INTERNAL REVENUE
BULLETIN

IRS

HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2019–39
September 23, 2019

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

ADMINISTRATIVE

NOTICE 2019-47, page 731.

This notice provides penalty relief for organizations exempt from tax under section 501(a), other than those organizations described in section 501(c)(3), that did not report the names and addresses of their contributors on the Schedule B of their Forms 990 or 990-EZ filed for a taxable year ending on or after December 31, 2018, and on or prior to July 30, 2019.

INCOME TAX

REG-104554-18, page 737.

This document contains proposed regulations regarding the timing of income inclusion under section 451 of the Internal Revenue Code of advance payments for goods, services, and certain other items. The proposed regulations reflect changes made by the Tax Cuts and Jobs Act. These proposed regulations affect taxpayers that use an accrual method of accounting and receive advance payments.

REG-104870-18, page 754.

This document contains proposed regulations regarding the timing of income inclusion under section 451 of the Internal Revenue Code. The proposed regulations reflect changes made by the Tax Cuts and Jobs Act. These proposed regulations affect taxpayers that use an accrual method of accounting and have an applicable financial statement.

REV. PROC. 2019-37, page 731.

This revenue procedure modifies Rev. Proc. 2018-31, 2018-22 I.R.B. 637, to provide procedures under section 446 and the accompanying regulations to obtain automatic consent of the Commissioner of Internal Revenue to change methods of accounting to comply with sections 451 and the proposed regulations under sections 1.451-3 and 1.451-8.

Finding Lists begin on page ii.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

Part III – Administrative, Procedural, and Miscellaneous

PENALTY RELIEF RELATED TO RELIANCE ON REVENUE PROCEDURE 2018-38

Notice 2019-47

This Notice provides penalty relief related to taxpayer reliance on Revenue Procedure 2018-38, which was set aside by an order issued on July 30, 2019, by the United States District Court for the District of Montana in the case of *Bullock v. IRS*, 2019 WL 3423485 (D. Mont. Jul. 30, 2019).

Revenue Procedure 2018-38, 2018-31 IRB 280, provided information reporting relief to organizations exempt from tax under section 501(a), other than organizations described in section 501(c)(3), that are required to file an annual Form 990, Return of Organization Exempt From Income Tax, or Form 990-EZ, Short Form Return of Organization Exempt From Income Tax. Pursuant to Revenue Procedure 2018-38, those organizations that are exempt from tax under section 501(a), other than organizations described in section 501(c)(3), were granted relief from the general requirement to report the names and addresses of their contributors on the Schedule B of their Forms 990 or 990-EZ filed for taxable years ending on or after December 31, 2018. The information reporting relief did not apply to political organizations described in section 527. The instructions to Schedule B of Forms 990 and 990-EZ were modified to conform to Revenue Procedure 2018-38.

Section 6652(c)(1)(A)(i) imposes a penalty for a failure to file a return required under section 6033(a)(1) on the date and in the manner prescribed. Section 6652(c)(1)(A)(ii) imposes a penalty for a failure to include any of the information required to be shown on a return filed under section 6033(a)(1) or to show the correct information. The section 6652(c) penalty is not imposed if it is shown that the failure was due to reasonable cause. I.R.C. § 6652(c)(5). In general, an organization exempt from tax under section 501(a) must file its Form 990 or 990-EZ by the 15th day of the 5th month after the organization's accounting period ends. Treas. Reg. § 1.6033-1(e).

The court's July 30, 2019 order in *Bullock* has raised questions from taxpayers regarding the filing requirements for the 2018 tax year because the order was issued after the due date for most 2018 Forms 990 or 990-EZ. Any exempt organization filing before July 30, 2019, other than organizations described in section 501(c)(3), that did not report the names and addresses of its contributors on the Schedule B of its Forms 990 or 990-EZ, would have filed consistent with Revenue Procedure 2018-38 and according to the instructions to Schedule B of Forms 990 and 990-EZ.

In consideration of these facts, and the reliance interests of taxpayers, and consistent with how the IRS has previously exercised the authority under section 6652(c)(5) to provide relief from penalties for failures due to reasonable cause, the IRS will not impose a penalty under section 6652(c) for organizations exempt from tax under section 501(a), other than those organizations described in section 501(c)(3), that do not report the names and addresses of their contributors on the Schedule B of their Forms 990 or 990-EZ filed for a taxable year ending on or after December 31, 2018, and on or prior to July 30, 2019. Exempt organizations may still be liable for a penalty under section 6652(c) for a failure to report any information required under section 6033(a) that is unrelated to the donor information described in Revenue Procedure 2018-38.

The Office of the Associate Chief Counsel (Procedure & Administration) is the principal author of this notice. For further information regarding this Notice, call 202-317-3400 (not a toll-free number).

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.

(Also: Part I, Sections 446, 451; 1.451-1.)

Rev. Proc. 2019-37

SECTION 1. PURPOSE

This revenue procedure modifies Rev. Proc. 2018-31, 2018-22 I.R.B. 637, to provide procedures under § 446 of the Internal Revenue Code (Code) and § 1.446-1(e) of the Income Tax Regulations to obtain automatic consent of the Commissioner of Internal Revenue (Commissioner) to change methods of accounting to comply with § 451 and the proposed regulations under §§ 1.451-3 and 1.451-8.

SECTION 2. BACKGROUND

.01 Section 13221 of the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054, 2113 (Dec. 22, 2017) (TCJA) made several changes to the timing of income for accrual method taxpayers by redesignating § 451(b) through (i) as § 451(d) through (k), and adding new § 451(b) and (c). New § 451(b) and (c) are generally effective for taxable years beginning after December 31, 2017. Section 451(b), as amended by the TCJA, generally provides that for an accrual method taxpayer the all events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in an applicable financial statement (AFS) of the taxpayer, or such other financial statement as the Secretary may specify. Section 451(c), as amended by the TCJA, provides an elective deferral method of accounting for an accrual method taxpayer that receives an advance payment during the taxable year.

.02 Concurrently with the release of this revenue procedure, the Department of Treasury and the Internal Revenue Service are issuing proposed regulations under § 1.451-3 (REG-104870-18) and § 1.451-8 (REG-104554-18). The proposed regulations under § 1.451-3 provide rules relating to the taxable year of inclusion in gross income under § 451(b) for taxpayers with an AFS. The proposed regulations under § 1.451-8 provide rules relating to the use of the deferral method for advance payments within the meaning of § 451(c) for taxpayers with or without an AFS. These proposed regulations generally apply to taxable years beginning on or after the date the final regulations are published in the Federal Register. However, until the date the Treasury decision adopting proposed § 1.451-3 is published in the Federal Register, a taxpayer may rely on proposed § 1.451-3 for taxable years beginning after December 31, 2017 (or in the case of the specified credit card fees defined in proposed § 1.451-3(i)(2), for taxable years beginning after December 31, 2018). However, a taxpayer relying on proposed § 1.451-3 is neither required to, nor permitted to, apply proposed § 1.451-3 to specified fees (as defined in proposed § 1.451-3(i)(2)) other than specified credit card fees. See proposed § 1.451-3(n). In addition, until the date the Treasury decision adopting proposed § 1.451-8 is published in the Federal Register, a taxpayer may rely on proposed § 1.451-8 for taxable years beginning after December 31, 2017. See proposed § 1.451-8(f).

.03 Except as otherwise provided by the Code or the regulations, § 446(e) and § 1.446-1(e)(2) require a taxpayer to secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures that provide the terms and conditions necessary for a taxpayer to obtain consent to a change in method of accounting. Rev. Proc. 2015-13, 2015-5 I.R.B. 419, as clarified and modified by Rev. Proc. 2015-33, 2015-24 I.R.B. 1067, as modified by Rev. Proc. 2016-1, 2016-1 I.R.B. 1, and as modified by Rev. Proc. 2017-59, 2017-48 I.R.B. 543, provides the general procedures by which a taxpayer may obtain automatic consent of the Commissioner to a change in method of accounting described in the List of Automatic Changes. Rev. Proc. 2018-31 contains the current List of Automatic Changes.

.04 Rev. Proc. 2018-60, 2018-51 I.R.B. 1045, added section 16.12 to Rev. Proc. 2018-31 for taxpayers that want to change their method of accounting for the timing of the recognition of income for federal income tax purposes to comply with § 451(b) as amended by the TCJA. In general, Rev. Proc. 2018-60 provides procedures for taxable years beginning after December 31, 2017. Rev. Proc. 2018-60 permits certain taxpayers to make changes in method of accounting to comply with § 451(b) using streamlined method change procedures if the change results in a zero § 481(a) adjustment or if the taxpayer requesting the change is a small business taxpayer, as defined in the guidance.

.05 Section 3 of this revenue procedure modifies Rev. Proc. 2018-31 to provide additional automatic changes in method of accounting for a taxpayer to change its method of accounting under § 451 to apply the proposed regulations under § 1.451-3 and/or § 1.451-8. Section 3 of this revenue procedure also modifies Rev. Proc. 2018-31 to provide an additional automatic change for a taxpayer that changes the manner in which it recognizes amounts in revenue in an AFS and that wants to change its method of accounting for federal income tax purposes.

SECTION 3. MODIFICATIONS TO REV. PROC. 2018-31

.01 *Modifications to section 16.12 of Rev. Proc. 2018-31.*

(1) The heading to section 16.12 of Rev. Proc. 2018-31 is modified to read as follows:

.12 *Changes in the timing of income recognition under § 451(b) or proposed § 1.451-3, and changes relating to advance payments under proposed § 1.451-8.*

(2) Section 16.12(1) of Rev. Proc. 2018-31 is modified to read as follows:

(1) *Description of change*. This change applies to an accrual method taxpayer with an applicable financial statement (AFS) that wants to make certain changes in method of accounting described in section 16.12(2)(a) of this revenue procedure for taxable years beginning after December 31, 2017, or, in the case of a specified credit card fee (as defined in proposed § 1.451-3(i)(2)), for taxable years beginning after December 31, 2018. This change also applies to a taxpayer without an AFS that wants to make certain changes in method of accounting described in section 16.12(2)(b) of this revenue procedure for a taxable year beginning after December 31, 2017. For purposes of this section 16.12, the term AFS is defined under § 451(b)(3), or for a taxpayer making a change to apply proposed § 1.451-3 or proposed § 1.451-8, the term AFS is defined in proposed § 1.451-3(c)(1).

(3) Section 16.12(2) of Rev. Proc. 2018-31 is modified to read as follows:

(2) *Applicability*.

(a) *Taxpayer with an AFS*. This change applies to a taxpayer with an AFS that:

(i) wants to change to a method of accounting that treats an item of gross income, or portion thereof, as meeting the all events test no later than when such item, or portion thereof, is taken into account as revenue in its AFS under § 451(b)(1)(A);

(ii) is not adopting the New Standards (as defined in section 16.11(1) of this revenue procedure) for the year of change, and wants to allocate the transaction price to performance obligations under § 451(b)(4);

(iii) wants to change to a method of accounting that complies with the proposed regulations under § 1.451-3 (including a change for a specified credit card fee under proposed §§ 1.451-3(i) and 1.1275-2(l)); or

(iv) wants to change to a method of accounting that complies with the proposed regulations under § 1.451-8(c).

(b) *Taxpayer without an AFS*. This change applies to a taxpayer that does not have an AFS and that wants to change to a method of accounting that complies with the proposed regulations under § 1.451-8(d).

(4) Section 16.12(3) of Rev. Proc. 2018-31 is modified to read as follows:

(3) *Inapplicability*. This change does not apply to:

(a) a taxpayer that wants to make a change for federal income tax purposes to a method that adopts the New Standards, as provided in section 16.11 of this revenue procedure (for example, a change to comply with § 451(b)(4), proposed § 1.451-3(g), or proposed § 1.451-8(c)(6));

(b) a taxpayer that wants to make a change in method of accounting to a method described in § 451(b)(2);

(c) a taxpayer without an AFS that wants to change to defer income based on earned income under proposed § 1.451-8(d)(4)(ii) determined using the following: (i) a statistical basis if adequate data are available to the taxpayer; (ii) a straight line ratable basis over the term of the agreement; or (iii) the use of any other basis that in the opinion of the Commissioner results in a clear reflection of income; or

(d) a taxpayer that wants to make a change in method of accounting for specified fees (as defined in proposed § 1.451-

3(i)(2)) other than specified credit card fees.

(5) Section 16.12(4) of Rev. Proc. 2018-31 is modified as follows:

(a) Section 16.12(4)(b) of Rev. Proc. 2018-31 is modified to read as follows:

(b) *Special rules relating to § 481(a) adjustment or cut-off basis*.

(i) *Section 481(a) adjustment period for changes relating to specified credit card fees*. In the case of income from a specified credit card fee, the § 481(a) adjustment period for any qualified change in method of accounting described in this section 16.12(4)(b)(i) is six taxable years (year of change and next five taxable years). For purposes of the preceding sentence, a qualified change in method of accounting is a change in method of accounting for income from a specified credit card fee to a method that is required by § 451(b), as added by section 13221 of the Tax Cuts and Jobs Act (TCJA), Public Law 115-97, 131 Stat. 2054 (Dec. 22, 2017), for such income, but only for the taxpayer's first taxable year beginning after December 31, 2018. Section 16.12(4)(b)(ii) of this revenue procedure may not be used for a change relating to specified credit card fees.

(ii) *Cut-off basis or § 481(a) adjustment*.

(A) *Cut-off basis or § 481(a) adjustment for changes made under section 16.12(2)(a)(i) or (iii) of this revenue procedure*. Except as otherwise provided in this section 16.12(4)(b)(ii), a taxpayer making a change described in section 16.12(2)(a)(i) or (iii) of this revenue procedure may implement the change with either a § 481(a) adjustment as provided in sections 7.02 and 7.03 of Rev. Proc. 2015-13 or on a cut-off basis provided the taxpayer is also making a concurrent method change under section 16.11 of this revenue procedure. See section 16.12(8)(b) of this revenue procedure for information on making this concurrent change. A taxpayer described in section 16.12(4)(c)(i)(B) of this revenue procedure that uses the streamlined procedures provided in section 16.12(4)(c) of this revenue procedure may not make a change in method of accounting on a cut-off basis. If the taxpayer makes a concurrent change under section 16.11 of this revenue procedure and implements the change under this section 16.12(4)(b)(ii) of this revenue procedure on a cut-off basis, (*1*) the change applies to contracts entered into on or after the beginning of the year of change, (*2*) all changes made under section 16.12(2)(a)(i) or (iii) of this revenue procedure must be implemented using a cut-off basis, and (*3*) a § 481(a) adjustment is neither permitted nor required. Notwithstanding anything to the contrary in this section 16.12(4)(b)(ii)(A), if a taxpayer is a member of a consolidated group (within the meaning of § 1.1502–1(h)), then the member must implement all changes under this section 16.12 with respect to its intercompany transactions (within the meaning of § 1.1502–13(b)(1)(i)) under this section 16.12(4)(b)(ii) on a cut-off basis.

(B) *Cut-off basis or § 481(a) adjustment for changes to use proposed § 1.451-8(c)*. Except as otherwise provided in this section 16.12(4)(b)(ii), a taxpayer making a change described in section 16.12(2)(a)(iv) of this revenue procedure may implement the change with either a § 481(a) adjustment as provided in sections 7.02 and 7.03 of Rev. Proc. 2015-13 or on a cut-off basis. A taxpayer described in section 16.12(4)(c)(i)(B) of this revenue procedure that uses the streamlined procedures provided in section 16.12(4)(c) of this revenue procedure may not make a change in method of accounting on a cut-off basis. If the taxpayer implements the change on a cut-off basis, (*1*) the change applies to contracts entered into on or after the beginning of the year of change, (*2*) all changes made under this section 16.12 to adopt proposed § 1.451-8(c) must be implemented using a cut-off basis, and (*3*) a § 481(a) adjustment is neither permitted nor required. Notwithstanding anything to the contrary in this section 16.12(4)(b)(ii)(B), if a taxpayer is a member of a consolidated group (within the meaning of § 1.1502–1(h)), then the member must implement all changes to adopt proposed § 1.451-8(c) with respect to its intercompany transactions (within the meaning of § 1.1502–13(b)(1)(i)) under this section 16.12(4)(b)(ii)(B) on a cut-off basis.

(b) Section 16.12(4)(c)(i) of Rev. Proc. 2018-31 is modified to read as follows:

(i) *Applicability*. The procedures described in this section 16.12(4)(c) may be used by a taxpayer to make a change in method of accounting described in section 16.12(2)(a)(i) or (ii) of this revenue procedure in the taxpayer's first taxable year beginning after December 31, 2017. The procedures described in this section 16.12(4)(c) may also be used by a taxpayer to make a change in method of accounting described in section 16.12(2)(a)(iii), 16.12(2)(a)(iv), or 16.12(2)(b) of this revenue procedure in the taxpayer's first or second taxable year beginning after December 31, 2017. A taxpayer is permitted to use the streamlined method change procedures if the taxpayer meets one of the following requirements:

(A) the taxpayer, other than a tax shelter (as defined in § 448(d)(3)), meets the § 448(c) gross receipts test (a "small business taxpayer"). The taxpayer meets the § 448(c) gross receipts test if the taxpayer has average annual gross receipts for the three prior taxable years of $25,000,000 or less (adjusted for inflation); or

(B) the taxpayer is making one or more changes under section 16.12(2)(a) of this revenue procedure, and the § 481(a) adjustment required by each of the changes is zero. A taxpayer making more than one change in method of accounting under section 16.12(2)(a) of this revenue procedure is not permitted to net the § 481(a) adjustments to determine if the taxpayer meets the requirements to use the streamlined method change procedures. See section 16.12(8)(a) of this revenue procedure for more information on making a permitted concurrent change.

(6) Section 16.12(5) is modified as follows:

(a) Section 16.12(5)(b) of Rev. Proc. 2018-31 is modified to read as follows:

(b) *Changes related to specified credit card fees*. For a change related to income from a specified credit card fee, the eligibility rule in section 5.01(1)(f) of Rev. Proc. 2015-13 does not apply to this change for a taxpayer's first, second, or third taxable year beginning after December 31, 2018.

