KPMG report: Proposed regulations on changes to income recognition rules; initial impressions

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Introduction

The U.S. Treasury Department and the IRS on September 5, 2019, issued proposed regulations addressing amendments made to section 451 by the 2017 tax reform legislation commonly referred to as the "Tax Cuts and Jobs Act" (TCJA).

The guidance takes the form of two sets of proposed regulations.

- The first (REG-104870-18) provides guidance regarding section 451(b), amending the "all events test" to require certain taxpayers to recognize income no later than the tax year in which the amount is included in revenue for financial accounting purposes. Read the **Proposed regulations (REG-104870-18)** [PDF 446 KB] (20 pages as published in the Federal Register)

- The second (REG-104554-18) provides guidance regarding section 451(c), codifying the deferral method of accounting for certain advance payments. Section 451(c), as amended, largely codifies Rev. Proc. 2004-34, with which many taxpayers are already familiar, but makes certain changes to those rules as well. **Proposed regulations (REG-104554-18)** [PDF 446 KB] (17 pages as published in the Federal Register)

The guidance is proposed to be effective for tax years beginning on or after the date the final regulations are published in the Federal Register, except in the case of specified fees, for which there is a one-year deferral. Each proposed regulation may be "early adopted" on an "all or nothing" basis.

The following discussion provides a high-level summary of each of the proposed regulations. A more comprehensive analysis will be provided in a future KPMG report.

Section 451(b): AFS income inclusion rule

The TCJA amended section 451(b) to impose a one-directional book-tax conformity requirement upon the recognition of gross income for federal tax purposes. Importantly, this requirement potentially **accelerates** the recognition of income for tax purposes when the taxpayer's financial statements report revenue sooner than the all-events test would otherwise require, but cannot be used to **defer** income recognition to a year later than that in which the income would have been recognized without regard to section 451(b).

Summary of Prop. Reg. §1.451-3

- The proposed regulations establish the "AFS income inclusion rule," potentially accelerating (but not deferring) the time when the all events test is satisfied based on the manner in which revenue is included in a taxpayer's applicable financial statement (AFS).

- Under the AFS income inclusion rule, the all events test with respect to an item of gross income is met upon the earlier of (i) when the item is taken into account as revenue on the taxpayer's AFS, or (ii) when the item would have been recognized as income under the traditional all events test.

- The AFS income inclusion rule applies only to taxpayers having an AFS for the entire tax year, determined on a year-by-year basis.

- The AFS income inclusion rule specifically applies to all categories of unbilled revenue, whether for goods or services.

- The proposed regulations define "revenue" to include any item that would be gross income under section 61, regardless of how it is characterized or reflected on the AFS.

- The AFS income inclusion rule does not apply to an item of income for which the taxpayer uses a "special method of accounting," such as the installment method, a long-term contract method, section 467 for certain leasing agreements, or specific methods of accounting for market discount and original issue discount (OID), other than certain specified fees.

- In calculating a contract's "transaction price" (the total amount to be included in revenue using some pattern of timing recognition), the taxpayer must disregard potential adjustments for items such as rebates, refunds, chargebacks, or trade allowances, and may not make cost offsets, such as adjustments for cost of goods sold.

- The AFS income inclusion rule does not affect the application of specific Code provisions either excluding an item from income or providing for non-recognition treatment (such as section 1031 or section 1033 and specific rules applicable to business formations, liquidations, and reorganizations).
- The proposed regulations do not change the manner in which a transaction is characterized for tax purposes (i.e., as a lease rather than as a financing or sale transaction, or vice versa), but instead determine only the recognition timing pattern for amounts otherwise treated as income for tax purposes.

- The proposed regulations do not explicitly distinguish between the realization and recognition of income, but instead propose a rule based upon whether an amount is subject to the occurrence or non-occurrence of future contingencies as of the end of the tax year.

- The AFS income inclusion rule applies to multi-year contracts on a "cumulative" rather than an "annualized" basis.

- The proposed regulations require allocating the contract's transaction price among individual "performance obligations" consistently with any such allocations made on the AFS. The AFS income inclusion rule applies separately to each such amount.

- The proposed regulations considerably narrow the scope of the statute as it applies to OID; the AFS income inclusion rule is limited to credit card late fees, cash advance fees, and interchange fees.

- Reflecting an earlier announcement, the AFS income inclusion rule does not apply to accrued market discount.

- The proposed regulations do not apply to income earned in connection with mortgage servicing contracts.

- No special rules are provided for CFCs or other foreign persons.

