Guidance issued on Section 451(c) advance payments, Section 451(b) and (c) method changes

September 30, 2019

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 new rules. The Section 451(b) proposed regulations are discussed in Proposed regulations interpret the all-events test under Section 451(b). This Insight discusses the Section 451(c) proposed regulations and Rev. Proc. 2019-37.

Section 451(c) provides rules for a taxpayer using an accrual method of accounting to elect to defer including certain advance payments in gross income.

The regulations are proposed to apply to tax years beginning on or after the date final regulations are published in the Federal Register. The rules allow a taxpayer to apply the proposed Section 451(c) regulations for tax years beginning after December 31, 2017, if the taxpayer applies all the proposed rules and consistently applies the proposed regulations to all advance payments.

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. Until then, taxpayers have the option of relying on the proposed regulations, continuing to rely on Rev. Proc 2004-34, or reasonably interpreting Section 451(c).

PwC professionals will discuss the Section 451(c) proposed regulations and Rev. Proc. 2019-37 in a Tax Readiness series webcast on Tuesday, October 1, 2019, at 2 PM EDT. Registration details for the webcast are available here.

In detail

Background

Section 451(b) requires an accrual-method taxpayer to include an item in gross income at the earliest of when the income is due, paid, earned, or recognized in an applicable financial statement (AFS). Accordingly, an accrual-method taxpayer generally must include an item in gross income no later than the tax year it receives payment. Section 451(c) provides that an accrual-method taxpayer receives payment if an amount is actually or constructively received or if an amount is due and payable.

However, Section 451(c) allows an accrual-method taxpayer to elect a limited deferral beyond the tax year of receipt for certain advance payments. Under Section 451(c), in general a taxpayer may elect to recognize income from an advance payment in the year of receipt to the extent revenue is recognized in an AFS, and recognize the remaining gross income in the next tax year. Section 451(c) defines AFS by reference to Section 451(b). Recognition is accelerated in a tax year a taxpayer ceases to exist.

Under Section 451(c), an advance payment is a payment (1) for which full inclusion in income for the year of receipt is a permissible method of accounting, (2) any part of which is included in revenue in a taxpayer's AFS in a later tax year, and (3) for goods or services. An advance payment does not include payments related to a financial instrument or certain warranty or guarantee contracts, or for items such as rent or insurance premiums, among others. The statute authorizes Treasury to provide rules adding or excluding other items to or from the definition of advance payment.

Section 451(c) codifies, in part, the deferral provisions of Rev. Proc. 2004-34, which applies to advance payments for items such as licenses, subscriptions, and memberships, in addition to goods and services. Rev. Proc. 2004-34 generally allows a taxpayer with an AFS to defer an advance payment for up to one tax year, to the extent the payment is deferred in the taxpayer's AFS. A taxpayer without an AFS generally may defer an advance payment for up to one tax year to the extent the payment is not earned in the year of receipt. Following the modifications to Section 451 made by the Act, the IRS issued Notice 2018-35, which allows taxpayers to continue to rely on Rev. Proc. 2004-34 pending the effective date of additional guidance on the treatment of advance payments.

Like Section 451(b), Section 451(c) requires a taxpayer to allocate transaction price to each performance obligation under a contract consistently with the allocation in the taxpayer's AFS.

Proposed regulations

The preamble to the Section 451(c) proposed regulations recognizes that Section 451(c) generally is intended to codify Rev. Proc. 2004-34, and concludes that rules in the proposed regulations similar to the rules in Rev. Proc. 2004-34 are appropriate and necessary. Accordingly, the proposed regulations incorporate from Rev. Proc. 2004-34 an expanded definition of advance payments, rules on limitations and short tax years, and an advance payment deferral method for taxpayers that do not have an AFS (the non-AFS deferral method).

Scope of advance payment deferral method

Consistent with this approach, the proposed regulations define items that a taxpayer may treat as advance payments consistent with Rev. Proc. 2004-34. Thus, an advance payment is not limited to payments for goods and services, but also may relate to a lease or license for the use of intellectual property, a license for the use of software, certain use or occupancy of property ancillary to providing services, certain guaranty or warranty contracts, certain subscriptions, certain organization memberships, eligible gift card sales, and combinations of these items.