(b) Section 16.12(5)(c) of Rev. Proc. 2018-31 is modified to read as follows:

(c) *Changes made under the streamlined method change procedures*. For a change made using the streamlined procedures of section 16.12(4)(c) of this revenue procedure for a change in method of accounting described in section 16.12(2)(a)(i) or (ii) of this revenue procedure, the eligibility rule in section 5.01(f) of Rev. Proc. 2015-13 does not apply to this change for a taxpayer's first taxable year beginning after December 31, 2017. For a change made using the streamlined procedures of section 16.12(4)(c) of this revenue procedure for a change in method of accounting described in section 16.12(2)(a)(iii), 16.12(2)(a)(iv), or 16.12(2)(b) of this revenue procedure, the eligibility rule in section 5.01(f) of Rev. Proc. 2015-13 does not apply to this change for the taxpayer's first or second taxable year beginning after December 31, 2017.

(7) Section 16.12(6) of Rev. Proc. 2018-31 is modified to read as follows:

(6) *Audit protection*.

(a) *Streamlined procedures*. A taxpayer making a change in method of accounting under this section 16.12 using the streamlined method change procedures provided in section 16.12(4)(c) of this revenue procedure does not receive audit protection under section 8.01 of Rev. Proc. 2015-13.

(b) *Taxpayers under examination*.

(i) *In general – certain audit protection exception temporarily inapplicable*. Except as otherwise provided in this section 16.12(6)(b), for a taxpayer's first, second, or third taxable year beginning after December 31, 2017, the audit protection rule in section 8.02(1) of Rev. Proc. 2015-13 does not apply to a change in method of accounting made under section 16.12(2)(a)(iii) or (iv) of this revenue procedure. However, section 8.02(1) of Rev. Proc. 2015-13 continues to apply for purposes of determining the § 481(a) adjustment period for a positive § 481(a) adjustment provided in section 7.03(3)(b) of Rev. Proc. 2015-13. This paragraph applies to a taxpayer under examination that does not use the streamlined procedures described in section 16.12(4)(c) of this revenue procedure.

(ii) *Changes related to specified credit card fees*. For a change related to income from a specified credit card fee, for a taxpayer's first, second, or third taxable year beginning after December 31, 2018, the audit protection rule in section 8.02(1) of Rev. Proc. 2015-13 does not apply to a taxpayer that makes a change in method of accounting described in section 16.12(2)(a)(iii) of this revenue procedure. However, for a taxpayer's second or third taxable year beginning after December 31, 2018, section 8.02(1) of Rev. Proc. 2015-13 continues to apply for purposes of determining the § 481(a) adjustment period for a positive § 481(a) adjustment provided in section 7.03(3)(b) of Rev. Proc. 2015-13.

(8) Section 16.12(7) of Rev. Proc. 2018-31 is modified to read as follows:

(7) *No ruling on method used*. The consent granted under section 9 of Rev. Proc. 2015-13 for a change made under section 16.12 of this revenue procedure for a change in method of accounting described in section 16.12(2)(a)(i) or (ii) of this revenue procedure is not a determination by the Commissioner that the new method of accounting is a permissible method of accounting under § 451 and does not create a presumption that the allocation method used under § 451(b)(4) is a permissible method of accounting. The Director may ascertain whether the new method of accounting is a permissible method of accounting under § 451 and whether the allocation method is permissible under § 451(b)(4).

(9) Section 16.12(8) of Rev. Proc. 2018-31 is modified to read as follows:

(8) *Concurrent automatic changes*.

(a) *In general*. A taxpayer that wants to make one or more concurrent changes in method of accounting under this section 16.12 may file a single Form 3115 that includes all of the changes, must separately state the § 481(a) adjustment for each change, if applicable, and may not net the § 481(a) adjustment for a change with the § 481(a) adjustment from another change. However, a taxpayer that makes a concurrent change in method of accounting to allocate transaction price to performance obligations under section 16.12(2)(a)(ii), (iii), or (iv) of this revenue procedure is required to make the allocation change before a change to a method under section 451(b)(1)(A), the AFS income inclusion rule in proposed § 1.451-3, or the deferral method described in proposed § 1.451-8(c), as applicable. For example, a taxpayer that makes a change under both section 16.12(2)(a)(i) and (2)(a)(ii) of this revenue procedure is required to implement the change under section 16.12(2)(a)(ii) of this revenue procedure before making the change under section 16.12(2)(a)(i) of this revenue procedure.

(b) *Concurrent change in the timing of recognition of income due to the New Standards*. Except as provided in section 16.12(4)(c)(i) of this revenue procedure, a taxpayer that wants to make a change under section 16.12(2)(a)(i), (iii), or (iv) of this revenue procedure and a change under section 16.11 of this revenue procedure for the same year of change may file a single Form 3115 for both changes and enter the designated automatic accounting method change number for both changes on the appropriate line of Form 3115. A taxpayer that makes both changes is required to make the change under section 16.11 of this revenue procedure before making the change under this section 16.12(2)(a)(i), (iii), or (iv), as applicable.

(10) Section 16.12(9) of Rev. Proc. 2018-31 is modified to read as follows:

(9) *Designated automatic accounting method change number*. The designated automatic method change number for a change under section 16.12(2)(a)(i) or (ii) of this revenue procedure is "239." The designated automatic method change number for a change under section 16.12(2)(a)(iii), (iv), or 16.12(2)(b) of this revenue procedure (that is, a change to comply with the proposed regulations under § 1.451-3 or § 1.451-8) is "242."

.02 *Modification to section 16.11 of Rev. Proc. 2018-31*. Section 16.11 of Rev. Proc. 2018-31 is modified to renumber existing paragraphs (6)-(10) as (7)-(11) and adding new paragraph (6) to read as follows:

(6) *Under examination – certain audit protection exceptions temporarily inapplicable*. For a taxpayer's first, second, or third taxable year beginning after December 31, 2017, section 8.02(1) of Rev. Proc. 2015-13 does not apply to a change in method of accounting made under section 16.11(2) of this revenue procedure if the method of accounting to be used complies with the proposed regulations under § 1.451-3 and/or § 1.451-8. However, section 8.02(1) of Rev. Proc. 2015-13 continues to apply for purposes of determining the § 481(a) adjustment period for a positive § 481(a) adjustment provided in section 7.03(3)(b) of Rev. Proc. 2015-13.

.03 *Modifications to section 16.10 of Rev. Proc. 2018-31*.

(1) The heading of section 16.10 of Rev. Proc. 2018-31 is modified as follows:

.10 *Change in applicable financial statements (AFS) for purposes of applying* *certain revenue recognition methods of accounting*.

(2) Section 16.10(1)(a) of Rev. Proc. 2018-31 is modified to add new divisions (ii)-(iv) to read as follows:

(ii) This change applies to a taxpayer that: (A) receives advance payments, as defined in proposed § 1.451-8(b)(1); (B) uses the deferral method described in proposed § 1.451-8(c); (C) changes the manner in which it recognizes advance payments in revenues in its AFS; and (D) wants to change its method of accounting to use its proposed method of recognizing advance payments in revenues in its AFS for determining the extent to which advance payments are included in income under proposed § 1.451-8(c).

(iii) This change applies to a taxpayer that: (A) includes amounts in income in accordance with § 451(b); (B) changes the manner in which the item, or portion thereof, is taken into account in revenue in its AFS; and (C) wants to change its method of accounting to use the proposed method of taking into account the item, or portion thereof, in revenue in its AFS for purposes of § 451(b), including, if applicable, allocation of the transaction price to performance obligations under § 451(b)(4).

(iv) This change applies to a taxpayer that: (A) includes amounts in income in accordance with proposed § 1.451-3; (B) changes the manner in which the item, or portion thereof, is taken into account as revenue in its AFS; and (C) wants to change its method of accounting to use the proposed method of taking into account the item, or portion thereof, in revenue in its AFS for purposes of proposed § 1.451-3, including for purposes of allocating transaction price to performance obligations under proposed § 1.451-3(g).

(3) Section 16.10(1)(b) of Rev. Proc. 2018-31 is modified to renumber existing divisions (i) and (ii) as subparagraphs (i)(A) and (i)(B), respectively, to add a heading to (i), and to add division (ii) to read as follows:

(i) *Changes relating to Rev. Proc. 2004-34*.

(A) a taxpayer that uses a present method of accounting for advance payments that is not the deferral method described in section 5.02(3)(a) of Rev. Proc. 2004-34. For example, this change does not apply to a taxpayer that uses the full inclusion method under section 5.01 of Rev. Proc. 2004-34;

(B) a taxpayer that wants to change its method for allocating payments under section 5.02(4) of Rev. Proc. 2004-34.

(ii) *Changes relating to § 451(b), proposed § 1.451-3, or proposed § 1.451-8*.

(A) a taxpayer whose present method of accounting does not use its AFS for purposes of § 451(b), proposed § 1.451-3, or proposed § 1.451-8;

(B) a change in the manner in which the taxpayer identifies contracts or determines the transaction price, including the inclusion and exclusion of variable consideration in the transaction price, under the New Standards, as defined in section 16.11(1) of this revenue procedure;

(C) any change in method of accounting that qualifies under another automatic change described in the List of Automatic Changes provided in this revenue procedure (or any successor); or

(D) with respect to a change described in section 16.10(1)(a)(ii) of this revenue procedure, a taxpayer whose present method is not the deferral method under proposed § 1.451-8(c). For example, this change does not apply to a taxpayer that uses the full inclusion method under § 451(c) or the non-AFS deferral method under proposed § 1.451-8(d).

(4) Section 16.10(1) of Rev. Proc. 2018-31 is modified to add new subparagraph (c) to read as follows:

(c) *Restatements*. A taxpayer's restatement of its AFS for financial accounting presentation does not affect the propriety of the taxpayer's method of accounting for revenue recognized in the prior taxable year(s). For example, if the taxpayer uses the deferral method described in section 5.02(3)(a) of Rev. Proc. 2004-34 for including advance payments in gross income in accordance with its AFS (even if the AFS for that taxable year is later restated), the taxpayer satisfies the requirement of section 16.10(1)(a)(i)(B) of this revenue procedure and may change its method of accounting under this section if it is otherwise eligible.

(5) Section 16.10(2) of Rev. Proc. 2018-31 is modified as follows:

(a) Section 16.10(2)(a) is modified to read as follows:

(a) *Cut-off basis for certain changes*. A change made under section 16.10(1)(a)(i) or (ii) of this revenue procedure is made on a cut-off basis and applies to items of income received by the taxpayer on or after the beginning of the year of change. Any advance payments received prior to the year of change are accounted for under the taxpayer's former method of accounting (that is, according to its former AFS), and any advance payments received in the year of change and in subsequent taxable years are accounted for under the taxpayer's new method of accounting. A taxpayer that makes a change in allocation for purposes of § 451(c)(4)(D) must allocate any payment allocations prior to the year of change using the taxpayer's former method of accounting. Accordingly, a § 481(a) adjustment is neither permitted nor required.

(b) Section 16.10(2)(b)(iv), (b)(v), and (b)(vi) are modified to read as follows:

(iv) for each applicant, identify the type of applicable financial statement used by the taxpayer, as defined in applicable guidance. See, as applicable, section 4.06 of Rev. Proc. 2004-34, § 451(b)(3), proposed § 1.451-8(b)(2), or proposed § 1.451-3(c)(1);

(v) a detailed and complete description of each type of item affected by the change in revenue recognition and the line number (or schedule) where the affected item is reflected on the federal tax return for the year of change, and if applicable, the section 481(a) adjustment for each change;

(vi) a detailed description of the basis used for revenue recognition (that is, the method the taxpayer uses in its applicable financial statement or how the taxpayer determines amounts earned, as applicable) both before and after the change in the revenue recognition policy for the applicable financial statement.

(c) Section 16.10(2) of Rev. Proc. 2018-31 is modified to add new subparagraph (c) to read as follows:

(c) *Concurrent automatic change*. A taxpayer may make more than one change under this section 16.10 on the same statement in lieu of a Form 3115 for the same year of change. The taxpayer must provide all of the information required for each change.

(6) The heading of section 16.10(5) of Rev. Proc. 2018-31 is modified to read as follows:

(5) *Special rule – advance payments under Rev. Proc. 2004-34*.

.04 *Modification to section 15.01 of Rev. Proc. 2018-31*. Section 15.01(5) of Rev. Proc. 2018-31, as modified by Rev. Proc. 2018-60, is modified to read as follows:

(5) *No ruling on method used*. The consent granted under section 9 of Rev. Proc. 2015-13 for a change made under section 15.01 of this revenue procedure is not a determination by the Commissioner that the new method of accounting is a permissible method of accounting under § 451 and does not create a presumption that the allocation method used under § 451(b)(4) is a permissible method of accounting. The Director may ascertain whether the new method of accounting is a permissible method of accounting under § 451 and whether the allocation method is permissible under § 451(b)(4). This section 15.01(5) does not apply to a taxpayer with an AFS that is making a change to comply with the proposed regulations under § 1.451-3.

SECTION 4. EFFECTIVE DATE

.01 *In general*. This revenue procedure is effective for taxable years beginning after December 31, 2017, or in the case of specified credit card fees, for taxable years beginning after December 31, 2018.

.02 *Return of Form 3115 filed under the non-automatic change procedures*. The National Office will return any Form 3115 requesting a change in method of accounting that was filed with the National Office on or before September 9, 2019, under the non-automatic procedures of Rev. Proc. 2015-13 for a taxable year beginning after December 31, 2017, that is pending with the National Office on September 9, 2019, and that is described in section 3 of this revenue procedure. The National Office will send a letter to the taxpayer acknowledging the return of the Form 3115 and will return the user fee submitted with the Form 3115. For purposes of the rules of Rev. Proc. 2015-13, the timely resubmitted Form 3115 will be considered filed as of the date the taxpayer originally filed the Form 3115 under the non-automatic change procedures in Rev. Proc. 2015-13. This paragraph does not extend the date the taxpayer must file the original (returned) Form 3115 under section 6.03(1)(a)(i)(A) of Rev. Proc. 2015-13.

SECTION 5. EFFECT ON OTHER DOCUMENTS

This revenue procedure modifies Rev. Proc. 2018-31.

SECTION 6. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1551. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number. The collection of information in this revenue procedure is in section 3.03. This information is necessary and will be used to determine whether the taxpayer properly changed to a permitted method of accounting. The collections of information are required for the taxpayer to obtain consent to change its method of accounting. The likely respondents are the following: individuals, farms, business or other for-profit institutions, nonprofit institutions, and small businesses or organizations that use an accrual method of accounting. The estimated cumulative annual reporting and/or recordkeeping burden for the method changes described under OMB control number 1545-1551 before this revenue procedure is 27,336 respondents, and a total annual reporting and/or recordkeeping burden of 30,580 hours. The estimated annual burden per respondent/recordkeeper under OMB control number 1545-1551 before this revenue procedure varies from 1/6 hour to 8½ hours, depending on individual circumstances, with an estimated average of 1¼ hours.

The estimated cumulative annual reporting and/or recordkeeping burden for the method changes described under OMB control number 1545-1551 after this revenue procedure is accounted for is 27,346 respondents, and a total annual reporting and/or recordkeeping burden is 31,479 hours. The change described in section 3.03 of this revenue procedure has an estimated annual burden per respondent/recordkeeper that varies from 3/4 hour to 2¼ hours, depending on individual circumstances, with an estimated average of 1½ hours. The estimated number of respondents is 80. The estimated annual frequency of responses is on occasion.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Peter E. Ford of the Office of the Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Ford on (202) 317-7003 (not a toll free number).

Part IV

Notice of Proposed Rulemaking

Advance Payments for Goods, Services, and Other Items

REG-104554-18

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the timing of income inclusion under section 451 of the Internal Revenue Code (Code) of advance payments for goods, services, and certain other items. The proposed regulations reflect changes made by the Tax Cuts and Jobs Act. These proposed regulations affect taxpayers that use an accrual method of accounting and receive advance payments.

DATES: Written or electronic comments or a request for a public hearing must be received by November 8, 2019.

ADDRESSES: Submit electronic submissions via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-104554-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to Internal Revenue Service, CC:PA:LPD:PR (REG-104554-18), Room 5205, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to Courier's Desk, Internal Revenue Service, CC:PA:LPD:PR (REG-104554-18), 1111 Constitution Avenue, NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning this proposed regulation, Peter E. Ford, (202) 317-7003; concerning submission of comments or a request for a public hearing, Regina L. Johnson, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 451(c). On December 22, 2017, section 451(c) was amended by section 13221 of the Tax Cuts and Jobs Act, Public Law No. 115-97 (131 Stat. 2054) (the Act), to provide that a taxpayer using an accrual method of accounting (accrual method taxpayer) with an applicable financial statement (AFS) may use the deferral method of accounting provided in section 451(c) for advance payments. These proposed regulations also provide a deferral method of accounting for taxpayers that do not have an AFS. Unless otherwise indicated, all references to section 451(c) in this preamble are to section 451(c), as amended by the Act.

In general, section 451 provides that the amount of any item of gross income is included in gross income for the taxable year in which it is received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Under §1.451-1, accrual method taxpayers generally include items of income in gross income in the taxable year when all the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (the all events test). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. See Revenue Ruling 2003-10 (2003-1 CB 288); Revenue Ruling 84-31 (1984-1 CB 127); Revenue Ruling 80-308 (1980-2 CB 162). Section 451(c) requires an accrual method taxpayer who receives an advance payment to include the amount thereof in income in the taxable year of receipt. Section 451(c) also generally codifies the current deferral method of accounting for certain advance payments for goods, services, and other specified items provided by the IRS under Revenue Procedure 2004-34 (2004-22 IRB 991) by allowing accrual method taxpayers to elect to defer the inclusion of income associated with certain advance payments to the taxable year following the taxable year of receipt if such income also is deferred for AFS purposes.