Explanation of Prop. Reg. §1.451-3

The TCJA amended section 451(b) to impose a one-directional book-tax conformity requirement to potentially accelerate (but not defer) the recognition of gross income for federal tax purposes. The requirement potentially accelerates the recognition of income that has been reported sooner in the taxpayer's financial statements than would otherwise occur under the pre-TCJA all events test. The proposed regulations implement the potential acceleration requirement by establishing the "AFS income inclusion rule."

The proposed regulations apply only to taxpayers having an AFS for the entire tax year. For this purpose, "AFS" is defined similarly to its use in Rev. Proc. 2004-34 to include such documents as Forms 10-K or other annual shareholder statements filed with the U.S. Securities and Exchange Commission (SEC); audited financial statements used for specific purposes; and financial statements other than tax returns filed with federal agencies other than the SEC or the IRS. AFS definitions are provided for both GAAP and IFRS taxpayers.

The proposed regulations do not provide special rules for foreign persons, but request comments regarding whether special rules are needed for CFCs and other foreign persons.

Under the AFS income inclusion rule, accrual method taxpayers having an AFS must treat the all events test as having been satisfied for an item of gross income no later than the year in which the item is taken into account as revenue on the taxpayer's AFS. For this purpose, "revenue" is defined broadly to include any amount that would be treated as gross income for purposes of section 61. The manner in which the item is reflected or characterized on the AFS is not determinative.

Importantly, the AFS income inclusion rule serves only to potentially **accelerate** the recognition of an item of gross income. The book treatment of the item may not be used to **defer** the recognition of an item of gross income beyond the tax year in which it would have been recognized under the traditional (pre-TCJA) all events test.

Central to applying the AFS income inclusion rule is determining a contract's "transaction price." Similar to the financial accounting definition, the proposed regulations define "transaction price" as the gross amount of consideration to which the taxpayer expects to be entitled for AFS purposes in exchange for transferring goods, services, or other property promised under the contract.

Consistent with current law, a contract's transaction price excludes amounts collected on behalf of third parties, including such items as certain sales taxes.

Disappointingly, in determining a contract's transaction price, the proposed regulations prohibit any cost offsets, including for costs of goods sold (COGS). Specifically, the proposed regulations provide that the gross income potentially subject to accelerated recognition may not be reduced for "amounts subject to section 461," including allowances, adjustments, rebates, chargebacks, refunds, rewards (for example, estimated redemption costs associated with loyalty programs), or for amounts included in COGS. The proposed regulations request comments on Treasury's authority to permit such cost offsets. As this may result in reporting even more income for tax purposes than has been reported in the financial statements, this rule does not seem to carry out the intent of Congress in enacting section 451(b).

Equally disappointing, the proposed regulations do not distinguish between the "realization" and "recognition" of gross income in applying the AFS income inclusion rule. The TCJA's legislative history states that the accelerated recognition requirement does not apply to items of income that have not yet been realized for tax purposes, and provide examples distinguishing between the realization and recognition concepts for that purpose. Observers had hoped the proposed regulations would provide definitions and standards for distinguishing between realization and recognition for this purpose.

Instead, the proposed regulations establish a rule under which a contract's transaction price (i.e., the amount potentially subject to recognition in the current tax year) does not include amounts that are "contingent on the occurrence or nonoccurrence of a future event" (such as bonuses contingent on performance and insurance contract commissions contingent on renewal) if the amount remains contingent as of the end of the tax year.

The proposed regulations create a rebuttable presumption under which any amount included in a contract's transaction price for AFS purposes is presumed to **not** be contingent under this rule. The presumption may be rebutted by satisfying the IRS that the income does in fact remain contingent under all of the facts and circumstances existing at the end of the tax year. The proposed regulations include examples demonstrating how the presumption may be overcome, such as through the terms of a written contract.

The proposed regulations also contain a "per se" rule, however, treating an amount as **not** being contingent if it is included in the contract's transaction price for AFS purposes, and the taxpayer has an equitable, contractual, or other enforceable right to partial payment for performance completed to date.
It is important to determine whether an item of income remains contingent as of the end of the tax year under these standards. Only those amounts included in the contract's transaction price are potentially subject to accelerated recognition for tax purposes. Establishing that an amount remains contingent as of the end of the tax year effectively serves the same analytical function as establishing that the amount has not yet been "realized" as of the end of that year. Accordingly, whether an amount is contingent on the "occurrence or nonoccurrence" of a future event is likely to attract considerable discussion.

The AFS income inclusion rule applies to contracts spanning more than one tax year using a "cumulative approach" rather than an annualized approach. Under a cumulative approach, the taxpayer must take into account the cumulative amounts included in income in prior tax years on the contract, if any, to determine the amount to be included for the tax years remaining on the contract. The proposed regulations provide examples demonstrating this concept.