The proposed regulations exclude items as advance payments that Section 451(c) and Rev. Proc. 2004-34 specifically exclude, such as rent, insurance premiums, and payments relating to financial instruments, service warranty contracts, or warranty and guaranty contracts.

The proposed regulations add a new category of items excluded from the definition of advance payments, for payments received in a tax year earlier than the tax year that immediately precedes the tax year that a specified good is contractually required to be delivered (i.e., payments received two or more tax years before a specified good must be delivered). A 'specified good' is defined in the proposed regulations as a good that (1) a taxpayer does not have on hand (or available to it through its normal source of supply) in sufficient quantity and of a substantially similar kind to satisfy a contract in the year the taxpayer receives an advance payment, and (2) for which all the revenue is recognized in the taxpayer's AFS in the year of delivery.

Observation: A payment that is excluded from the scope of Section 451(c) presumably would be subject to the all-events test under Section 451(b) to determine when it is recognized as gross income.

Non-AFS deferral method

The proposed regulations provide a non-AFS deferral method that adapts rules that depend on recognition in an AFS for taxpayers without an AFS. Thus, instead of including an amount in gross income no later than the tax year recognized in an AFS, a taxpayer without an AFS must include an amount in gross income no later than the tax year the taxpayer earns the amount.

A taxpayer earns a payment when the all-events test is met, disregarding the tax year of receipt. A taxpayer that is unable to determine the amount of a payment earned in the tax year received may determine the amount using a statistical or straight-line rateable method, with certain limitations, or on another basis the IRS approves.

The proposed regulations apply the special rules, discussed below, for accelerating advance payments, short tax years, and financial statement adjustments to the non-AFS deferral method.

Acceleration of recognition of advance payments

The proposed regulations adopt rules, similar to the rules in Rev. Proc. 2004-34, that accelerate recognition of certain advance payments. Thus, in addition to the statutory rule accelerating recognition when a taxpayer ceases to exist, recognition is accelerated when a taxpayer satisfies its obligation regarding an advance payment or the obligation otherwise ends. The acceleration rules do not apply if the obligation is satisfied or the taxpayer ceases to exist in connection with certain transactions under Section 351 or a transaction subject to Section 381.

Short tax years

The proposed regulations adopt the following rules for short tax years from Rev. Proc. 2004-34:

1) For a year of receipt that is a short tax year, a taxpayer includes the advance payment in gross income under the general rules;
2) For a tax year following the year of receipt that is a short tax year of more than 92 days (or is a short year resulting from the taxpayer ceasing to exist), the taxpayer includes any remaining amount in gross income;
3) or a tax year following the year of receipt that is a short tax year of 92 days or less (other than a short tax year resulting from the taxpayer ceasing to exist), the taxpayer includes in gross income only the amount of the advance payment recognized in revenue in an AFS or, for taxpayers without an AFS, the amount earned for that tax year; and
4) The taxpayer includes any remaining amount in gross income in the second tax year after receipt to the extent not fully recognized in years one and two.

Financial statement adjustments

Under the proposed regulations, a taxpayer that treats an item as deferred revenue in its financial statement, and then in a later tax year adjusts or writes down the revenue, must include the adjusted or written-down amount in revenue in the tax year of the adjustment or write-down.

Example. In February 2019, taxpayer B, a calendar year taxpayer that uses the advance payment deferral method, receives a $100 advance payment and treats $25 as revenue and $75 as deferred revenue in its AFS. Another corporation acquires B's stock on August 31, 2019, ending B's short tax year. On September 1, 2019, the $75 deferred revenue liability is written down to $35. For federal income tax purposes, B must recognize $25 in the short tax year ending August 31, 2019, and $75 ($35 remaining deferred revenue plus $40 write-down) in the short tax year beginning September 1, 2019.

Financial statement conformity

The proposed regulations require taxpayers with an AFS to use the same AFS in applying both the Section 451(b) and 451(c) rules.

Transaction price allocation

For a taxpayer with an AFS, the proposed regulations define ‘transaction price’ and ‘performance obligation’ by cross-reference to, and apply the transaction price allocation rules in, the Section 451(b) proposed regulations. See Proposed regulations interpret the all-events test under Section 451(b) for further discussion of these rules.