On April 12, 2018, the Treasury Department and the IRS issued Notice 2018-35 (2018-18 IRB 520) requesting, in part, comments on future guidance under section 451(c). The record of public comments received in response to Notice 2018-35 may be requested by sending an email to Notice.comments@irscounsel.treas.gov. This document provides guidance on the application of section 451(c), taking into account comments that were received regarding section 451(c). The application of section 451(c) is addressed in separate guidance published in the same issue of the **Federal Register** as these proposed regulations.

Explanation of Provisions

These proposed regulations describe and clarify the statutory requirements of section 451(c) by providing new §1.451-8.

1. *Deferral Methods under §1.451-8*

A. AFS Deferral Method

Consistent with section 451(c)(1)(A), these proposed regulations provide that an accrual method taxpayer with an AFS includes an advance payment in gross income in the taxable year of receipt unless the taxpayer uses the deferral method in section 451(c)(1)(B) and proposed §1.451-8(c) (AFS deferral method). A taxpayer using the AFS deferral method must have an AFS, as described in section

451(b)(1)(A)(i) or (ii). These proposed regulations define the term AFS by reference to the definition of that term in proposed §1.451-3(c)(1) (REG-104870-18). Under the AFS deferral method, a taxpayer with an AFS that receives an advance payment must include: (i) The advance payment in income in the taxable year of receipt, to the extent that it is included in revenue in its AFS, and (ii) the remaining amount of the advance payment in income in the next taxable year. The AFS deferral method provided in these proposed regulations closely follows the deferral method of Revenue Procedure 2004-34, as modified by Revenue Procedure 2011-14 (2011-4 IRB 330), and as modified and clarified by Revenue Procedure 2011-18 (2011-5 IRB 443), and Revenue Procedure 2013-29 (2013-33 IRB 141) (Revenue Procedure deferral method). Because new section 451(c)(1)(B) was intended to generally codify the Revenue Procedure deferral method, the Treasury Department and the IRS believe that rules similar to the Revenue Procedure deferral method are necessary and appropriate for the proper application of section 451(c). *See* H.R. Rep. No. 115-466, at 429 (2017) (Conf. Rep.).

B. Non-AFS Deferral Method

Section 451(c)(4)(A) generally defines an advance payment as any payment the full inclusion of which in gross income of the taxpayer for the year of receipt is a permissible method of accounting, any portion of which is included in revenue by the taxpayer in an AFS, and which is for goods, services, or other items identified by the Secretary. One commenter noted that the financial statement requirement within the definition of an advance payment means that the rule in Revenue Procedure 2004-34 that depended on determining when the advance payment was earned was not within the statutory text of section 451(c). The Treasury Department and the IRS have concluded that section 451(c) does not prohibit a deferral method that is otherwise permissible under Revenue Procedure 2004-34. *See* H.R. Rep. No. 115-466, at 429 (2017) (Conf. Rep.). See also, Joint Committee on Taxation, General Explanation of Public Law 115-97 (JCS-1-18) at 170-171 (Dec. 20, 2018). Revenue Procedure 2004-34 permitted non-AFS taxpayers to use the Revenue Procedure deferral method based on when the income is earned (earned standard). *See* section 5.02(3)(b) of Revenue Procedure 2004-34. The Revenue Procedure deferral method using the earned standard is a permissible method of accounting for non-AFS taxpayers and, therefore, these proposed regulations also provide a similar deferral method for non-AFS taxpayers in proposed §1.451-8(d) (non-AFS deferral method). Under the non-AFS deferral method, an accrual method taxpayer without an AFS that receives an advance payment must include: (i) The advance payment in income in the taxable year of receipt, to the extent that it is earned, and (ii) the remaining amount of the advance payment in income in the next taxable year.

2. *Definition of Advance Payment*

A. In general

Section 451(c)(4)(A) generally defines advance payment as any payment (i) the full inclusion of which in gross income of the taxpayer for the taxable year of receipt is a permissible method of accounting, (ii) any portion of which is included in revenue by the taxpayer in an AFS (or such other financial statement as the Secretary may specify) for a subsequent taxable year, and (iii) which is for goods, services, or such other items as may be identified by the Secretary.

Proposed §1.451-8(b)(1)(i) clarifies that the definition of advance payment under the AFS and non-AFS deferral methods is consistent with the definition of advance payment in Revenue Procedure 2004-34, which section 451(c) was meant to codify. See H.R. Rep. No. 115-466, at 429 (2017) (Conf. Rep.). The Treasury Department and the IRS believe this definition of advance payment: (1) is consistent with section 451(c), (2) minimizes additional tax compliance burden and cost, (3) provides clarity to taxpayers, and (4) uses rules which are familiar to both taxpayers and the IRS.

Two commenters suggested that airline miles be explicitly included in the list of items for which an advance payment may be received. The commenters suggested that airline miles are a unique type of item, generally redeemed for air travel and non-travel rewards. The Treasury Department and the IRS decline to specifically include airline miles in the definition of advance payment because the use of the deferral method under these proposed regulations, to the extent airline miles are redeemable for goods or services, is already permissible. Therefore, these proposed regulations include examples to illustrate that, to the extent certain reward points are treated as separate performance obligations, they may be eligible for the deferral methods provided under these proposed regulations.

Another commenter suggested that progress payments with respect to the sale of an interest in real property should be included in the definition of an advance payment. Revenue Procedure 2004-34 was intended to provide a simplified and consistent deferral period for the sale of goods, services, and other items. However, the definition of advance payment in Revenue Procedure 2004-34 does not include prepayments for interests in real property. These proposed regulations generally provide the same types of items in the definition of advance payment to those items provided in Revenue Procedure 2004-34. However, the Treasury Department and IRS will consider any comments received in determining whether it is appropriate to include additional types of items in the definition of advance payment.

B. Items Excluded from the Definition of an Advance Payment

Section 451(c)(4)(B) provides that certain items, except as otherwise provided by the Secretary, are to be excluded from the definition of an advance payment. Pursuant to section 451(c)(4)(B), the term advance payment does not include rent; insurance premiums governed by subchapter L; payments with respect to financial instruments; payments with respect to certain warranty or guaranty contracts; payments subject to section 871(a), 881, 1441, or 1442; payments in property to which section 83 applies; and other payments identified by the Secretary.

Several commenters requested that certain payments for certain types of goods be excluded from the definition of an advance payment under section 451(c)(4)(B). A commenter requested that certain pre-delivery payments for the sale of high-value customer-configured equipment that will be delivered to customers at reasonably certain times not be included in the definition of advance payment. Another commenter requested that an exclusion be provided for goods for which (i) a taxpayer receives a payment in a taxable year with respect to a contract for the sale of goods not properly includible in such taxpayer's finished goods inventory, and (ii) on the last day of such taxable year the taxpayer does not have on hand (or available to it in such year through its normal source of supply) goods of a substantially similar kind and in a sufficient quantity to satisfy the contract during such contract year. This commenter suggested a narrowing of this exclusion could be done according to whether a good is commercially significant or of high-value. A commercially significant good has a useful life equal to or in excess of 10 years and it is developed, marketed, and sold to customers in the aerospace industry. Generally these goods require a significant amount of capital to produce and may require considerable time from development to delivery. Generally, for financial statement purposes, such manufacturers recognize revenue related to these goods when the product is completed and delivered to the customer and title and risk of loss have transferred to the customer.

Proposed §1.451-8(b)(1)(ii) provides a list of items excluded from the definition of advance payment that is similar to Revenue Procedure 2004-34. An additional exclusion is provided for payments received in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery date for a specified good, as defined in §1.451-8(b)(9). In response to the comments received, the Treasury Department and IRS have determined that an exclusion is appropriate for certain goods for which a taxpayer requires a customer to make an upfront payment under the contract if (i) the contracted delivery month and year of the good occurs at least two taxable years after an upfront payment, (ii) the taxpayer does not have the good or a substantially similar good on hand at the end of the year the upfront payment is received, and (iii) the taxpayer recognizes all of the revenue from the sale of the good in its AFS in the year of delivery.

The Treasury Department and the IRS have employed the authority granted to the Secretary in section 451(c)(4)(B)(vii) to exclude certain payments, in a limited manner, that would otherwise constitute advance payments within the meaning of section 451(c)(4)(A), in response to the proposals described in comments already received. In order to fully consider other such potential exclusions, detailed comments that specifically address the following issues are requested:

1. Does the authority granted to the Secretary by section 451(c)(4)(B)(vii) to exclude certain payments from the definition of an advance payment under section 451(c) also permit an exception for those payments from the rules regarding the all events test under section 451(b)?
2. What significance, if any, should the time it takes to manufacture or create an item of property, or such item of property's useful life, be given in determining whether a pre-delivery payment for such item of property should be included in income as an advance payment?
3. Does the authority granted to the Secretary by section 451(c)(4)(B)(vii) authorize rules that change the timing of deductions or provide a safe harbor allowing specified categories of taxpayers to use methods of accounting for recognizing income other than an accrual method under section 451? Is there any particular authority under the Code that would allow changing the timing of deductions in this context under section 451 or another section of Subchapter E?
4. Does the authority granted to the Secretary by section 451(c)(4)(B)(vii) to exclude certain payments from the definition of an advance payment also authorize the imposition of conditions unrelated to an accrual method of accounting with respect to any such exclusions? For example, could the Secretary require that a taxpayer use an alternative method of accounting as a condition for excluding a type of payment from the definition of advance payment?
5. Does the authority granted to the Secretary by section 451(c)(4)(B)(vii) to exclude certain payments from the definition of advance payment also authorize the imposition of a time limit on such exclusion? For example, could an exclusion under section 451(c)(4)(B)(vii) be limited to a specified number of years after which all remaining amounts would have to be recognized in income? If so, what would be an appropriate time limit?
6. Does the authority granted to the Secretary by section 451(c)(4)(B)(vii) allow deferral of income in an amount equal to the estimated future performance costs while requiring current recognition of estimated profits not in excess of the amounts of advance payments? If so, does the authority granted to the Secretary by section 451(c)(4)(B)(vii) permit rules to account for the time value of money for any variances in estimated costs or profits?
7. Would it be inappropriate to reduce the amount a C corporation would be permitted to defer for a given taxable year under a potential exclusion under section 451(c)(4)(B)(vii) by an amount equal to the excess of (i) distributions the C corporation made to its shareholders with respect to its stock, over (ii) the C corporation's taxable income for that taxable year?.

3. *Advance Payment Acceleration Provisions*

Section 451(c)(3) provides that the deferral method does not apply to an advance payment received by the taxpayer during a taxable year if such taxpayer ceases to exist during (or with the close of) the taxable year. In contrast, Revenue Procedure 2004-34 provides more detailed acceleration rules.

The Treasury Department and the IRS have determined that rules similar to the acceleration rules provided in Revenue Procedure 2004-34 are appropriate for the proper application of the AFS and non-AFS deferral methods. The continued use of the deferral method for an advance payment is not appropriate and should be limited in certain situations, such as when the taxpayer ceases to exist, or when their obligation regarding the advance payment is satisfied or otherwise ends. Accordingly, proposed §1.451-8(c)(2) and (d)(6) provide rules to ensure the acceleration of an advance payment when a taxpayer either dies or ceases to exist, or when a taxpayer's obligation regarding an advance payment is satisfied or otherwise ends, except in certain circumstances. Consistent with Revenue Procedure 2004-34, the acceleration rules do not apply to a taxpayer that engages in a transaction to which section 381 applies or certain transactions in which section 351 applies in the taxable year in which an advance payment is received.

Section 451(c) does not specifically address whether the deferral method may be used when an amount is earned in the taxable year, but deferred for AFS purposes. The deferral method under section 451(c) is an exception to the requirement to include an amount in income when it is received but is not an exception to the requirement to include an amount in income when it is earned under the all events test. Accordingly, consistent with Revenue Procedure 2004-34, these proposed regulations permit deferral of advance payments received to the extent, in the year of receipt, the amount is not included in revenue in the taxpayer's AFS, and is not otherwise earned in the taxable year of receipt. The amounts not included in gross income in the year of receipt must be included in gross income in the next taxable year.

4. *Advance Payments and Financial Statement Adjustments*

Section 451(c) does not address the treatment of financial statement adjustments that cause amounts to not be included in income.

Proposed §1.451-8(c)(3) and (d)(7) provide that a taxpayer that defers inclusion of all or a portion of an advance payment must include the remainder of the advance payment in gross income in the subsequent year, notwithstanding any write-down or adjustment for financial accounting purposes. This provision is consistent with a plain reading of section 451(c)(1)(B) and the rule in proposed §1.451-3(j), which require that an item of income treated as deferred revenue in a taxpayer's AFS in one year and charged, in whole or part, to a capital account in a subsequent year, is included in revenue in the subsequent year.

A financial accounting adjustment may occur after certain equity acquisitions. For example, after certain equity acquisitions, the acquiring entity may write-down or adjust the target's deferred revenue in the subsequent year under purchase accounting rules. Some taxpayers have asserted that a write-down or adjustment for financial accounting purposes results in a permanent exclusion of income for federal income tax purposes. Proposed §1.451-8(c)(3) and (d)(7) provide clarification for instances in which a taxpayer defers inclusion of an advance payment and is subsequently acquired in certain equity acquisitions. The Treasury Department and the IRS believe that financial statement write-downs or adjustments to deferred revenue should not be taken into account for federal income tax purposes when determining the proper amount to be included in income under the deferral method. This clarification ensures that a financial statement write-down or adjustment to deferred revenue does not result in a permanent exclusion of income for federal income tax purposes.

5. *Short Taxable Years and the 92-Day Rule*

Section 451(c) does not provide rules relating to the treatment of short taxable years. Proposed §1.451-8(c)(4) and (d)(8) use the short taxable year rules of Revenue Procedure 2004-34 for the AFS and non-AFS deferral methods because a rule for short taxable years is necessary to properly implement the deferral method provided in section 451(c)(1)(B).

6. *Performance Obligations for AFS and Non-AFS Taxpayers*

Sections 451(b) and (c)(4)(D) require that taxpayers with contracts that contain multiple performance obligations must allocate transaction price, and therefore defer (or accelerate) income inclusion, consistent with the transaction price allocation used for AFS purposes. Proposed §1.451-3(c)(3) (REG-104870-18) defines the term performance obligation to mean a promise in a contract with a customer to transfer to the customer either a good or service (or a bundle of goods or services) that is distinct, or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. Proposed §1.451-8(b)(4) defines the term performance obligation by cross-reference to proposed §1.451-3(c)(3) for purposes of the allocation rule provided in section 451(c)(4)(D).

Proposed §1.451-8(b)(7) defines the term transaction price by cross-reference to proposed §1.451-3(c)(6). Proposed §1.451-3(c)(6) defines the term transaction price to mean the gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes in exchange for transferring promised goods, services, or other property, including amounts referred to in proposed §1.451-3(i). However, the term transaction price does not include certain items, such as amounts collected on behalf of third parties that are not otherwise income to the taxpayer, increases for consideration to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event, and reductions for amounts subject to section 461. Proposed §1.451-3(c)(6)(ii) presumes that an amount included in the transaction price for AFS purposes is not contingent unless, upon examination of all of the facts and circumstances existing at the end of the taxable year, it can be established to the satisfaction of the Commissioner that the amount is contingent on the occurrence or nonoccurrence of a future event. Proposed §1.451-3(c)(6)(ii) also provides that certain amounts included in transaction price for AFS purposes, however, will not be treated as contingent on the occurrence or nonoccurrence of a future event.

Comments are requested on allocation of the transaction price (i) to performance obligations that are not contractually based, (ii) for arrangements that include both income subject to section 451 and long-term contracts subject to section 460, and (iii) when the income realization event for federal income tax purposes differs from the income realization event for AFS purposes.

For non-AFS taxpayers, there is a continued need to provide an allocation method consistent with the objective criteria standard in Revenue Procedure 2004-34 because such taxpayers do not have an AFS and cannot use the transaction price allocation used for AFS purposes, as provided in section 451(b)(4). Therefore, proposed §1.451-8(d)(5) permits a non-AFS taxpayer to allocate the revenue of multiple obligations in a single contract based on how such obligations are separately priced or on any method that may be provided in guidance published in the IRB.

7. *Accelerated Cost Offset*

Several commenters discussed the need for a regulatory exception to the existing statutory and regulatory timing rules that apply to liabilities (for example, deductions and offsets for rebates, refunds, and cost of goods sold (COGS) prior to when the liability for such items is incurred under section 461) when advance payments are required to be included in income under section 451(c) prior to the completion of the sale of goods or provision of services (accelerated cost offset). The commenters argued that not providing an accelerated cost offset in the regulations would cause a mismatch of income and expenses and result in the taxation of gross receipts.

An allowance to account for future cost of goods sold, for future estimated costs, or other cost offset is inconsistent with sections 461(h) and, 471, 263A, and the accompanying regulations. Moreover, section 13221 does not change the timing rules provided in sections 461, 471, 263A and elsewhere that apply to liabilities. Section 13221 changes the timing of income for advance payments for goods and generally codifies Revenue Procedure 2004-34. *See* H.R. Rep. No. 115-466, at 429 (2017) (Conf. Rep.). Revenue Procedure 2004-34 does not include an accelerated cost offset when amounts are included in income prior to the sale of goods or provision of services.

The Conference Report also indicates that section 13221 of the Act is "intended to override any deferral method provided by Treasury Regulation §1.451-5 for advance payments received for goods." H.R. Rep. No. 115-466, at 429 n 880 (2017) (Conf. Rep.). Section 1.451-5 includes a deferral method that allows an accelerated cost offset when certain amounts are included in income prior to the sale of goods. *See* §1.451-5(c). Section 451(c) does not provide a cost offset, and the Conference Report does not provide any indication that Congress intended to preserve the cost offset rules permitted under §1.451-5. See also, Joint Committee on Taxation, General Explanation of Public Law 115-97 (JCS-1-18) at 156-157 and 164-165 (December 20, 2018). Final regulations were published in the **Federal Register** (84 FR 33691) on July 15, 2019, that withdraw §1.451-5, consistent with the Act.