The AFS income inclusion rule is inapplicable to any item of income for which the taxpayer uses a "special method of accounting." The proposed regulations provide a non-exclusive list of 12 examples of special methods of accounting, including the installment method, long-term contract methods, the treatment of certain rental agreements under section 467, or specific methods of accounting for market discount and OID, other than certain specified fees.

The AFS income inclusion rule also does not change the application of any exclusion provision of the Code (such as sections 101-140) or any non-recognition provision (such as sections 1031 and 1033, as well as specific provisions deferring the recognition of income upon various business formations, liquidations, or reorganizations).

The proposed regulations do not alter the treatment of OID in general and do not apply to market discount. Other than for OID and market discount, the statute contains an exception to the AFS income inclusion rule for income subject to a special method of accounting. Favorably, however, the proposed regulations narrowly apply the AFS income inclusion rule to OID. As proposed, the AFS income inclusion rule would apply only to credit card late fees, credit card cash advance fees, and interchange fees.

A change to begin using the AFS income inclusion rule is a change in accounting method requiring IRS consent. The proposed regulations also provide that changes in the method of reporting revenue on an AFS that change "or could change" the timing of the recognition of income for tax purposes is a change in accounting method requiring IRS consent. In certain circumstances, restating revenue on an AFS may be treated as an accounting method change as well.

The proposed regulations provide a "transition rule" for a "qualified change in accounting method" for the taxpayer's first tax year beginning after December 31, 2017. Given the publication date of the proposed regulations, it is questionable as to how many taxpayers will be able to use this transition rule.

Instead, most taxpayers will look to **Rev. Proc. 2019-37** [PDF 87 KB], issued concurrently with the proposed regulations. Rev. Proc. 2019-37 details the procedures applicable in making accounting method changes required by the proposed regulations. Those procedures will be discussed separately in a KPMG report.

The regulations are proposed to be effective for tax years beginning on or after the date the final regulations are published in the Federal Register. A delayed effective date applies to specified fees.

Taxpayers may "early adopt" the AFS income inclusion rule for tax years beginning after December 31, 2017, but must do so on an "all or nothing" basis.

Section 451(c): Advance payments

The TCJA amended section 451 to add subsection (c), which essentially codified the deferral method of accounting for advance payments for goods and services under Rev. Proc. 2004-34. This rule permitted a one-year deferral beyond the year of receipt of certain advance payments. However, the statutory language of section 451(c) did not align exactly with the language originally provided in Rev. Proc. 2004-34. Treasury and the IRS have issued Prop. Reg. section 1.451-8 concerning advance payments for goods, services, and other items, which generally incorporates the language and rules as described in Rev. Proc. 2004-34.

Summary of Prop. Reg. §1.451-8

The proposed regulation:

- Provides the general one-year deferral rule for taxpayers with an Applicable Financial Statement (AFS)
- Expands the definition of "advance payment" provided in section 451(c)(4)(A)(iii) to include payments for all items which were previously eligible under Rev. Proc. 2004-34, as modified by Rev. Proc. 2011-18 and Rev. Proc. 2013-29
- Excludes from "advance payment" amounts received at least two tax years prior to the contractual delivery date for a specified good
- Applies the advance payment acceleration rules previously provided in Rev. Proc. 2004-34
- Provides a requirement for write-downs or adjustments to deferred revenue in a taxpayer's AFS to be included in income
- Includes the short tax year rules of Rev. Proc. 2004-34
- Clarifies that, to the extent certain reward points are treated as separate performance obligations, they may be eligible for the deferral methods provided under the proposed regulations

- Provides a deferral method for taxpayers without an AFS similar to that provided under Rev. Proc. 2004-34

- Declines to provide an accelerated cost offset when advance payments are required to be included in income under section 451(c) prior to the completion of a sale of goods or provision of services

Explanation of proposed regulations

The proposed regulations—consistent with section 451(c)(1)(B)—provide that an accrual method taxpayer with an AFS who receives an advance payment may use a deferral method. Under the deferral method, the taxpayer must include the advance payment in income in the year of receipt to the extent that it is included in revenue in its AFS. Any remaining amount of the advance payment must be included in income in the next tax year.

Amounts treated as "advance payments" under section 451(c)(4)(A)(iii) include payments for goods, services, or other items identified by the Secretary. However, Section 4.01(3) of Rev. Proc. 2004-34 also included payments for the use of certain intellectual property, the occupancy or use of property if ancillary to the provision of services, certain payments related to computer software, certain guaranty or warranty contracts, subscriptions, memberships in an organization, or any combination of these items in the list of payments eligible to be treated as "advance payments." Rev. Proc. 2011-18 and Rev. Proc. 2013-29 modified this list to include advance payments received from eligible gift card sales. The proposed regulations expand the Code's list of advance payments eligible to use the deferral method to include payments for all of these items eligible under Rev. Proc. 2004-34, as modified by Rev. Proc. 2011-18 and Rev. Proc. 2013-29.