Under the proposed regulations, a taxpayer without an AFS that receives a payment that applies to more than one item within the scope of the deferral method must allocate the payment to the items based on objective criteria. A taxpayer’s allocation method is based on objective criteria if the allocation is based on payments the taxpayer regularly receives for an item or items it regularly sells or provides separately, or under a method the IRS provides in future guidance.

Observation: Rev. Proc. 2004-34 applies this rule to taxpayers both with and without an AFS. The proposed regulations apply this rule only to the non-AFS deferral method. Section 451(c) requires a taxpayer with an AFS to allocate transaction price to performance obligations consistent with the AFS allocation. The preamble indicates that the proposed regulations retain this rule for the non-AFS deferral method as an adaptation of the transaction price allocation requirement for taxpayers without an AFS.

Accelerated cost offsets

Former Reg. sec. 1.451-5 required taxpayers to offset certain advance payments for inventoriable goods required to be included in gross income by related costs before the costs were incurred under Section 461 or taken into account under Sections 471 and 263A. The preamble to the proposed regulations notes that the conference report to the Act states that Section 451(c) is intended to override Reg. sec. 1.451-5. Therefore, the proposed regulations do not allow taxpayers to offset these costs against advance payments required to be included in income.

Observation: Numerous commenters proposed cost-offset mechanisms similar to former Reg. sec. 1.451-5 for taxpayers with inventoriable goods to (1) permit a taxpayer to elect to use its AFS percentage of completion method (book PCM) for federal income tax purposes, (2) permit a taxpayer that uses book PCM to elect to apply Section 460 even if the taxpayer is not otherwise subject to Section 460, (3) expand the recurring item exception of Section 461(h)(3) to apply to cost of goods sold, and (4) provide a cost offset for taxpayers that can demonstrate a net operating loss will remain unused for five years after receiving the advance payment. Although the government rejected all of these proposals, the preamble to the proposed regulations states that the IRS and Treasury continue to consider whether any exceptions are appropriate, and requests comments on issues involving the potential use of book PCM or elective or mandatory Section 460.

Method of accounting

Section 451(c) provides that the advance payment deferral method is a method of accounting for taxpayers with or without an AFS. A change to this method requires IRS consent. In this context, the preamble to the proposed regulations provides that taxpayers may continue to rely on Rev. Proc. 2004-34 until further guidance applies.

Observation: This statement in the preamble suggests that taxpayers that account for advance payments under Rev. Proc. 2004-34 are not required to change their methods of accounting until final regulations are effective.

Sections 451(b) and 451(c) accounting method changes

Use of automatic procedures

Rev. Proc. 2019-37 allows a taxpayer with an AFS to use the automatic procedures to change its methods of accounting to:

1) The modified all-events test under Section 451(b),
2) Allocate transaction price in accordance with Section 451(b) (when the taxpayer is not adopting ASC 606 in the same tax year), and
3) Comply with the Section 451(b) and/or Section 451(c) proposed regulations.

Taxpayers without an AFS may use the automatic procedures to change to a method that complies with the Section 451(c) proposed regulations. These procedures apply for tax years beginning after December 31, 2017 (tax years beginning after December 31, 2018, for specified credit card fees).

Rev. Proc. 2019-37 does not apply to a change:

1) For federal income tax purposes to a method that adopts ASC 606 (see IRS authorizes making certain automatic method changes consistent with financial accounting standard ASC 606), which is an automatic method change under Rev. Proc. 2018-29,

2) To a special method of accounting, which may be eligible under Rev. Proc. 2018-31 for method changes using the automatic procedures,

3) To a method that determines when income is earned using a statistical basis, a straight-line ratable basis, or another basis the IRS approves, by a taxpayer without an AFS, and

4) To a method for specified fees, other than specified credit card fees.

Note: A taxpayer also may use automatic procedures to change its method of accounting to full inclusion of payments under the all-events test or, until final regulations are issued, to the deferral method under Rev. Proc. 2004-34.