The Treasury Department and the IRS believe that Congress intentionally simplified the rules for advance payments by limiting the deferral of advance payments for taxpayers with an AFS to a prescribed statutory method that: (1) does not include an accelerated cost offset, (2) is consistent with Revenue Procedure 2004-34, and (3) overrides §1.451-5. See H.R. Rep. No. 115-466, at 429 (2017) (Conf. Rep.). Accordingly, the Treasury Department and the IRS decline to provide an accelerated cost offset in these proposed regulations. The Treasury Department and the IRS do not agree with the contention that changes to the timing of income under section 451 without an accelerated cost offset cause a taxation of gross receipts. Section 451(c) and these proposed regulations merely change the timing of income recognition, do not preclude any associated reduction or deduction for properly incurred liabilities, and are consistent with existing statutory and regulatory timing requirements that apply to liabilities.

Several commenters proposed a cost offset mechanism for manufacturers of certain property and taxpayers with inventoriable goods in order to ensure matching of income and the associated expenses. Commenters made the following suggestions to alleviate the potential mismatch of the acceleration of income recognition with different timing rules for associated costs: (i) permitting a taxpayer that uses a percentage of completion method for AFS purposes (book PCM), but not subject to section 460, to elect to use their AFS method for tax purposes; (ii) permitting a taxpayer that uses book PCM, but not subject to section 460, to elect to apply section 460 for federal income tax purposes; (iii) expanding the recurring item exception in section 461(h)(3) to permit a taxpayer to offset the portion of the advance payment included in income for the taxable year by the cost of goods sold related to this payment if the goods are completed and shipped to the customer within 8 ½ months of the end of the taxable year that the advance payment is included in income; or (iv) providing a cost offset for taxpayers that can demonstrate at the time of the purchase agreement that a net operating loss will remain unused for the 5-year period after the taxable year the advance payment is received.

The Treasury Department and the IRS continue to consider whether any such exceptions are an appropriate use of the Secretary's authority under section 461(h) or 460. To facilitate further consideration of such potential exceptions, detailed comments that specifically address the following issues are requested:

1. Under what authority would it be appropriate for the Secretary to permit a taxpayer to use book PCM as its tax method? When inventory is involved, what limitations could be instituted to ensure that book PCM could not be used to recover costs related to inventoriable goods prior to the time when such costs could be recovered under sections 471 and 263A? Under what specific authority would it be appropriate to permit a book PCM method to be used to recover costs related to inventoriable goods?
2. Would elective use of book PCM for tax purposes provide an appropriate cost offset? Would such a method be characterized as one that reports contract revenue according to a taxpayer's book method, while accounting for costs, including nondeductible costs, as deductions under the Code? If not, how would such a method account for costs for federal income tax purposes?
3. Rather than make book PCM elective, would it be appropriate for the definition of "unique item" for purposes of section 460 to be expanded?
4. Section 460 requires use of the look-back method to compensate for improper acceleration or deferral of income under PCM. It also requires that all contract income be reported no later than the year following con-

tract completion. Would elective use of a PCM under section 460 without these provisions invite abuse? If so, how could such abuse be prevented?

8. *Section 451(c) is a Method of Accounting*

Section 451(c)(2) provides that a taxpayer may elect deferral treatment of an advance payment governed by section 451(c), and such election shall be made at such time and manner and with respect to such categories of advance payments as specified by the Secretary. Section 451(c)(2)(B) provides that the deferral method is treated as a method of accounting and the election is effective for taxable years with respect to which it is first made and for all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to change to a different method of accounting.

The use of the AFS or non-AFS deferral method is the adoption of, or a change in, a method of accounting under section 446. A taxpayer may change its method of accounting to use the deferral methods only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations. The Treasury Department and the IRS intend to issue future guidance that will provide the procedures by which a taxpayer may change its method of accounting to use one of the deferral methods described in these proposed regulations. However, until further guidance for the treatment of advance payments is applicable, a taxpayer may continue to rely on Revenue Procedure 2004-34, as described in Notice 2018-35.

Proposed Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provides that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the **Federal Register**, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the **Federal Register**.

These regulations are proposed to apply to taxable years beginning on or after the date the final regulations are published in the **Federal Register**. Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2017, provided that the taxpayer: (1) applies all the applicable rules contained in these proposed regulations, and (2) consistently applies these proposed regulations to all advance payments. See section 7805(b)(7).

Statement of Availability of IRS Documents

The IRS notice, revenue ruling, and revenue procedures cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at http://www.irs.gov.

Special Analysis

l.*Regulatory Planning and Review*

Executive Orders 13771, 13563, and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits, including potential economic, environmental, public health and safety effects, distributive impacts, and equity. Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility. The Executive Order 13771 designation for any final rule resulting from these proposed regulations will be informed by comments received. The preliminary Executive Order 13771 designation for this proposed rule is regulatory.

The proposed regulations have been designated by the Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these proposed regulations as significant under section 1(b) of the MOA. Accordingly, OMB has reviewed these proposed regulations.

1.Background

Under section 451(a) of the Internal Revenue Code, income is "recognized" (that is, included in gross income for tax purposes) in the year in which it is received by the taxpayer, unless it is properly accounted for in a different period under the taxpayer's method of accounting. Because of this latter condition, the tax treatment of certain forms of income depends on the method of accounting a taxpayer is using. For taxpayers using the accrual method of accounting, income is generally recognized in the year in which all events have occurred that fix the right to receive that income and when the amount of income can be determined with reasonable accuracy (the "all events test"). Receipt of payment by the business satisfies the all events test. However, recognition of certain payments for goods or services not yet provided may be deferred to the year following receipt of payment, to the extent that recognition is also deferred for on the taxpayer's Applicable Financial Statement (AFS). Such payments are referred to as "advance payments."

Prior to the December 22, 2017, enactment of, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Public Law 115-97, 131 Stat. 2054 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA), taxpayers were generally permitted to defer the tax on these advance payments; in other words, advance payments could be recognized in a later taxable year. Section 451(c), added by the TCJA, allows accrual-method taxpayers to elect to recognize as income only a portion of such an advance payment in the taxable year in which it is received, and then recognize the remainder in the following taxable year. Section 451(c) essentially codifies the deferral method of accounting for advance payments that was permitted in Revenue Procedure 2004-34. (Joint Committee on Taxation, *General Explanation of Public Law 115-97,* (Washington, U.S. Government Publishing Office, December 2018), at 167.) New section 451(c), the subject of the proposed regulations, deals with issues around how these advance payments are defined and the timing in which they need to be recognized in the business's income tax.

2. *Need for the Proposed Regulations*

These proposed regulations provide certainty and clarity to taxpayers affected by statutory changes introduced in section 451(c). The Treasury Department and IRS have received questions and comments regarding the meaning of various provisions in section 451(c) and issues not explicitly addressed in the statute. The Treasury Department and the IRS have determined that such comments warrant the issuance of further guidance.

3. *Overview of the proposed regulations*

The proposed regulations provide guidance regarding the new section 451(c). The subsequent economic analysis covers proposed regulations to: (1) Describe and clarify the deferral rules for advance payments for taxpayers without an Applicable Financial Statement (AFS); (2) provide acceleration rules for taxpayers that cease to exist; (3) clarify the treatment of financial statement adjustments for taxpayers that have deferred advance payments; (4) provide rules relating to the treatment of short taxable years for taxpayers deferring advance payments; and (5) define and clarify the treatment of performance obligations.

4. *Economic analysis*

A. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations. The following largely qualitative analysis describes the anticipated economic effects of the proposed regulation relative to this baseline.

B. Summary of Economic Effects

The proposed regulations provide certainty and consistency in the application of section 451(c) by providing definitions and clarifications regarding the statute's terms and rules. An economically efficient tax system generally aims to treat income and expense derived from similar economic decisions consistently across taxpayers and across activities in order to reduce incentives for businesses to make choices based on tax rather than market incentives. In the absence of the guidance provided in these proposed regulations, the chances that different taxpayers might interpret the statute differently is exacerbated. For example, two similarly situated taxpayers might interpret the statutory provisions pertaining to the definition of advanced payments differently, with one taxpayer pursuing a project that another comparable taxpayer might decline because of a different interpretation of how the income may be treated under section 451(c). If this second taxpayer's activity is more profitable, an economic loss arises. An economic loss might also arise if all taxpayers have identical interpretations under the baseline of the tax treatment of particular income streams but are more conservative (or less conservative) regarding the interpretation than Congress intended for these income streams. In this case, guidance provides value by bringing economic decisions closer in line with the intents and purposes of the statute.

Because the proposed regulations clarify the tax treatment of certain income streams, there is the possibility that investments or other business decisions may change as a result of these regulations. The Treasury Department and the IRS have not made projections of the change in investment patterns that might arise due to the discretionary aspects of the proposed regulations. The Treasury Department and the IRS have also not made projections of any change in compliance costs arising from the proposed regulations, relative to the baseline. The Treasury Department project that changes in investment patterns and compliance costs relative to the baseline may generally be small because the proposed regulations affect a relatively small number of entities and because they largely mirror the rules of Rev. Proc. 2004-34.

The economic consequences of these proposed regulations depend in part on their interaction with other sections of the Code, including section 460, which governs when costs can be recovered under the percentage of completion method, and section 461(h), which governs when costs incurred by a taxpayer satisfy the all events test, including a requirement for economic performance, and are thereby allowed as deductions for Federal income tax purposes. The economic analysis of the final regulations under section 451(c) may address the economic effects of regulatory guidance, if any, under sections 460 and 461(h) or other sections of the Code that interact with section 451(c), that is issued between the proposed and final regulations.

The Treasury Department and the IRS project that approximately 15,000 business entities may be affected by these regulations.

The Treasury Department and the IRS solicit comments on this conclusion and particularly solicit comments that provide data, evidence, or models that would enhance the rigor by which the non-revenue economic effects might be estimated for the final regulations.

C. Economic Analysis of Specific Provisions

The Treasury Department and the IRS solicit comments on the economics of each of the items discussed subsequently and of any other items of the proposed regulations not discussed in this section. The Treasury Department and the IRS particularly solicit comments that provide data, other evidence, or models that could enhance the rigor of the process by which provisions might be developed for the final regulations.

i. Deferral Methods under section 451(c)

The statute prescribes a particular deferral method for accrual-method taxpayers that have an AFS (AFS taxpayers) but does not explicitly describe a deferral method to be used by taxpayers that do not have an AFS (non-AFS taxpayers). To remedy this gap, the proposed regulations describe and clarify that a method similar to the deferral method available to non-AFS taxpayers under Revenue Procedure 2004-34 will be available to non-AFS taxpayers.

The Treasury Department and the IRS considered and rejected a narrow interpretation of section 451(c) that would have precluded non-AFS taxpayers from using a deferral method similar to that provided in Revenue Procedure 2004-34. Section 451(c) does not explicitly prohibit the use of such a method by non-AFS taxpayers, and the Treasury Department and IRS continue to have authority under the Code to prescribe a deferral method for such taxpayers. Precluding non-AFS taxpayers from using a deferral method similar to that of AFS taxpayers would treat AFS and non-AFS taxpayers quite differently regarding business decisions they might make that are otherwise similar. Such treatment would result in a less economically efficient tax system, which generally treats similar economic decisions similarly.

The Treasury Department and the IRS solicit comments on this decision on the treatment of deferral by non-AFS taxpayers and particularly solicit comments that provide data, other evidence, or models that could enhance the rigor by which the final regulations over non-AFS deferral might be developed.

ii. Advance Payment Acceleration Provisions

If a taxpayer ceases to exist by the close of a taxable year in which an advance payment has been received and deferred, then issues may arise as to when or whether the remaining amount of the payment will be recognized as taxable income because there may not be a succeeding taxable year in which such income can be recognized.

Under the statute, if the taxpayer dies or ceases to exist by the close of the taxable year in which the advance payment was received, any remaining untaxed amounts of advance payments must be included in income in the year they were received. The proposed regulations extend this payment "acceleration" rule to situations in which a performance obligation is satisfied or otherwise ends in the taxable year of receipt or in a succeeding short taxable year, a treatment that is consistent with a similar rule in Revenue Procedure 2004-34.

The Treasury Department and the IRS considered not modifying or expanding the acceleration rule contained in section 451(c), but rejected this alternative because of the remaining amount may never be picked up into income risking a permanent exclusion of the amount from taxable income. The possibility of a permanent exclusion of income provides incentives for taxpayers to structure payments in ways that avoid tax liability, thus reducing Federal tax revenue without providing an accompanying general economic benefit. The proposed regulations treat the expanded set of accelerated transactions consistently with similar types of transactions based on the timing and structure of the payments involved.

The Treasury Department and the IRS solicit comments on the proposed regulation's treatment of acceleration and particularly solicit comments that provide data, other evidence, or models that would enhance the rigor by which the treatment of acceleration might be developed for the final regulations.

iii. Advance Payments and Financial Statement Adjustments

Under the statute, if a taxpayer counts an advance payment as an item of deferred revenue, under certain conditions (for example, certain acquisitions of one corporation by another), the taxpayer may be required by its system of accounting to adjust that item on the balance sheet in a subsequent year. The item would then not be included in current earnings or AFS revenues. In this case, taxpayers might argue that they can exclude the amount deferred from taxable income because it is never "earned" nor included in revenue under their AFS. If this argument is upheld, taxpayers could convert an income "deferral" amount into an income "exemption" amount. To address this issue and avoid this possibility, the proposed regulations specify that such financial statement adjustments are to be treated as "revenue."

The Treasury Department and the IRS considered not providing clarity on the treatment of financial statement write-downs, but rejected that approach, because it would have risked an inappropriate permanent exclusion of income. The possibility of a permanent exclusion of income provides incentives for taxpayers to structure payments in ways that avoid tax liability, thus reducing Federal tax revenue without providing an accompanying general economic benefit.

The Treasury Department and the IRS solicit comments on these proposed regulations and particularly solicits comments that provide data, other evidence, and models that would enhance the rigor by which the final regulations dealing with financial statement adjustments might be developed.

iv. Short Taxable Years and the 92-Day Rule

Section 451(c) does not provide a rule relating to the treatment of short taxable years. In the absence of such a rule, it will be unclear to taxpayers how they should implement the deferral method provided in section 451(c) in the case of a short taxable year. To address this issue, the proposed regulations provide rules relating to the treatment of short taxable years for advance payments that are generally consistent with Revenue Procedure 2004-34. The Treasury Department and the IRS considered and rejected not providing short taxable year rules because such a decision would have created significant confusion among taxpayers, increased administrative costs for the IRS, and increased compliance costs for taxpayers.

The Treasury Department and the IRS solicit comments on these proposed regulations and particularly solicit comments that would provide data, other evidence, and models that would enhance the rigor by the treatment of short taxable years might be developed for the final regulations.

v. Performance Obligations for Non-AFS Taxpayers

A performance obligation is a contractual arrangement with a customer to provide a good, service or a series of goods or services that are basically the same and have a routine pattern of transfer. The statute requires that taxpayers with contracts that include multiple performance obligations to allocate the transaction price to each performance obligation in the same manner that revenue is allocated in the taxpayer's AFS. The statute does not, however, specify the allocation rules to be used by non-AFS taxpayers.

To address this issue, the proposed regulations provide allocation rules for non-AFS taxpayers consistent with a similar rule in Revenue Procedure 2004-34. That rule specifies that the transaction price be allocated in a manner that is based on payments the taxpayer regularly receives for an item or items it regularly sells or provides separately. The Treasury Department and the IRS considered not providing allocation rules for non-AFS taxpayers but rejected such an approach because it would have treated similarly situated taxpayers quite differently, and would have led to increased administrative costs for the IRS and increased compliance costs for taxpayers. While the allocation rules for AFS taxpayers and non-AFS taxpayers under the proposed regulations do differ, the chosen solution provides a rule upon which non-AFS taxpayers can rely, while minimizing the differences between AFS and non-AFS taxpayers in this regard within the constraints imposed by the statute.

The Treasury Department and the IRS solicit comments on these proposed regulations and particularly solicit comments that would provide data, other evidence, and models that would enhance the rigor by which final regulations affecting the treatment of performance obligations taxable for non-AFS taxpayers might be developed for the final regulations.

II. *Paperwork Reduction Act*

These proposed regulations do not impose any additional information collection requirements in the form of reporting, recordkeeping requirements or third-party disclosure requirements related to tax compliance. However, because the deferral methods described in proposed §§1.451-8(c) and (d) are methods of accounting, a portion of affected taxpayers would be required to request the consent of the Commissioner for a change in their method of accounting under section 446(e) and the accompanying regulations. The IRS expects that these taxpayers will request this consent by filing Form 3115, *Application for Change in Accounting Method (Parts I, II, IV and Schedule B)*. Filing of Form 3115 and statements attached thereto (for taxpayers who are required to do so or who elect to do so as a result of the proposed regulations) is the sole collection of information requirement imposed by the statute and the proposed regulations. See subsequent paragraphs for a description of taxpayers who would be required to change the method of accounting under the statute and the proposed regulations.

For purposes of the Paperwork Reduction Act, the reporting burden associated with the collection of information with respect to section 451(c) will be reflected in the Paperwork Reduction Act submissions for IRS Form 3115 (OMB control numbers 1545-0074 for individual filers, 1545-0123 for business filers, and 1545-2070 for all other types of filers). The IRS may provide streamlined method change procedures which could permit the filing of a statement in lieu of filing a Form 3115, or, in certain cases, no notification (see, for example, the revenue procedure accompanying these proposed regulations).

