same time, the proposed regulations provide that gross income may differ from AFS revenue in the characterization of the transaction or exclusion/nonrecognition tax treatment.

'Transaction price' is the gross amount of consideration a taxpayer expects to be entitled to for AFS purposes for transferring goods, services, or property (including specified fees on debt instruments), but does not include amounts collected for third parties that are not otherwise income (such as sales taxes or amounts received as a conduit), contingent future income, and reductions for amounts subject to Section 461 such as refunds, rebates, rewards, chargebacks, and amounts included in cost of goods sold.

Observation: The rule relating to cost reductions may result in recognizing more gross income for tax purposes than revenue the taxpayer recognizes in its AFS, resulting in a lack of tax and AFS conformity for revenue recognition. For example, the proposed regulations include an example in which a taxpayer recognizes a net amount of revenue in its AFS, i.e., gross revenue reduced by anticipated chargebacks. Nonetheless, the proposed regulations require the taxpayer to recognize the gross amount as gross income without a reduction for the chargebacks. Similarly, a taxpayer not subject to Section 460 that recognizes revenue net of cost of goods sold under a percentage of completion method for AFS purposes must include an amount in gross income without an offset for costs.

Contingent future income is income to which a taxpayer's entitlement is contingent on the occurrence or non-occurrence of a future event. Although the proposed regulations exclude contingent future income from the transaction price, the proposed regulations create a presumption that an amount included in transaction price for AFS purposes is not contingent future income. However,

the proposed regulations permit a taxpayer to rebut that presumption if it can establish to the satisfaction of the IRS, based on all facts and circumstances as of the end of the tax year, that the amount is contingent on the occurrence or non-occurrence of a future event. In addition, an amount included in AFS transaction price is not contingent if the amount is received or due and payable or the taxpayer has an enforceable right to payment for completed performance.

Observation: The proposed regulations' exclusion of contingent income is a welcome provision in light of the new financial statement revenue recognition standards, which may require acceleration of variable or contingent consideration. However, the proposed regulations do not provide guidance on how a taxpayer rebuts the presumption that an amount is not contingent income, other than through an example in which a taxpayer rebutted the presumption because the amount was contingent on future performance and the taxpayer had no enforceable right to payment.

A taxpayer that adjusts or writes down deferred revenue must treat the amount of the adjustment or write-down as revenue recognized in the AFS in the year of the adjustment.

Example: In 2018, a taxpayer contracts to perform services in 2019 and 2020 for $100. The taxpayer treats the $100 in its AFS as deferred revenue in 2018. In 2019, the taxpayer adjusts deferred revenue to $90 and recognizes $50 in revenue in its AFS. The taxpayer must include the $50 recognized as revenue in the AFS plus the $10 adjustment in gross income in 2019.

Multi-year contracts

The proposed regulations apply a cumulative rather than an annualized approach to amounts included in income under a contract covering more than one tax year. Thus, a taxpayer must take into account the cumulative amounts included in income in earlier tax years in determining the amount included in income in the current and succeeding tax years.

Certain income items with respect to debt instruments

The proposed regulations provide that, except for 'specified fees,' the existing timing rules for original issue discount (OID) and market discount (including amounts that are treated as 'de minimis') control the timing of income. These rules are treated as special methods of accounting under the proposed regulations and, thus, generally are not subject to the AFS inclusion rule.

The exclusion from the AFS inclusion rule includes the general OID and market discount rules, as well as the special rules for accounting for income from contingent payment debt instruments, variable rate debt instruments, integrated transactions under Reg. sec. 1.1275-6 or 1.988-5, and inflation-indexed debt instruments.

Under the proposed regulations, the AFS inclusion rule applies to an item of income from a debt instrument that is characterized as a 'specified fee' before applying the OID rules to determine the timing of income (i.e., it is included in gross income when recognized as revenue on the taxpayer's AFS).

A 'specified fee' is defined as a fee that is not treated as discount or as an adjustment to the yield of a debt instrument over the life of the instrument in the taxpayer's AFS and that, but for these proposed regulations, would be treated as creating or increasing OID for US tax purposes. The proposed regulations include, as examples of specified fees, credit card late fees, credit card cash advance fees, and interchange fees received by credit or debit card issuers (collectively, 'specified credit card fees'). The proposed regulations provide that a taxpayer does not take specified fees into account to determine whether the debt instrument has any OID (i.e., the taxpayer does not treat the item as creating or increasing OID).

Observation: The proposed regulations provide welcome clarity to the scope of the AFS inclusion rule. Although Notice 2018-80 had announced that proposed regulations would provide that accrued market discount is not includible under Section 451(b), the potential scope of the inclusion rule to OID remained unclear. The list of 'specified fees' subject to the AFS inclusion rule under the proposed regulations is not all-inclusive. Therefore, a taxpayer must analyze any fees that are not treated as discount or as an adjustment to the yield of the debt instrument over its life in the taxpayer's AFS to determine whether these amounts may be subject to the AFS inclusion rule.

The proposed regulations provide a special one-year delay in the effective date of the rules related to specified fees that are not specified credit card fees, and state that taxpayers generally may not rely on the proposed regulations for this subset of specified fees. The preamble notes that the delayed effective date for these specified fees is provided because the treatment of the fees is unclear for tax purposes and that the additional time will allow the IRS and Treasury to determine the types of fees that should be subject to the AFS inclusion rule.

Observation: The 2018-2019 priority guidance plan, which identifies formal published guidance priorities for the IRS and Treasury, includes guidance

on the treatment of fees relating to debt instruments and other securities. In the absence of this guidance or the ability to rely on the proposed regulations related to specified fees that are not specified credit card fees, taxpayers generally may look to existing authorities regarding characterization of these fees and reasonable interpretations of Section 451(b).

Allocation of transaction price to multiple performance obligations

Consistent with Section 451(b), the proposed regulations provide that a taxpayer must allocate transaction price to performance obligations in a contract with more than one performance obligation consistent with the transaction price allocation in the taxpayer's AFS. The proposed regulations define 'performance obligation' for purposes of allocating transaction price as a promise to transfer to a customer a distinct good or service or a series of substantially the same distinct goods or services with the same pattern of transfer.

Methods of accounting

The proposed regulations provide that the following changes are changes in method of accounting requiring IRS consent:

(1) A restatement of revenue in an AFS that changes the timing of including an item in revenue;

(2) A change in the method of recognizing revenue in an AFS that changes or could change the timing for including an item in income for tax purposes;

(3) A change in the method for determining revenue when a taxpayer's financial accounting and tax years do not coincide.

The takeaway

The issuance of the proposed regulations provides needed clarity for Section 451(b) rules that apply for tax years beginning in 2018. Until final regulations are issued, taxpayers may rely on the proposed regulations (other than certain specified fee rules), or may look to existing authorities and reasonable interpretations of Section 451(b).

Let's talk

For a deeper discussion of how this issue might affect your business, please contact one of the PwC professionals listed below, or your local Accounting Method Services contact:

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