Streamlined procedures

Rev. Proc. 2019-37 allows taxpayers that either are small business taxpayers (generally taxpayers with three-year average annual gross receipts of $25 million or less) or have a zero Section 481(a) adjustment (eligible taxpayer) to use streamlined procedures for certain method changes.

An eligible taxpayer with an AFS may use the streamlined procedures for the taxpayer’s first tax year beginning after December 31, 2017, to change to the modified all-events test or, if not adopting ASC 606 in the same tax year, to allocate transaction price under Section 451(b). For the first or second tax years beginning after December 31, 2017, the streamlined procedures apply to a change by an eligible taxpayer (1) with an AFS, to comply with the Section 451(b) or Section 451(c) proposed regulations, and (2) without an AFS, to comply with the Section 451(c) proposed regulations.

A taxpayer using the streamlined procedures is not required to file a Form 3115 and does not receive audit protection in earlier tax years for its method for that item.

Adjustments

In general, taxpayers making method changes under Rev. Proc. 2019-37 must make the change with a Section 481(a) adjustment in the year of change for negative adjustments or spread over four tax years for positive adjustments. However, under Rev. Proc. 2019-37, for a taxpayer’s first tax year beginning after December 31, 2018, an adjustment for a change to a method required by Section 451(b) for specified credit card fees is spread over six tax years.

The revenue procedure permits a taxpayer with an AFS to use either a Section 481(a) adjustment or a cut-off for changes (1) to the modified all-events test under Section 451(b) or to comply with the Section 451(b) proposed regulations, if also concurrently changing its method for federal income tax purposes to a method that adopts ASC 606 in the same tax year, or (2) to comply with the Section 451(c) regulations. However, a taxpayer may not use a cut-off under the streamlined procedures for a change with a zero Section 481(a) adjustment.

A member of a consolidated group must make these changes for intercompany transactions only on a cut-off basis.

Waiver of five-year eligibility rule

Generally, a taxpayer may use the automatic procedures to change a method of accounting for an item only once every five tax years. This rule is waived for a taxpayer making changes under the revenue procedure for the taxpayer’s first, second, or third tax year beginning after December 31, 2017 (December 31, 2018, for changes relating to specified credit card fees).

Rev. Proc. 2019-37 waives the five-year rule for the first tax year beginning after December 31, 2017, for a taxpayer with an AFS using the streamlined procedures to change to the modified all-events test or, if not also adopting ASC 606 in that tax year, to allocate transaction price under Section 451(b). The five-year rule is waived for the first or second tax years beginning after December 31, 2017, for a taxpayer (1) with an AFS, using the streamlined procedures to change its method to comply with the Section 451(b) or Section 451(c) proposed regulations, and (2) without an AFS, using the streamlined procedures to comply with the Section 451(c) proposed regulations.

Audit protection

Taxpayers making method changes under the automatic procedures generally receive audit protection for past tax years unless the taxpayer is under examination and does not meet one of several exceptions. Rev. Proc. 2019-37 generally waives the limitations on audit protection for a taxpayer under examination for changes to comply with the Section 451(b) or Section 451(c) proposed regulations for the taxpayer's first, second, or third tax year beginning after December 31, 2017. Thus, a taxpayer generally receives audit protection for these method changes although under examination, unless the present method of accounting is an issue under consideration. The limitations apply in determining the spread period for a positive Section 481(a) adjustment.

A taxpayer under examination and changing a method to comply with the Section 451(b) proposed regulations for specified credit card fees generally receives audit protection for the taxpayer's first, second, or third tax year beginning after December 31, 2018. The limitations on audit protection apply in determining the Section 481(a) spread period for a positive adjustment for changes made in the taxpayer's second or third tax year beginning after December 31, 2018.

Taxpayers using the streamlined procedures do not receive audit protection.

The takeaway

The proposed regulations provide needed clarification of the Section 451(c) rules, which apply for tax years beginning in 2018. Adopting many of the rules from Rev. Proc. 2004-34 and allowing taxpayers to continue using that method of accounting until final regulations are effective avoid the need to make multiple accounting method changes and reduce administrative burden. However, until the proposed regulations are finalized and effective, taxpayers should carefully evaluate whether they want to follow Rev. Proc. 2004-34 or the proposed regulations.

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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