The Treasury Department and the IRS anticipate that these proposed regulations would require an accrual method taxpayer that receives an advance payment and chooses to make an election to use the deferral method described in proposed §1.451-8(c) or (d) to file a Form 3115 to change the method of accounting to comply with these proposed regulations. See proposed §1.451-8(e). The Treasury Department and IRS estimate that 20,000-40,000 taxpayers will be required to file a Form 3115 in order to change to the deferral method described in proposed §1.451-8(c).[1] The Treasury Department and the IRS anticipate a certain number of accrual method taxpayers without an AFS that receive advance payments may choose to use the non-AFS deferral method described in proposed §1.451-8(d). The Treasury Department and IRS plan to provide streamlined procedures for taxpayers to change to the methods of accounting described in proposed §1.451-8(c) and (d). See the revenue procedure accompanying these proposed regulations.

For a taxpayer with an AFS that uses the deferral method in proposed §1.451-8(c), a change in the taxpayer's revenue recognition policies for financial accounting purposes requires the taxpayer to seek the consent of the Commissioner under section 446(e) to use the method for federal income tax purposes. See proposed §1.451-8(e). It is anticipated that the reporting burden associated with the collection of information for a statement in lieu of the Form 3115 would be reflected in the Paperwork Reduction Act Submission associated with Revenue Procedure 2018-31, 2018-22 IRB 637 (or successor) (OMB control number 1545-1551). See the revenue procedure accompanying these proposed regulations.

In 2018, the IRS released and invited comment on a draft of Form 3115 in order to give members of the public the opportunity to benefit from certain specific provisions made to the Code. The IRS received no comments on the forms during the comment period. Consequently, the IRS made the forms available in January 2019 for use by the public. The IRS notes that Form 3115 applies to changes of accounting methods generally and is therefore broader than section 451(c).

The current status of the Paperwork Reduction Act submissions related to the information collections in the proposed regulations is provided in the accompanying table. The overall burden estimates provided for the OMB control numbers below are aggregate amounts that relate to the entire package of forms associated with the applicable OMB control number and will in the future include, but not isolate, the estimated burden of the tax forms that will be created or revised as a result of the information collections in the proposed regulations. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by the proposed regulations. These burdens have

[1] This estimate is based on data from the Compliance Data Warehouse of accrual-method taxpayers (includes C corporations, S corporations, partnerships, and sole proprietorships) with an AFS that E-filed schedule M-3 during 2012-2016. Schedule M-3 is used to report a net income (loss) reconciliation but not all taxpayers who should file an M-3 do so. The rules for filing the M-3 differ based on taxpayer status. For example, for C corporations, in general only those with assets of $10 million or more file an M-3 schedule with their Form 1120.

been reported for other regulations that rely on the same OMB control numbers to conduct information collections under the Paperwork Reduction Act, and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burden that the regulations that cite these OMB control numbers impose. No burden estimates specific to the forms affected by the proposed regulations are currently available. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations. For the OMB control numbers discussed above, the Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Those estimates capture both changes made by the Act and those that arise out of discretionary authority exercised in the proposed regulations (when final) and other regulations that affect the compliance burden for that form.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. In addition, when available, drafts of IRS forms are posted for comment at *https://apps.irs.gov/app/picklist/list/draftTaxForms.htm*. IRS forms are available at *https://www.irs.gov/forms-instructions*. Forms will not be finalized until after they have been approved by OMB under the PRA.

<table>
<tr><th>Form</th><th>Type of Filer</th><th>OMB Number(s)</th><th>Status</th></tr>
<tr><td rowspan="6">Form 3115</td><td>All other Filers (mainly trusts and estates) (Legacy system)</td><td>1545-2070</td><td>Published in the Federal Register on 2/15/17 by IRS. Public Comment period closed on 4/17/17.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2017/02/15/2017-02985/proposed-information-collection-comment-request</td></tr>
<tr><td>Business (NEW Model)</td><td>1545-0123</td><td>Published in the Federal Register on 10/8/18. Public Comment period closed on 12/10/18.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd</td></tr>
<tr><td>Individual (NEW Model)</td><td>1545-0074</td><td>Limited Scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 3-2019. 60-Day Federal Register notice not published yet for full collection.</td></tr>
<tr><td colspan="3">Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031</td></tr>
<tr><td rowspan="2">Revenue Procedure 2018-31</td><td>IRS Research estimates</td><td>1545-1551</td><td>Published in the Federal Register on 8-31-16. Public Comment period closed on 9/30/16.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2016/08/31/2016-20993/submission-for-omb-review-comment-request</td></tr>
</table>

III. Regulatory Flexibility Act

It is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6).

The Treasury Department and the IRS have estimated the number of business entities that may be affected by the statute and these proposed regulations. The statute and proposed regulations affect only those business entities that use an accrual method of accounting.

Regarding the accrual method of accounting, the Treasury Department and the IRS estimate that approximately 9 percent of business entities with gross receipts of $25 million or less used an accrual method of accounting in taxable year 2016. Furthermore, section 13102 of TCJA modified section 448 to expand the number of taxpayers eligible to use the cash method. In general, C corporations and partnerships with a C corporation partner are now permitted to use the cash receipts and disbursements method of accounting if average annual gross receipts are $25 million or less (up from $5 million or less in 2016). The Treasury Department and the IRS project that in future years, the number of entities with gross receipts not greater than $25 million that will be using the accrual method will be less than 9 percent of all entities with gross receipts not greater than $25 million.

	Number of Returns (Taxable Year 2016) (Thousands)		
Entity	**All Returns**	**Method of Accounting**	
		Accrual	**Cash**
C Corporations			
Gross Receipts > $25 mil.	30	28	2
Gross Receipts <= $25 mil.	1,567	700	867
Total	1,597	728	869
S Corporations			
Gross Receipts > $25 mil.	41	34	7
Gross Receipts <= $25 mil.	4,551	1,140	3,411
Total	4,592	1,174	3,418
Partnerships			
Gross Receipts > $25 mil.	20	17	3
Gross Receipts <= $25 mil.	3,743	860	2,883
Total	3,763	877	2,886
Sole Proprietors and LLCs			
Gross Receipts > $25 mil.	1	1	0
Gross Receipts <= $25 mil.	25,524	358	25,166
Total	25,525	359	25,166
All Entities			
Gross Receipts > $25 mil.	92	80	12
Gross Receipts <= $25 mil.	35,385	3,058	32,327
Total	35,477	3,138	32,339

Source: Statistics of Income data. Cash accounting includes cash, other, and unknown.

Regarding the applicable financial statement, the Treasury Department and the IRS estimate that 235,000 – 250,000 entities with gross receipts of $25 million or less had an audited income statement in taxable year 2016. This is an upper bound estimate of entities that may be affected by these proposed regulations because small entities are less likely to have a financial statement that falls within the definition of AFS in proposed §1.451-3(c)(1) (which generally refers to certified audited financial statements in accordance with GAAP or IFRS). An AFS is generally a financial statement that is certified as being prepared in accordance with GAAP or IFRS that is issued for credit purposes, reporting to shareholders, or other non-tax purpose. The smaller the entity, the less likely that it will engage a CPA firm to audit their financial statements. An AFS does not include financial statements that have only been compiled or reviewed by a CPA firm, which are more affordable for small entities, as these types of statements are not certified as prepared in accordance with GAAP or IFRS.

Affected taxpayers would be required to file Form 3115. As an indicator of whether a taxpayer is likely to have to file a Form 3115, the Treasury Department and the IRS estimated the number of businesses that used the accrual method of accounting, had a financial statement, and indicated they had unearned or deferred income. Approximately 15,000 businesses with gross receipts of $25 million or less fit this category. This is an upper bound estimate of the number of taxpayers relying of Revenue Procedure 2004-34 that will need to file a Form 3115 since some reporting of unearned or deferred income may just have deferral for financial reporting and not tax reporting reasons.

These proposed rules will not have a significant economic impact on small entities affected because the costs to comply with these proposed regulations are not significant. An entity is required to file a Form 3115 (Parts I, II, IV and Schedule B) to change its method of accounting in order to use the deferral method described in proposed §1.451-8(c) or (d). The Treasury Department and IRS plan to provide streamlined procedures for taxpayers to change to the methods of accounting described in proposed §1.451-8(c)1 and (d). See the revenue procedure accompanying these proposed regulations. As noted in this revenue procedure, the estimated cumulative annual reporting and/or recordkeeping burden for the statutory method changes described under OMB control number 1545-1551, before publication of the revenue procedure, is 27,336 respondents, and a total annual reporting and/or recordkeeping burden of 30,580 hours. The estimated annual burden per respondent/recordkeeper under OMB control number 1545-1551 before publication of this revenue procedure varies from 1/6 hour to 8½ hours, depending on individual circumstances, with an estimated average of 1¼ hours. The estimated cumulative annual reporting and/or recordkeeping burden for the method changes described under OMB control number 1545-1551 after that revenue procedure is accounted for is 27,346 respondents, and a total annual reporting and/or recordkeeping burden is 31,479 hours, leaving the average reporting and recordkeeping burden essentially unchanged. These burdens are essentially unaffected by these proposed regulations.

Notwithstanding this certification that the proposed rule would not have a significant economic impact on a substantial number of small entities, the Treasury Department and the IRS invite comments from the public about the impact of this proposed rule on small entities.

Pursuant to section 7805(f), these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "**ADDRESSES**" heading. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. All comments will be available at *http://www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Effect on Other Documents

When finalized, these proposed regulations will obsolete Revenue Procedure 2004-34, Revenue Procedure 2011-18, Revenue Procedure 2013-29 and Notice 2018-35.

Drafting Information

The principal author of these proposed regulations is Peter E. Ford, IRS Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Sections 26 U.S.C. 451(c)(2)(A), (3), (4)(A)(iii), (4)(B)(vii);

Par. 2. Section 1.451-8 is added to read as follows:

§ *1.451-8 Advance payments for goods, services, and certain other items*.

(a) *In general*. Except as provided in paragraph (c) or (d) of this section, an accrual method taxpayer shall include an advance payment in gross income no later than in the taxable year in which the taxpayer receives the advance payment as provided under § 1.451-1(a).

(b) *Definitions*. Except as otherwise provided in this section, the following definitions apply for purposes of this section:

(1) *Advance payment*—(i) *In general*. An advance payment is a payment received by a taxpayer if:

(A) The full inclusion of the payment in the gross income of the taxpayer for the taxable year of receipt is a permissible method of accounting, without regard to this section;

(B) Any portion of the payment is included in revenue by the taxpayer in an applicable financial statement for a subsequent taxable year;

(C) The payment is for:

(*1*) Services;

(*2*) The sale of goods;

(*3*) The use, including by license or lease, of intellectual property, including copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights, such as franchise rights and arena naming rights;

(*4*) The occupancy or use of property if the occupancy or use is ancillary to the provision of services, for example, advance payments for the use of rooms or other quarters in a hotel, booth space at a trade show, campsite space at a mobile home park, and recreational or banquet facilities, or other uses of property, so long as the use is ancillary to the provision of services to the property user;

(*5*) The sale, lease, or license of computer software;

(*6*) Guaranty or warranty contracts ancillary to an item or items described in paragraph (b)(1)(i)(C)(*1*), (*2*), (*3*), (*4*), or (*5*) of this section;

(*7*) Subscriptions in tangible or intangible format. Subscriptions for which an election under section 455 is in effect is not included in this paragraph (b)(1)(i)(C)(*7*);

(*8*) Memberships in an organization. Memberships for which an election under section 456 is in effect are not included in this paragraph (b)(1)(i)(C)(*8*);

(*9*) An eligible gift card sale;

(*10*) Any other payment specified by the Secretary in other guidance published in the Internal Revenue Bulletin (*see* §601.601(d)(2)); or

(*11*) Any combination of items described in paragraphs (b)(1)(i)(C)(*1*) through (*10*) of this section.

(ii) *Exclusions from the definition of advance payment*. An advance payment does not include:

(A) Rent, except for amounts paid with respect to an item or items described in paragraph (b)(1)(i)(C)(*3*), (*4*) or (*5*) of this section;

(B) Insurance premiums, to the extent the inclusion of those premiums is governed by subchapter L;

(C) Payments with respect to financial instruments (for example, debt instruments, deposits, letters of credit, notional principal contracts, options, forward contracts, futures contracts, foreign currency contracts, credit card agreements (including rewards or loyalty points under such agreements), financial derivatives, or similar items), including purported prepayments of interest;

(D) Payments with respect to service warranty contracts for which the taxpayer uses the accounting method provided in Revenue Procedure 97-38 (1997-2 CB 479);

(E) Payments with respect to warranty and guaranty contracts under which a third party is the primary obligor;

(F) Payments subject to section 871(a), 881, 1441, or 1442;

(G) Payments in property to which section 83 applies; and

(H) Payments received in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery date for a specified good.

(2) *Applicable financial statement*. Applicable financial statement has the same meaning as provided in proposed §1.451-3(c)(1).

(3) *Eligible gift card sale*. Eligible gift card sale means the sale of a gift card or gift certificate if:

(i) The taxpayer is primarily liable to the customer, or holder of the gift card, for the value of the card until redemption or expiration; and

(ii) The gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer as payment for items listed in paragraphs (b)(1)(i)(C)(*1*) through (*11*) of this section.

(4) *Performance obligation*. Performance obligation has the same meaning as provided in proposed §1.451-3(c)(3).

(5) *Received*. An item of gross income is received by the taxpayer if it is actually or constructively received, or if it is due and payable to the taxpayer.

(6) *Revenue*. Revenue has the same meaning as provided in proposed §1.451-3(c)(4) and is determined under the rules provided in proposed §1.451-3.

(7) *Transaction price*. Transaction price has the same meaning as provided in proposed §1.451-3(c)(6).

(8) *Contractual delivery date*. Contractual delivery date means the month and year of delivery listed in the written contract to the transaction.

(9) *Specified good*. A specified good means a good for which:

(i) During the taxable year a payment is received, the taxpayer does not have on hand (or available to it in such year through its normal source of supply) goods of a substantially similar kind and in a sufficient quantity to satisfy the contract to transfer the good to the customer; and

(ii) All the revenue from the sale of the good is recognized in the taxpayer's AFS in the year of delivery.

(c) *Deferral method for taxpayers with an applicable financial statement (AFS)*—

(1) *In general*. An accrual method taxpayer with an AFS that receives an advance payment may elect the deferral method described in this paragraph (c) if the taxpayer is able to determine the extent to which advance payments are included in revenue in its AFS in the taxable year received, including a short taxable year (if applicable). A taxpayer that uses the deferral method must:

(i) Include the advance payment, or any portion thereof, in gross income in the taxable year of receipt to the extent included in revenue in its AFS; 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.

(2) *Acceleration of advance payments*—(i) *In general*. A taxpayer that uses the deferral method described in this paragraph (c) must include in gross income for the taxable year of receipt or, if applicable, for a short taxable year described in paragraph (c)(4) of this section, all advance payments not previously included in gross income:

(A) If, in that taxable year, the taxpayer either dies or ceases to exist in a transaction other than a transaction to which section 381(a) applies; or

(B) If, and to the extent that, in that taxable year, the taxpayer's obligation with respect to the advance payments is satisfied or otherwise ends other than in:

(*1*) A transaction to which section 381(a) applies; or

(*2*) A section 351(a) transfer that is part of a section 351 transaction in which:

(*i*) Substantially all assets of the trade or business (including advance payments) are transferred;

(*ii*) The transferee adopts or uses the deferral method in the year of transfer; and

(*iii*) The transferee and the transferor are members of the same consolidated group, as defined in §1.1502-1(h).

(ii) *Example. Ceasing to exist*. A is a calendar year taxpayer and is in the business of selling and licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support. On July 1, 2018, A enters into a 2-year software maintenance contract and receives an advance payment. Under the contract, A will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. A ceases to exist on December 1, 2018, in a transaction that does not involve a section 351(a) transfer described in paragraph (c)(2)(i)(B)(*2*) of this section and is not a transaction to which section 381(a) applies. For federal income tax purposes, A must include the entire advance payment in gross income in its 2018 taxable year.

(3) *Financial statement adjustments*—(i) *In general*. Notwithstanding section 451(c)(4)(A)(ii), if a taxpayer treats an advance payment as an item of deferred revenue in its AFS and writes-down or adjusts that item, or portion thereof, to an equity account (for example, retained earnings) or otherwise writes-down or adjusts that item of deferred revenue in a subsequent taxable year, revenue for that subsequent taxable year includes that item, or portion thereof, that is written down or adjusted.

(ii) *Examples*—(A) *Example 1*. On May 1, 2018, A, a corporation that files its federal income tax return on a calendar year basis, received $100 as an advance payment for a 2-year contract to provide services. For financial accounting purposes, A recorded $100 as a deferred revenue liability in its AFS, expecting to report 1/4 of the advance payment in revenue in its AFS for 2018, 1/2 for 2019, and 1/4 for 2020. On August 31, 2018, C, an unrelated corporation that files its federal income tax return on a calendar year basis, acquired all of the stock of A, and A joined C's consolidated group. A's short taxable year ended on August 31, 2018, and, as of that date, A had included only 1/4 ($25) of the advance payment in revenue in its AFS. On September 1, 2018, after the stock acquisition, and in accordance with purchase accounting rules, C wrote down A's deferred revenue liability to its fair value of $10 as of the date of the acquisition. The $10 will be included in revenue on A's AFS in accordance with the method of accounting A uses for financial accounting purposes. For federal income tax purposes, A uses the deferral method. For federal income tax purposes, A must take 1/4 ($25) of the advance payment into income for its short taxable year ending August 31, 2018, and the remainder of the advance payment ($75) ($65 write down + $10 future financial statement revenue) must be included in income for A's next succeeding taxable year.

(B) *Example 2*. On May 1, 2018, B, a corporation that files its federal income tax return on a calendar year basis, received $100 advance payment for a contract to be performed in 2018, 2019, and 2020. On August 31, 2018, D, a corporation that is not consolidated for federal income tax purposes, acquired all of the stock of B. Before the stock acquisition, on its AFS for 2018, B included $40 of the advance payment in revenue, and $60 as a deferred revenue liability. On September 1, 2018, after the stock acquisition and in accordance with purchase accounting rules, D wrote down its $60 deferred revenue liability to $10 (its fair value) as of the date of the acquisition. After the acquisition, B does not include in revenue any of the $10 deferred revenue liability in its 2018 AFS. B does include $5 in revenue in 2019, and $5 in revenue in 2020. For federal income tax purposes, B uses the deferral method. For federal income tax purposes, B must take $40 of the advance payment into income in 2018, and the remainder of the advance payment ($60) ($50 write down + $10 future financial statement revenue) must be included in income for B's next succeeding taxable year, 2019.