Newly excluded from the definition of "advance payments" under the proposed regulations are payments received at least two tax years prior to the contractual delivery date for a specified good. The preamble to the proposed regulations indicates that the Treasury Department and IRS believe an exclusion is appropriate for certain goods for which a taxpayer requires a customer to make an upfront payment and which require a considerable amount of time to produce. Goods meeting this exception include goods for which: (i) the contracted delivery month and year of the goods occurs at least two tax years after an upfront payment; (ii) the taxpayer does not have on hand goods of a substantially similar kind and quantity in the year payment is received to satisfy the contract; and (iii) all revenue from the sale of the goods is recognized in the taxpayer's AFS in the year of delivery.

Section 451(c)(3) prohibits the use of the deferral method with respect to advance payments received by a taxpayer during a tax year if such taxpayer ceases to exist during or with the close of such tax year. The proposed regulations include expanded acceleration rules identical to those previously provided in Rev. Proc. 2004-34, including the requirement that a taxpayer include in gross income in the tax year of receipt all payments with which the taxpayer's obligation with respect to the advance payment is satisfied. As such, taxpayers remain bound by the all events test and are only permitted to defer advance payments received to the extent the amount is not otherwise earned in the year of receipt.

Guidance did not previously exist regarding the treatment of financial statement adjustments to deferred revenue for amounts treated as advance payments. The proposed rules provide that if a taxpayer defers inclusion of all or a portion of advance payments under section 451(c)(1)(B) and Prop. Reg. §1.451-8(c), the remainder of the advance payment must be included in the taxpayer's gross income in the following tax year, regardless of any write-down or adjustment made to deferred revenue for financial statement purposes.

The proposed regulations incorporate the short tax year rules previously provided in Rev. Proc. 2004-34. Under these rules, if the taxpayer's next succeeding tax year consists of 92 days or less, the taxpayer must include the portion of the advance payment not included in income in the year of receipt in gross income in the short tax year to the extent it is included in revenue in the AFS in that short tax year. Any amount remaining after the year of receipt and the short year must be included in gross income in the year after the short tax year.

Included in the proposed regulations are 25 examples of the application of the deferral rules under section 451(c) and Prop. Reg. §1.451-8.

- Example 22 relates to a retail rewards program when the rewards points are treated as a separate performance obligation in the taxpayer's AFS. The example provides that if the taxpayer uses the deferral method, the portion of the sales price allocated to the rewards points may be deferred until the next succeeding tax year, to the extent it is not included in income in the taxpayer's AFS in the year of receipt.

- Example 24 indicates that similar treatment is appropriate for airline miles.

Rev. Proc. 2004-34 permitted a taxpayer without an AFS to adopt a deferral method that included advance payments in gross income for the year of receipt to the extent earned in that tax year and included the remaining amount of advance payments in gross receipts in the next succeeding tax year. However, section 451(c) does not specifically address the use of the deferral method by taxpayers without an AFS. Treasury and the IRS concluded that section 451(c) does not prohibit a deferral method that is otherwise permissible under Rev. Proc. 2004-34, and as such, the proposed regulations adopt the earned standard for taxpayers without an AFS. If the taxpayer is unable to determine the extent to which a payment is earned in the tax year of receipt, the amount may be determined on a statistical basis, on a straight line ratable basis over the term of the agreement, or any other basis resulting in a clear reflection of income. The rules for acceleration of advance payments, financial statement adjustments, and short tax years provided for taxpayers with an AFS also apply to taxpayers using the non-AFS deferral method.

Noticeably absent from the proposed regulations is a provision for cost offsets in situations when advance payments are required to be included in income under section 451(c) prior to the completion of a sale of goods or provision of services. The preamble to the proposed regulations indicate that Treasury and the IRS specifically decline to provide an accelerated cost offset in the proposed regulations but seem to be considering exceptions in the case of manufacturers of certain property and taxpayers with inventoriable goods.

The regulations are proposed to apply to tax years beginning on or after the date the final regulations are published in the Federal Register. However, taxpayers may rely on the proposed regulations for tax years beginning after December 31, 2017, but must do so on an "all or nothing" basis.

Concurrently with issuance of the proposed regulations, Treasury and the IRS released **Rev. Proc. 2019-37** [PDF 87 KB] detailing the procedures by which a taxpayer may change its method of accounting to use one of the deferral methods described in the proposed regulations. Rev. Proc. 2019-37 will be discussed separately in a forthcoming report from KPMG.

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