(4) *Short taxable year rule*—(i) *In general*. If the taxpayer's next succeeding taxable year is a short taxable year, other than a taxable year in which the taxpayer dies or ceases to exist in a transaction other than a transaction to which section 381(a) applies, and the short taxable year consists of 92 days or less, a taxpayer using the deferral method must include the portion of the advance payment not included in the taxable year of receipt in gross income for the short taxable year to the extent included in revenue in an AFS. Any amount of the advance payment not included in the taxable year of receipt and the short taxable year must be included in gross income for the taxable year immediately following the short taxable year.

(ii) *Example*. A is a calendar year taxpayer and is in the business of selling and licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support. On July 1, 2018, A receives an advance payment for a 2-year software maintenance contract. Under the contract, A will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. A changes its taxable period to a fiscal year ending March 31 so that A has a short taxable year beginning January 1, 2019, and ending March 31, 2019. In its AFS, A includes 1/4 of the payment in revenue for the taxable year ending December 31, 2018; 1/6 in revenue for the short taxable year ending March 31, 2019; 1/4 in revenue for the taxable year ending March 31, 2020; and 1/4 in revenue for the taxable year ending March 31, 2021. Because the taxable year ending March 31, 2019, is 92 days or less, A must include 1/4 of the payment in gross income for the taxable year ending December 31, 2018, 1/6 in gross income for the short taxable year ending March 31, 2019, and the remaining amount in gross income for the taxable year ending March 31, 2020.

(5) *Financial statement conformity requirement*. A taxpayer that uses the deferral method under this paragraph (c) must use the same financial statement that is used to apply the rules in section 451(b) and the accompanying regulations when applying the deferral method provided in section 451(c) and these regulations.

(6) *Allocation of transaction price*. A taxpayer using the deferral method under this paragraph (c) must use the allocation rules provided in proposed §1.451-3(g).

(7) *Rules relating to eligible gift card sales*. For purposes of paragraphs (b)(1)(i)(B) and (c)(1) of this section, if an eligible gift card is redeemable by an entity described in paragraph (b)(3)(ii) of this section whose financial results are not included in the taxpayer's AFS, a payment will be treated as included by the taxpayer in revenue in its AFS to the extent the gift card is redeemed by the entity during the taxable year.

(8) *Examples*. The following examples illustrate the rules of this paragraph (c). In each example in paragraphs (c)(8)(i) through (xxv) of this section, the taxpayer uses an accrual method of accounting for federal income tax purposes and files its returns on a calendar year basis. Except as stated otherwise, the taxpayer in each example has an AFS.

(i) *Example 1. Services*. On November 1, 2018, A, in the business of giving dancing lessons, receives an advance payment for a 1-year contract commencing on that date and providing for up to 48 individual, 1-hour lessons. A provides eight lessons in 2018 and another 35 lessons in 2019. In its AFS, A includes 1/6 of the payment in revenue for 2018, and 5/6 of the payment in revenue for 2019. A uses the deferral method. For federal income tax purposes, A must include 1/6 of the payment in gross income for 2018, and the remaining 5/6 of the payment in gross income for 2019.

(ii) *Example 2. Services*. Assume the same facts as in Example 1 in paragraph (c)(8)(i) of this section, except that the advance payment is received for a 3-year contract under which up to 96 lessons are provided. A provides eight lessons in 2018, 48 lessons in 2019, and 40 lessons in 2020. In its AFS, A includes 1/12 of the payment in revenue for 2018, 1/2 of the payment in revenue for 2019, and 5/12 of the payment in gross revenue for 2020. For federal income tax purposes, A must include 1/12 of the payment in gross income for 2018, and the remaining 11/12 of the payment in gross income for 2019.

(iii) *Example 3. Goods and Services*. On June 1, 2018, B, a landscape architecture firm, receives an advance payment for goods and services that, under the terms of the agreement, must be provided by December 2019. On December 31, 2018, B estimates that 3/4 of the work under the agreement has been completed. In its AFS, B includes 3/4 of the payment in revenue for 2018 and 1/4 of the payment in revenue for 2019. B uses the deferral method. For federal income tax purposes, B must include 3/4 of the payment in gross income for 2018, and the remaining 1/4 of the payment in gross income for 2019, regardless of whether B completes the job in 2019.

(iv) *Example 4. Repair Contracts*. On July 1, 2018, C, in the business of selling and repairing television sets, receives an advance payment for a

2-year contract under which C agrees to repair or replace, or authorizes a representative to repair or replace, certain parts in the customer's television set if those parts fail to function properly. In its AFS, C includes 1/4 of the payment in revenue for 2018, 1/2 of the payment in revenue for 2019, and 1/4 of the payment in revenue for 2020. C uses the deferral method. For federal income tax purposes, C must include 1/4 of the payment in gross income for 2018 and the remaining 3/4 of the payment in gross income for 2019.

(v) *Example 5*. *Online Website Design*. D, in the business of building and designing websites, receives advance payments that oblige D to build and design various websites. D tracks each request for a website with unique identifying numbers. On July 20, 2018, D receives online payments for 2 websites. One of the website requests is submitted and processed on September 1, 2018, and the other is submitted and processed on February 1, 2020. In its AFS, D includes the payment for the September 1, 2018, website in revenue for 2018 and the payment for the February 1, 2020, website in revenue for 2020. D uses the deferral method. For federal income tax purposes, D must include the payment for the September 1, 2018, website in gross income for 2018 and the payment for the February 1, 2020, website in gross income for 2019.

(vi) *Example 6*. *Gift Cards*. E, a hair styling salon, receives advance payments for gift cards that may later be redeemed at the salon for hair styling services or hair care products at the face value of the gift card. The gift cards look like standard credit cards, and each gift card has a magnetic strip that, in connection with E's computer system, identifies the available balance. The gift cards may not be redeemed for cash and have no expiration date. In its AFS, E includes advance payments for gift cards in revenue when redeemed. E is not able to determine the extent to which advance payments are included in revenue in its AFS for the taxable year of receipt and therefore does not meet this requirement of paragraph (c)(1) of this section. Therefore, E may not use the deferral method for these advance payments.

(vii) *Example 7*. *Gift Cards*. Assume the same facts as in Example 6 in paragraph (c)(8)(vi) of this section, except that the gift cards have an expiration date 12 months from the date of sale, E does not accept expired gift cards, and E includes unredeemed gift cards in revenue in its AFS for the taxable year in which the cards expire. Because E tracks the sale date and the expiration date of the gift cards for purposes of its AFS, E is able to determine the extent to which advance payments are included in revenue for the taxable year of receipt. Therefore, E meets this requirement of paragraph (c)(1) of this section and may use the deferral method for these advance payments.

(viii) *Example 8*. *Online Subscriptions*. G is in the business of compiling and providing business information for a particular industry in an online format accessible over the internet. On September 1, 2018, G receives an advance payment from a subscriber for 1 year of access to its online database, beginning on that date. In its AFS, G includes 1/3 of the payment in revenue for 2018 and the remaining 2/3 in revenue for 2019. G uses the deferral method. For federal income tax purposes, G must include 1/3 of the payment in gross income for 2018 and the remaining 2/3 of the payment in gross income for 2019.

(ix) *Example 9*. *Membership Fees*. On December 1, 2018, H, in the business of operating a chain of "shopping club" retail stores, receives advance payments for membership fees. Upon payment of the fee, a member is allowed access for a 1-year period to H's stores, which offer discounted merchandise and services. In its AFS, H includes 1/12 of the payment in revenue for 2018 and 11/12 of the payment in revenue for 2019. H uses the deferral method. For federal income tax purposes, H must include 1/12 of the payment in gross income for 2018, and the remaining 11/12 of the payment in gross income for 2019.

(x) *Example 10*. *Cruise*. In 2018, I, in the business of operating tours, receives payments from customers for a 10-day cruise that will take place in April 2019. Under the agreement, I charters a cruise ship, hires a crew and a tour guide, and arranges for entertainment and shore trips for the customers. In its AFS, I includes the payments in revenue for 2019. I uses the deferral method. For federal income tax purposes, I must include the payments in gross income for 2019.

(xi) *Example 11*. *Travel agent services*. On November 1, 2018, J, a travel agent, receives payment from a customer for an airline flight that will take place in April 2019. J purchases and delivers the airline ticket to the customer on November 14, 2018. J retains a portion of the customer's payment (the excess of the customer's payment over the cost of the airline ticket) as its commission. Because J is not required to provide any services after the ticket is delivered to the customer, J earns its commission when the airline ticket is delivered. The customer may cancel the flight and receive a refund from J only to the extent the airline itself provides refunds. In its AFS, J includes its commission in revenue for 2019. The commission is not an advance payment because the payment is not earned by J, in whole or in part, in a subsequent taxable year. Thus, J may not use the deferral method for this payment.

(xii) *Example 12*. *Broadcasting Rights*. K, a professional sports franchise, is a member of a sports league that enters into contracts with television networks for the right to broadcast games to be played between teams in the league. The money received by the sports league under the contracts is divided equally among the member teams. The league entered into a 3-year broadcasting contract beginning October 1, 2018. K receives three equal installment payments on October 1 of each contract year, beginning in 2018. In its AFS, K includes 1/4 of the first installment payment in revenue for 2018 and 3/4 in revenue for 2019; K includes 1/4 of the second installment in revenue for 2019 and 3/4 in revenue for 2020; K includes 1/4 of the third installment in revenue for 2020 and 3/4 in revenue for 2021. K uses the deferral method. Each installment payment constitutes an advance payment under paragraph (b)(1) of this section. For federal income tax purposes, K must include 1/4 of the first installment payment in gross income for 2018 and 3/4 in gross income for 2019; 1/4 of the second installment in gross income for 2019 and 3/4 in gross income for 2020; and 1/4 of the third installment in gross income for 2020 and 3/4 in gross income for 2021.

(xiii) *Example 13*. *Insurance Claims Administration*. L is in the business of negotiating, placing, and servicing insurance coverage and administering claims for insurance companies. On December 1, 2018, L enters into a contract with an insurance company to provide property and casualty claims administration services for a 4-year period beginning January 1, 2019. Pursuant to the contract, the insurance company makes four equal annual payments to L; each payment relates to a year of service and is made during the month prior to the service year (for example, L is paid on December 1, 2018, for the service year beginning January 1, 2019). In its AFS, L includes the first payment in revenue for 2019; the second payment in revenue for 2020; the third payment in revenue for 2021; and the fourth payment in revenue for 2022. L uses the deferral method. Each annual payment constitutes an advance payment under paragraph (b)(1) of this section. For federal income tax purposes, L must include the first payment in gross income for 2019; the second payment in gross income for 2020; the third payment in gross income for 2021; and the fourth payment in gross income for 2022.

(xiv) *Example 14*. *Internet Services*. M is a cable internet service provider that enters into contracts with subscribers to provide internet services for a monthly fee (paid prior to the service month). For those subscribers who do not own a compatible modem, M provides a rental cable modem for an additional monthly charge (also paid prior to the service month). Pursuant to the contract, M will replace or repair the cable modem if it proves defective during the contract period. In December 2018, M receives payments from subscribers for January 2019 internet service and cable modem use. In its AFS, M includes the entire amount of these payments in revenue for 2019. M uses the deferral method. Because a subscriber's use of a cable modem is ancillary to the provision of internet services by M, and because the cable modem warranty is ancillary to the use of the cable modem, the payments are advance payments. For federal income tax purposes, M must include the advance payments in gross income for 2019.

(xv) *Example 15*. *License Agreement*. On January 1, 2019, N enters into, and receives advance payments pursuant to, a 5-year license agreement for the use of N's trademark. Under the contract, the licensee pays N both the first-year (2019) license fee and the fifth-year (2023) license fee upon commencement of the agreement. The fees for the second, third, and fourth years are payable on January 1 of each license year. The contract provides the customer with access to N's trademark throughout the term of the agreement. In its AFS, N includes the fees in revenue for the respective license year. N uses the deferral method. For federal income tax purposes, N must include the first-year license fee in gross income for 2019, the second-year and the fifth-year license fee in gross income for 2020, the third-year license fee in gross income for 2021, and the fourth-year license fee in gross income for 2022.

(xvi) *Example 16*. *Computer Software Subscription*. On July 1, 2018, O, in the business of licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support, receives an advance payment for a 2-year "software subscription contract" under which O will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. In its AFS, O includes 1/4 of the payment in revenue for 2018, 1/2 in revenue for 2019, and the remaining 1/4 in revenue for 2020, regardless of when O provides updates or customer support. O uses the deferral method. For federal income tax purposes, O must include 1/4 of the payment in gross income for 2018 and 3/4 in gross income for 2019.

(xvii) *Example 17. Performance Obligation*. P is in the business of licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support. On July 1, 2018, P receives an advance payment of $100 for a 2-year software subscription that includes a 1-year "software maintenance contract" under which P will provide integral software updates within the contract period, as well as a "customer support agreement" for online and telephone customer support. In its AFS, P allocates $80 of the payment to the subscription agreement and $20 to the customer support agreement. With respect to the $80 allocable to the subscription agreement, P includes 1/4 ($20) in revenue for 2018, 1/2 ($40) in revenue for 2019, and the remaining 1/4 ($20) in revenue for 2020 . With respect to the $20 allocable to the customer support agreement, P includes 1/2 ($10) in revenue for 2018, and the remaining 1/2 ($10) in revenue for 2019 regardless of when P provides the customer support. For federal income tax purposes, P must include $30 in gross income for 2018 ($20 allocable to the subscription agreement and $10 allocable to the customer support agreement) and the remaining $70 in gross income for 2019.

(xviii) *Example 18. Gift Cards Administered by Another*. Q corporation operates department stores. U corporation, V corporation, and W corporation are wholly owned domestic subsidiaries of Q that file a consolidated federal income tax return with Q. X corporation is a controlled foreign subsidiary of Q that is prohibited from filing a consolidated return with Q. U sells Brand A goods, V sells Brand B goods, X sells Brand C goods, and Z is an unrelated entity that sells Brand D goods. W administers a gift card program for the Q consolidated group, X, and Z. Pursuant to the underlying agreements, W issues gift cards that are redeemable for goods or services offered by U, V, X, and Z. In addition, U, V, X, and Z sell gift cards to customers on behalf of W and remit amounts received to W. The agreements provide that W is primarily liable to the customer for the value of the gift card until redemption, and U, V, X, and Z are obligated to accept the gift card as payment for goods or services. When a customer purchases goods or services with a gift card at U, V, X, or Z, W reimburses that entity for the sales price of the goods or services purchased with the gift card, up to the total gift card value. In 2018, W sells gift cards with a total value of $900,000, and, at the end of 2018, the unredeemed balance of the gift cards is $100,000. In the consolidated group's AFS, the group includes revenue from the sale of a gift card when the gift card is redeemed. W tracks sales and redemptions of gift cards electronically, is able to determine the extent to which advance payments are included in revenue in its consolidated AFS for the taxable year of receipt, and meets the requirements of paragraph (c)(1) of this section. The payments W receives from the sale of gift cards are advance payments because they are payments for eligible gift cards. Thus, W is eligible to use the deferral method. At the end of 2018, W includes $800,000 in income in its consolidated AFS. Under the deferral method, W must include $800,000 of the payments from gift card sales in gross income in 2018 and the remaining $100,000 of the payments in gross income in 2019.

(xix) *Example 19. Gift Cards of Affiliates*. R is a Subchapter S corporation that operates an affiliated restaurant corporation and manages other affiliated restaurants. These other restaurants are owned by other Subchapter S corporations, partnerships, and limited liability companies. R has a partnership interest or an equity interest in some of the restaurants. R administers a gift card program for participating restaurants. Each participating restaurant operates under a different trade name. Under the gift card program, R and each of the participating restaurants sell gift cards, which are issued with R's brand name and are redeemable at all participating restaurants. Participating restaurants sell the gift cards to customers and remit the proceeds to R, R is primarily liable to the customer for the value of the gift card until redemption, and the participating restaurants are obligated under an agreement with R to accept the gift card as payment for food, beverages, taxes, and gratuities. When a customer uses a gift card to make a purchase at a participating restaurant, R is obligated to reimburse that restaurant for the amount of the purchase, up to the total gift card value. In R's AFS, R includes revenue from the sale of a gift card when a gift card is redeemed at a participating restaurant. R tracks sales and redemptions of gift cards electronically, is able to determine the extent to which advance payments are included in revenue in its AFS for the taxable year of receipt, and meets the requirements of paragraph (c)(1) of this section. The payments R receives from the sale of gift cards are advance payments because they are payments for eligible gift card sales. Thus, for federal income tax purposes, R is eligible to use the deferral method. In the taxable year of receipt, R must include the advance payment in income to the extent included in its AFS, and must include any remaining amount in income in the taxable year following the taxable year of receipt.

(xx) *Example 20. Gift Cards for Domestic and International Hotels*. S is a corporation that operates for the benefit of its franchisee members, who own and operate domestic and international individual member hotels. S collects membership fees from the member hotels in exchange for providing a wide variety of management support services, which include making reservations for customers at the various member hotels. S also administers a gift card program for its members by selling gift cards that may be redeemed for hotel rooms and food or beverages provided by any member hotel. The agreements underlying the gift card program provide that S is entitled to the proceeds from the sale of the gift cards, must reimburse the member hotel for the value of a gift card redeemed, and until redemption remains primarily liable to the customer for the value of the card. In S's AFS, S includes payments from the sale of a gift card when the card is redeemed. S tracks sales and redemptions of gift cards electronically, is able to determine the extent to which advance payments are included in revenue in its AFS for the taxable year of receipt, and meets the requirements of paragraph (c)(1) of this section. The payments S receives from the sale of gift cards are advance payments because they are payments for eligible gift card sales. Thus, for federal income tax purposes, S is eligible to use the deferral method. In the taxable year of receipt, S must include in income the advance payment to the extent included in its AFS, and must include any remaining amount in income in the taxable year following the taxable year of receipt.

(xxi) *Example 21. Discount Voucher*. On December 10, 2018, T, in the business of selling home appliances, sells a washing machine for $500. As part of the sale, T gives the customer a 40 percent discount voucher for any future purchases of T's goods up to $100 in the next 60 days. In its AFS, T treats the discount voucher as a separate performance obligation and allocates $30 of the $500 sales price to the discount voucher. T includes $12 of the amount allocated to the discount voucher in revenue for 2018 and includes $18 of the discount voucher in revenue for 2019. T uses the deferral method. For federal income tax purposes, T must include the $12 allocable to the discount voucher in gross income in 2018 and the remaining $18 allocated to the discount voucher in gross income in 2019.

(xxii) *Example 22. Rewards*. On December 31, 2018, U, in the business of selling consumer electronics, sells a new TV for $1,000 and gives the customer 50 reward points. Each reward point is redeemable for a $1 discount on any future purchase of U's products. The reward points are not redeemable for cash and have a 2-year expiration date. U tracks each customer's reward points and does not sell reward points separately. In its AFS, U treats the rewards points as a separate performance obligation and allocates $45 of the $1,000 sales price to the rewards points. U does not include any of the amount allocated to the reward points in revenue for 2018. U includes $25 of the reward points in revenue for 2019 and $20 of the reward points in revenue for 2020. U uses the deferral method. For federal income tax purposes, U does not include any amount of the reward points in gross income in 2018, and includes the entire $45 allocated to the reward points in gross income in 2019.

(xxiii) *Example 23. Credit Card Rewards*. V, a wholly owned credit card company, issues credit cards. V also has a loyalty program in which cardholders earn reward points for the use of its credit card to make purchases. Each reward point is redeemable for a $1 on any future purchases. V may not use the deferral method because payments under credit card agreements including rewards for credit card purchases are excluded from the definition of an advance payment under paragraph (b)(1)(ii)(C) of this section.

(xxiv) *Example 24. Airline Reward Miles*. On January 1, 2018, W, in the business of transporting passengers on airplanes, sells a customer a $700 airline ticket to fly roundtrip in 2018. As part of the purchase, the customer also receives 7,000 points (air miles) from W to be used for future air travel. In its AFS, W allocates $665 to the roundtrip airfare and $35 to the air miles. In its AFS, the $665 allocated to the airfare is included in Year 1 when the customer takes the roundtrip flight. The $35 allocated to the air miles is deferred and included in Year 3 when the customer redeems the air miles. W uses the deferral method described in paragraph (c) of this section. For federal income tax purposes, the $665 is included in gross income in Year 1 and the $35 allocated to the air miles is included in gross income in Year 2.

(xxv) *Example 25*. *Chargebacks*. Taxpayer X, a manufacturer of pharmaceuticals, is a calendar-year accrual method taxpayer with an AFS. In addition to billing the wholesaler for the sale of the pharmaceuticals at the wholesale acquisition cost under the contract, X generally credits or pays wholesalers a chargeback of 40% of the wholesale acquisition cost for sales made by those wholesalers to qualifying customers. In 2018, X enters into a contract to sell 1,000 units to W, a wholesaler, for $10 per unit, totaling $10,000 (1,000 x $10 = $10,000). The contract also provides that X will issue a 40% chargeback for sales by W to certain qualifying customers. X delivers 600 units to W on December 31, 2018, and bills W $6,000 under the contract. For AFS purposes, X adjusts its revenue by 40% for all sales to W for anticipated chargebacks. As such, in its 2018 AFS, X reports $3,600 ($6,000 - $2,400 = $3,600) of revenue from the contract with W, decreasing revenue by $2,400 (40% x $6,000 = $2,400) for anticipated chargeback claims. For federal income tax purposes, under proposed § 1.451-3(c)(4), X's 2018 revenue is $6,000 because revenue is not reduced for anticipated chargebacks. Because no portion of the $6,000 is included in revenue on an AFS in a subsequent taxable year (that is, on an AFS after 2018), none of the $6,000 is an advance payment under paragraph (b)(1)(i) of this section.

(d) *Deferral method for taxpayers without an AFS (non-AFS deferral method)*—(1) *In general*. Only a taxpayer described in paragraph (d)(2) of this section may elect to use the non-AFS deferral method described in paragraph (d)(4) of this section.

(2) *Taxpayers eligible to use the non-AFS deferral method*. A taxpayer is eligible to use the non-AFS deferral method if the taxpayer does not have an applicable financial statement as defined in proposed §1.451-3(c)(1) and is able to determine the extent to which advance payments are earned in the taxable year of receipt, or a short taxable year, if applicable.

(3) *Advance payment*. For purposes of the non-AFS deferral method, in applying paragraph (b)(1)(i)(B) of this section, an advance payment is any portion of the payment received that is earned by the taxpayer, in whole or in part, in a subsequent taxable year.

(4) *Deferral of advance payments based on when payment is earned*—(i) *In general*. The non-AFS deferral method described in this paragraph (d) is a permissible method of accounting that may be used only by a taxpayer described in paragraph (d)(2) of this section. Under the non-AFS deferral method of accounting, a taxpayer includes the advance payment in gross income for the taxable year of receipt, including, if applicable, a short taxable year described in paragraph (d)(8) of this section, to the extent that it is earned in that taxable year and includes the remaining portion of the advance payment in gross income in the next succeeding taxable year.

(ii) *When payment is earned*. A payment is earned when the all events test described in §1.451-1(a) is met, without regard to when the amount is received, as defined under paragraph (b)(5) of this section, by the taxpayer. If a taxpayer is unable to determine the extent to which a payment is earned in the taxable year of receipt, the taxpayer may determine that amount:

(A) On a statistical basis if adequate data are available to the taxpayer;

(B) On a straight line ratable basis over the term of the agreement if the taxpayer receives advance payments under a fixed term agreement and if it is not unreasonable to anticipate at the end of the taxable year of receipt that the advance payment will be earned ratably over the term of the agreement; or

(C) By the use of any other basis that in the opinion of the Commissioner results in a clear reflection of income.

(5) *Contracts with multiple obligations*—(i) *In general*. If a taxpayer receives a payment that is attributable to more than one item described in paragraph (b)(1)(i)(C) of this section, the taxpayer must allocate the payment to such items in a manner that is based on objective criteria.

(ii) *Objective criteria*. A taxpayer's allocation method with respect to a payment described in paragraph (d)(5)(i) of this section is based on objective criteria if the allocation method is based on payments the taxpayer regularly receives for an item or items it regularly sells or provides separately or any method that may be provided in guidance published in the Internal Revenue Bulletin (*see* §601.601(d) of this chapter).

(6) *Acceleration of advance payments*. For purposes of this paragraph (d), the acceleration rules provided in paragraph (c)(2) of this section apply to a taxpayer that uses the non-AFS deferral method.

(7) *Advance payments in certain acquisitions and other financial statement adjustments*. For purposes of this paragraph (d), the rules provided in paragraph (c)(3) of this section apply to a taxpayer that uses the non-AFS deferral method.

(8) *Short taxable year rule*. For purposes of this paragraph (d), the short taxable year rule provided in paragraph (c)(4) of this section applies to a taxpayer that uses the non-AFS deferral method.

(9) *Eligible gift card sale*. For purposes of paragraphs (b)(1)(i)(B) and (d)(4) of this section, if an eligible gift card is redeemable by an entity described in paragraph (b)(3)(ii), including an entity whose financial results are not included in the taxpayer's financial statement, a payment will be treated as earned by the taxpayer to the extent the gift card is redeemed by the entity during the taxable year.

(10) *Examples*. The rules of this paragraph (d) are illustrated by the examples in paragraphs (d)(10)(i) and (ii). In each of these examples, the taxpayer uses the non-AFS deferral method described in this paragraph (d).

(i) *Example 1*. A, a video arcade operator, receives payments in 2018 for game tokens that are used by customers to play the video games offered by A. The tokens cannot be redeemed for cash. The tokens are imprinted with the name of the video arcade, but they are not individually marked for identification. A completed a study on a statistical basis, based on adequate data available to A, and concluded that for payments received in the current year, x percent of tokens are expected to be used in the current year, y percent of tokens are expected to be used in the next year, and the remaining z percent of tokens are expected to never be used. Based on the study, A treats as earned for 2018 x percent (for tokens expected to be used in that year) as well as z percent (for tokens that are expected to never be used). Using the study, A determines the extent to which advance payments are earned in the taxable year of receipt. A may determine the extent to which a payment is earned in the taxable year of receipt on a statistical basis provided that any portion that is not included in the taxable year of receipt is included in the next succeeding taxable year. Thus, for federal income tax purposes, A must include x percent and z percent of the advance payments in gross income for 2018 and y percent of the advance payments in gross income for 2019.

(ii) *Example 2*. B is in the business of providing internet services. On September 1, 2018, B receives an advance payment from a customer for a 2-year term for access to its internet services, beginning on that date. B does not have an AFS. B is unable to determine the extent to which the payment is earned in the taxable year of receipt. For federal income tax purposes, B may determine the extent to which the payment is earned in the year of receipt on a straight line ratable basis over the term of the agreement if it is not unreasonable to anticipate at the end of the taxable year of receipt that the advance payment will be earned ratably over the term of the agreement.

(e) *Method of accounting*. The use of the deferral method under paragraph (c) of this section or the non-AFS deferral method under paragraph (d) of this section is the adoption of, or a change in, a method of accounting under section 446 of the Internal Revenue Code or the accompanying regulations. In addition, a change in the manner of recognizing advance payments in revenue in an AFS that changes or could change the timing of the inclusion of income for federal income tax purposes is a change in method of accounting under section 446 and the accompanying regulations. A taxpayer may change its method of accounting to use the methods described in paragraphs (c) or (d) of this section, or change its manner of recognizing advance payments in revenue in an AFS only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations.

(f) *Applicability date*. The rules of this section are applicable for taxable years beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2017, provided that the taxpayer applies all the applicable rules contained in these proposed regulations, and consistently applies these proposed regulations to all advance payments. See section 7805(b)(7).

Kirsten Wielobob,
Deputy Commissioner for Services
and Enforcement.

(Filed by the Office of the Federal Register on September 5, 2019, 4:15 p.m., and published in the issue of the Federal Register for September 9, 2019, 84 F.R. 47191)

Notice of Proposed Rulemaking

Taxable Year of Income Inclusion under an Accrual Method of Accounting REG-104870-18

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the timing of income inclusion under section 451 of the Internal Revenue Code (Code). The proposed regulations reflect changes made by the Tax Cuts and Jobs Act. These proposed regulations affect taxpayers that use an accrual method of accounting and have an applicable financial statement.

DATES: Written or electronic comments and requests for a public hearing must be received by November 8, 2019.

ADDRESSES: Send submissions to Internal Revenue Service, CC:PA:LPD:PR (REG-104870-18), Room 5205, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to Courier's Desk, Internal Revenue Service, CC:PA:LPD:PR (REG-104870-18), 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, persons may submit comments electronically via the Federal eRulemaking Portal at http://www.regulations.gov (IRS REG-104870-18).

FOR FURTHER INFORMATION CONTACT: Concerning §§1.446-2, 1.451-3(d), 1.451-3(i), 1.1275-2(l), and any other provisions within the jurisdiction of the Associate Chief Counsel (Financial Institutions and Products), Charles Culmer, (202) 317-4528; concerning the rest of the proposed regulations, Charles Gorham, (202) 317-5091; concerning submissions of comments and requests for a public hearing, Regina L. Johnson, (202) 317-6091 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 451(b). On December 22, 2017, section 451(b) was amended by section 13221 of the Tax Cuts and Jobs Act, Public Law No. 115-97 (131 Stat. 2054) (the Act) to provide that, for a taxpayer using an accrual method of accounting, the all events test with respect to any item of gross income (or portion thereof) is not treated as met any later than when the item (or portion thereof) is included in revenue for financial accounting purposes on an applicable financial statement (AFS) or other financial statement specified by the Secretary. The amendments made to section 451(b) do not change the time at which income subject to the all events test is taken into income for accrual method taxpayers without an AFS or other specified financial statement. Unless otherwise indicated, all references to section 451(b) hereinafter are references to section 451(b), as amended by the Act.

In general, section 451 provides that the amount of any item of gross income is included in gross income for the taxable year in which it is received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Under §1.451-1, accrual method taxpayers generally include items of income in gross income in the taxable year when all the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (the all events test). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. Revenue Ruling 2003-10 (2003-1 CB 288); Revenue Ruling 84-31 (1984-1 CB 127); Revenue Ruling 80-308 (1980-2 CB 162).

On April 12, 2018, the Treasury Department and the IRS issued Notice 2018-35 (2018-18 IRB 520) requesting, in part, comments on future guidance under section 451(b). The record of public comments received in response to Notice 2018-35 may be requested by sending an email to Notice.comments@irscounsel.treas.gov. This document provides guidance on the application of section 451(b) taking into account comments that were received regarding section 451(b). The application of section 451(c) is addressed in separate guidance published in the same issue of the **Federal Register** as these proposed regulations.

Explanation of Provisions

The proposed regulations describe and clarify the statutory requirements of section 451(b) by providing new §1.451-3.

1. *Applicability of Section 451(b)(1)*

Section 451(b)(1) generally provides that, for an accrual method taxpayer with an AFS or other specified financial statement, the all events test with respect to any item of gross income, or portion thereof, is not treated as met any later than when such item, or portion thereof, has been taken into account as revenue in an AFS or other specified financial statement (the AFS income inclusion rule). The AFS income inclusion rule generally increases financial accounting and tax accounting conformity. On May 28, 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly announced new financial accounting standards for revenue recognition, titled "Revenue from Contracts with Customers (Topic 606)." See ASC Topic 606 and IASB International Financial Reporting Standard (IFRS) 15 (New Standards). Under the New Standards, items of income may be included as revenue in an AFS earlier than they would have been included in income under the all events test prior to the Act.

A. Taxpayers Subject to the AFS Income Inclusion Rule

The proposed regulations clarify how the AFS income inclusion rule applies to accrual method taxpayers with an AFS. Some taxpayers use an accrual method of accounting for all applicable items of income (overall accrual method taxpayers) and others use an accrual method of accounting for only some items of income. Both types of taxpayers (collectively, accrual method taxpayers) compute taxable income, at least in part, under an accrual method. Accordingly, proposed §1.451-3(b) provides that the AFS income inclusion rule generally applies to accrual method taxpayers with an AFS when the timing of income inclusion for one or more items of income is determined using the all events test.

The proposed regulations do not include special rules regarding the applicability of the AFS income inclusion rule to foreign persons. The Treasury Department and the IRS are aware that applying the AFS income inclusion rule to a controlled foreign corporation (CFC) may create mismatches between the CFC's taxable income for U.S. Federal and foreign tax purposes. As a result, certain taxpayers may lose the ability to credit foreign taxes imposed on a CFC's income, particularly where such taxes relate to amounts includible in gross income under section 951A and are therefore ineligible to be carried back or forward under section 904(c). Comments are requested regarding whether special rules are needed to address the applicability of the AFS income inclusion rule to foreign persons, including whether and how the rules for determining the taxable income of a CFC can be adjusted to better align the U.S. Federal and foreign income tax bases.

B. Exceptions to the AFS Income Inclusion Rule

Proposed §1.451-3(d) clarifies that the AFS income inclusion rule applies only to taxpayers that have one or more AFS covering the entire taxable year. This approach is consistent with the exception in section 451(b)(1)(B)(i), which provides that the AFS income inclusion rule does not apply to taxpayers without an AFS for a taxable year. In addition, some accrual method taxpayers may have an AFS in one taxable year and no AFS in another taxable year. To address this situation, the proposed regulations provide that the AFS income inclusion rule applies on a year-by-year basis and, therefore, an accrual method taxpayer with an AFS in one taxable year that does not have an AFS in another taxable year must apply the AFS income inclusion rule in the taxable year that it has an AFS, and does not apply the rule in the taxable year in which it does not have an AFS.

Consistent with section 451(b)(1)(B)(ii), proposed §1.451-3(d) also provides that the AFS income inclusion rule does not apply to items of income in connection with a mortgage servicing contract. A letter addressed to the Treasury Department indicated that it is unclear whether this exclusion can be applied to income relating to interest rate lock commitments (IRLCs) entered into by mortgage lenders. The proposed regulations do not address this issue because section 475 generally would require mortgage lenders to include income relating to IRLCs in taxable income in accordance with the mark-to-market method of accounting. As a result, a mortgage lender generally would not apply section 451(b) to determine when income relating to IRLCs is includible in income.

C. Transactions Treated Differently for Federal Income Tax and AFS Purposes

Except as provided in proposed §1.451-3(e), proposed §1.451-3(e) clarifies that the AFS income inclusion rule does not change the treatment of a transaction for Federal income tax purposes. The treatment of a transaction or event in a taxable year may be different for Federal income tax and AFS purposes. For example, a rental agreement that is treated as a lease for Federal income tax purposes may be treated as a sale or financing for AFS purposes, or vice versa. Similarly, a transaction that is deemed to occur (for example, under a mark-to-market method) for AFS purposes may not be deemed to occur for Federal income tax purposes. The AFS income inclusion rule generally was not intended to require taxpayers to recharacterize a transaction for Federal income tax purposes to conform to the characterization of the transaction in the taxpayer's AFS. As stated in the Conference Report, "The provision 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 Federal income tax realization event has not yet occurred." H.R. Rep. No. 115-466, at 428 fn. 872 (2017) (Conf. Rep.).

However, as also stated in the Conference Report, the AFS income inclusion rule was intended to include unbilled receivables for partially performed services:

> "Under the provision, an accrual method taxpayer with an applicable financial statement will include an item in income under section 451 upon the earlier of when the all events test is met or when the taxpayer includes such item in revenue in an applicable financial statement. For example, under the provision, any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes."

H.R. Rep. No. 115-466, at 428 fn. 874 (2017) (Conf. Rep.). Commenters suggested that the intent to include unbilled receivables conflicts with the intent to not change the treatment of a transaction to match the taxpayer's AFS treatment. The Treasury Department and the IRS do not agree. In applying the AFS income inclusion rule to unbilled receivables, a taxpayer is not changing the treatment of the transaction when it includes in income amounts included in its AFS. Moreover, these proposed regulations also apply to unbilled receivables for the sale of goods because there is no distinction in section 451(b) between unbilled receivables for services and unbilled receivables for the sale of goods, and service providers and sellers of goods that are including unbilled receivables in revenue for AFS purposes should be treated similarly for Federal income tax purposes under section 451(b). Accordingly, the proposed regulations provide that the AFS inclusion rule applies to unbilled receivables included in revenue for AFS purposes related to both services and goods.

Commenters raised concerns about the interaction between sections 61 and 461 with the AFS income inclusion rule. For AFS purposes, taxpayers may be required to include variable consideration when determining the transaction price of a contract. Under the New Standards, variable consideration includes items such as discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, and other similar items. Variable consideration may also include promised consideration that taxpayers are not yet entitled to under the contract because it is contingent on the occurrence or nonoccurrence of a future event. For Federal income tax purposes, these items of variable consideration may be contingent future income under section 61 or liabilities subject to section 461. Section 451(b) could be read to accelerate the timing of contingent future income and liabilities to match their inclusion in revenue for AFS purposes. However, section 451(b) was intended to change only the timing of income to ensure that those items of income are not included later than when they are included for AFS purposes. See H.R. Rep. No. 115-466, at 428 fn. 874 (2017) (Conf. Rep.) and Joint Committee on Taxation, General Explanation of Public Law 115-97 (JCS-1-18) at 166 (Dec. 20, 2018). Accordingly, proposed §1.451-3(c)(6) provides that the transaction price that is used to determine whether an amount has been included in revenue does not include items to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event, reductions for amounts subject to section 461 (including allowances, adjustments, rebates, chargebacks, refunds, rewards, and amounts included in the cost of goods sold), and amounts collected for third parties. However, in order to reduce compliance burden and prevent abuse and undue administrative burden, proposed §1.451-3(c)(6) presumes that an amount included in the transaction price for AFS purposes is not contingent future income unless, upon examination of all of the facts and circumstances existing at the end of the taxable year, it can be established to the satisfaction of the Commissioner that the amount is contingent on the occurrence or nonoccurrence of a future event.

In addition, section 451(b) was intended to accelerate income inclusion when (i) the taxpayer's customer controls the asset that is created or enhanced, or (ii) the taxpayer has a right to partial payment, even when a contract requires delivery, acceptance, and title transfer before a taxpayer can bill its customer. See Examples 2 and 4 of the Joint Committee on Taxation, General Explanation of Public Law 115-97 (JCS-1-18) at 162-163 (Dec. 20, 2018). Accordingly, proposed §1.451-3(c)(6)(ii) provides that an amount included in the transaction price for AFS purposes may not be treated as contingent on the occurrence or nonoccurrence of a future event if the taxpayer has been paid or has an equitable, contractual, or other right to partial payment for performance completed to date. Additionally, proposed §1.451-3(c)(6)(iii) provides that transaction price may not be reduced for amounts subject to section 461, including, in the case of credit card transactions, reward amounts.

Comments are requested on the interaction among sections 61, 461, and 451(b), and specific situations in which future contingent income and liabilities might be included in revenue for AFS purposes. Comments are requested, for example, on the applicability of the proposed rules to escalating rental agreements not subject to section 467, where amounts included in revenue in an AFS as rent for one year of a multi-year rental agreement exceed actual rent received for that year. Specifically, does the excess of the amount included in revenue as rent over the amount of actual rent in a particular year represent a contingency or merely an allocation of the overall transaction price? Comments are requested on the extent to which certain contract terms might affect the result. Comments also are requested on the proposed presumption that the AFS income inclusion rule should apply when an item is included in revenue in an AFS and what a taxpayer should be required to demonstrate in order to successfully rebut the presumption. Finally, comments are requested on how reassessments of variable consideration after the taxable year of the commencement of the contract should be treated for Federal income tax purposes.

D. Interaction with Exclusion Provisions and Effect on Non-Recognition Transactions

Commenters noted that the AFS income inclusion rule may appear to overturn numerous exclusion provisions and adversely affect the treatment of non-recognition transactions in the Code. For example, the AFS income inclusion rule could be read to apply to a transaction that is treated as a sale of property with profit or loss for AFS purposes but that is treated as a reorganization under section 368 for Federal income tax purposes. The proposed regulations clarify that the AFS income inclusion rule does not change the applicability of any exclusion provision, or the treatment of non-recognition transactions, in the Code, the Income Tax Regulations, or other guidance published in the Internal Revenue Bulletin, consistent with Congressional intent that the provision does not revise the rules associated with the time at which an item is realized for Federal income tax purposes. H.R. Rep. No. 115-466, at 428 fn. 872 (2017) (Conf. Rep.) and Joint Committee on Taxation, General Explanation of Public Law 115-97 (JCS-1-18) at 166 (Dec. 20, 2018).

E. Special Methods of Accounting

Section 451(b)(2) provides that the AFS income inclusion rule does not apply to any item of gross income for which the taxpayer uses a special method of accounting provided under any provision of Chapter 1, other than any provision of part V of subchapter P. Commenters raised questions about the interaction between the AFS income inclusion rule and special methods of accounting. In response, proposed §1.451-3(b) amplifies the meaning of the term "special method of accounting" and, except as provided in proposed §1.451-3(b), provides that the AFS income inclusion rule does not apply to any item of income, or portion of an item of income, when the timing of income inclusion is determined under a required or permitted special method of accounting used for Federal income tax purposes. The proposed regulations also clarify that when a taxpayer uses a special method of accounting, the special method of accounting determines the timing of the income inclusion. The proposed regulations provide a non-exclusive list of examples of special methods of accounting. In addition, the proposed regulations make clear that because the AFS income inclusion rule affects the time at which the all events test is met, the rule applies only to items of income that are subject to the all events test. For a discussion of special methods of accounting under the provisions of part V of subchapter P (relating to income from certain debt instruments), see section 7 of this preamble.

2. *Application of the AFS Income Inclusion Rule to Multi-year Contracts*

Section 451(b) does not address how to apply the AFS income inclusion rule and all events test to a multi-year contract. Proposed §1.451-3(k) provides that a taxpayer with a multi-year contract applies the all events test by applying a cumulative approach reflecting amounts previously included under section 451 rather than an annualized approach.

An annualized approach would look at payments received in each taxable year in isolation and compare the amounts included in the taxpayer's AFS and under the all events test to determine whether an amount should be included for Federal income tax purposes. This approach would generally result in an overall acceleration of income relative to income included in revenue for AFS purposes, could cause amounts to be included for Federal income tax purposes earlier than under a contract's terms, and could result in double counting of income. Section 451(b)(1) does not require this treatment.

A cumulative approach better reflects the economic reality of a multi-year transaction. Accordingly, the proposed regulations require taxpayers to take into account the cumulative amounts previously included in prior taxable years in determining a given contract year's income inclusions under section 451(b)(1). Comments are requested regarding the treatment of multi-year contracts under the AFS income inclusion rule.

3. *Applicable Financial Statement (AFS)*

The proposed regulations describe and clarify the definition of AFS under section 451(b)(3). Section 451(b)(3) generally defines AFS to mean financial statements prepared according to generally accepted accounting principles (GAAP financial statements), certain financial statements prepared according to international financial reporting standards (IFRS financial statements), and financial statements filed with certain regulatory or government bodies. Section 451(b)(1)(A)(ii) provides the Secretary with authority to specify other financial statements for purposes of section 451(b)(1).

The list of financial statements qualifying as an AFS under section 451(b)(3) is similar, but not identical, to the list of financial statements in Revenue Procedure 2004-34 (2004-1 CB 991). The general priority for identifying the AFS in section 451(b)(3)(A) through (C) is similar to the priority provided in Revenue Procedure 2004-34. Certain financial statements that have traditionally been treated as AFS under Revenue Procedure 2004-34, such as IFRS financial statements used for (1) credit purposes, (2) reporting to shareholders, partners, or other proprietors or to beneficiaries, and (3) any other substantial nontax purposes, are not expressly included in section 451(b)(3). However, the legislative history indicates that Congress intended for Revenue Procedure 2004-34 to be followed. See H.R. Rep. No. 115-466, at 429 (2017) (Conf. Rep.). Accordingly, proposed §1.451-3(c)(1) is generally consistent with the list of AFS from Revenue Procedure 2004-34.

The proposed regulations also clarify the financial statements filed with certain regulatory or government bodies that qualify as an AFS under section 451(b)(3)(C), which is similar to section 4.06(3) of Revenue Procedure 2004-34. The proposed regulations clarify that financial statements that are filed with a state government or state agency, or a self-regulatory organization, also qualify as an AFS under section 451(b)(3)(C). For example, the Financial Industry Regulatory Authority and state agencies that regulate insurance companies or public utilities are agencies requiring reports that qualify as an AFS.

Proposed §1.451-3(h) addresses various issues relating to how financial results are reported for certain taxpayers. These proposed regulations propose rules consistent with the rules provided in §1.56-1 because Congress indicated a desire for rules similar to those found in Revenue Procedure 2004-34 and the rules in Revenue Procedure 2004-34 follow certain rules in §1.56-1. See IRS Announcement 2004-48 (2004-22 IRB 998).

Section 451(b)(5) and proposed §1.451-3(h)(1), (2), and (3) provide that, for purposes of the general rule in section 451(b)(1), if the financial results of a taxpayer are reported on the AFS, as defined in section 451(b)(3), for a group of entities, such statement shall be treated as the AFS of the taxpayer. When a consolidated or combined AFS or other financial statement lists items separately for each member taxpayer, the amount of revenue attributable to a particular taxpayer is determined based on its respective separately stated item. If the amounts are aggregated, however, the taxpayer must rely on the source documents that were used to create the group's AFS to determine its percentage of each aggregated item reported on the consolidated or combined AFS. The source documents should be used to determine the taxpayer's respective share of revenue on the AFS, so as to properly reflect the correct amount of gross income under section 451(b).

Proposed §1.451-3(h)(4) provides guidance for taxpayers with a financial reporting period that is different than the taxpayer's taxable year. The proposed regulations provide that the taxpayer must use one of three permissible methods in order to determine whether an item of income has been included in revenue on an AFS. Under one method a taxpayer uses the accounting principles used to create its AFS to determine the items of income to be reported in revenue as if its financial reporting period coincided with its taxable year. Under the second method a taxpayer makes a reasonable estimate of revenue for the pro rata portion of the taxable year for which the financial statement year and taxable year do not align. Under the third method, if a taxpayer's financial accounting year ends five or more months after the end of its taxable year, the taxpayer computes revenue based on the revenue reported on the AFS for the financial accounting year ending within its taxable year.

Proposed §1.451-3(h)(5) provides guidance on a restatement of a taxpayer's financial statements. The rules generally provide that the taxpayer must determine the reason for the restatement of the AFS. For example, if a taxpayer restates revenue on an AFS and such restatement changes the time at which an item of income or a portion thereof is taken into account as revenue on the AFS, the change constitutes a change in method of accounting under section 446. This rule is consistent with current practice regarding the determination of a change in method of accounting.

The regulations under section 6001 require a taxpayer to keep books and records sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in an income tax return, which includes the identification of items includible in gross income under section 451. This requirement includes any books and records sufficient to establish a taxpayer's calculation of income when its financial results are included in an AFS of a group of entities.

4. *Revenue in an AFS*

Proposed §1.451-3(c)(4) defines the term revenue for purposes of section 451(b)(1) broadly to include all items of income under section 61 (gains, profits, and income for Federal income tax purposes). This definition is consistent with the current application of the all events test under §1.451-1(a) and ensures greater financial accounting and tax accounting conformity.

One commenter discussed the effect of the New Standards on sections 451(b) and (c). The commenter noted that, under the New Standards, certain revenue may be included earlier than under section 451 prior to amendment by the Act. The commenter also noted that an amount booked to retained earnings should be treated as revenue for purposes of section 451(b) even though that amount may not be shown as book revenue for financial accounting purposes. A narrow reading of the term revenue could result in items of income that are taken into account on an AFS and that otherwise would be required to be included in gross income escaping section 451(b) altogether. For example, taxpayers may include items, or portions of items, in other comprehensive income on an AFS that are excluded from the revenue line(s) on the AFS. Accordingly, a broad reading of revenue ensures that the correct amount of income that is taken into account in an AFS is subject to section 451(b).

Multiple commenters proposed allowing a cost offset when income is included under the AFS income inclusion rule. For example, one commenter suggested that, in determining the amount of income to include under section 451(b), taxpayers selling goods should reduce AFS revenue by the cost of goods sold associated with a sale that does not presently reduce AFS revenue. The commenter acknowledged that costs are not taken into account for Federal income tax purposes until the all events test is satisfied, which includes the economic performance rules under section 461. Because of the resulting inconsistency with sections 461 and 471, these regulations do not follow the commenter's suggestion that a cost offset or cost of goods sold reduction should apply without regard to the economic performance rules of section 461 and inventory accounting rules of section 471.

Congress has addressed various cost recovery mechanisms in the past. In 1955, Congress repealed the reserve method for estimated expenses under section 462 of the Code. See An Act to Repeal Sections 452 and 462 of the Internal Revenue Code of 1954, Public Law No. 84-74, section 1(b) (1955). Section 462 of the Code was a companion to section 452, which allowed taxpayers to report certain types of prepaid income over time. In the Senate Report discussing the repeal of sections 452 and 462, Congress noted that "the problem presented by section 462 is that of the timing of deductions when a taxpayer changes accounting methods." S. Rep. 84-372, at 4 (1955). The Senate noted that taxpayers would be entitled to the deductions even without section 462. In addition, section 462 increased the possibility of distortions of income because expenses were being deducted when the amount had not yet been incurred.

Thirty years later, Congress repealed the use of the reserve method for determining losses from bad debts under section 166 in the Tax Reform Act of 1986. In repealing the reserve method, Congress noted that this method was inconsistent with the rules for other deductions under the all events test and could result in deductions being allowed for Federal income tax purposes for losses that may never occur. S. Rep. No. 99-313, at 155 (1986). Moreover, "if a deduction is allowed prior to the taxable year in which the loss occurs, the value of the deduction to the taxpayer will be overstated." S. Rep. No. 99-313, at 155 (1986).

These proposed regulations do not allow a cost offset provision because similar potential distortions of income could result. An allowance to account for future cost of goods sold, for future estimated costs, or other cost offsets also is inconsistent with sections 461 (in particular section 461(h)), 263A, and 471, and the regulations under those sections. In addition, these proposed regulations do not allow a cost offset provision because there is nothing in the statute or legislative history that indicates that in amending section 451 Congress intended to change sections 461, 263A or 471, and the regulations under those sections. See also, General Explanation of Public Law 115-97 (JCS-1-18) at 150-151, and 164-165 (Dec. 20, 2018).

Nevertheless, the Treasury Department and the IRS continue to consider whether any exceptions are an appropriate use of the Secretary's authority under section 461(h) or 460. To facilitate further consideration of any potential exceptions, detailed comments that specifically address the following issues are requested:

1. Under what authority would it be appropriate for the Secretary to permit a taxpayer to use a book percentage-of-completion method (PCM) as its tax method? When inventory is involved, what limitations could be instituted to ensure that book PCM could not be used to recover costs related to inventoriable goods prior to the time when such costs could be recovered under sections 471 and 263A? Under what specific authority would it be appropriate to permit a book PCM method to be used to recover costs related to inventoriable goods?
2. Would elective use of book PCM for tax purposes provide an appropriate cost offset? Would such a method be characterized as one that reports contract revenue according to a taxpayer's book method, while accounting for costs, including nondeductible costs, as deductions under the Code? If not, how would such a method account for costs for Federal income tax purposes?
3. Rather than make book PCM elective, would it be appropriate for the definition of "unique item" for purposes of section 460 to be expanded?
4. Section 460 requires use of the look-back method to compensate for improper acceleration or deferral of income under PCM. It also requires that all contract income be reported no later than the year following contract completion. Would elective use of a PCM under section 460 without these provisions invite abuse? If so, how could such abuse be prevented?

5. *Allocation of Transaction Price*

The proposed regulations describe and clarify the allocation of transaction price under section 451(b)(4). Section 451(b)(4) provides that, in the case of a contract with 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 such item in revenue in the AFS of the taxpayer. Consistent with the definition of performance obligation found in the New Standards, proposed §1.451-3(c)(3) defines "performance obligation" to mean a promise in a contract with a customer to transfer to the customer either a good or service (or a bundle of goods or services) that is distinct, or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. See ASC Topic 606 and IFRS 15.

Comments are requested on allocation of the transaction price (i) to performance obligations that are not contractually based, (ii) for arrangements that include both income subject to section 451 and long-term contracts subject to section 460, and (iii) when the income realization event for Federal income tax purposes differs from the income realization event for AFS purposes.

6. *Taxpayers Including Income Over Time for AFS Purposes*

Commenters proposed allowing taxpayers that include items of income as revenue in an AFS over a period of time under the New Standards (AFS over-time method) to follow that method for Federal income tax purposes. Allowing taxpayers to follow their AFS over-time method for Federal income tax purposes would potentially defer income beyond what is permitted under section 451(b), section 451(c), and the all events test. The AFS income inclusion rule operates only to accelerate income inclusion; the AFS income inclusion rule can never cause income inclusion to occur later than when the all events test is satisfied. Allowing taxpayers to follow their AFS over-time method for Federal income tax purposes may also affect the treatment of costs in a manner that is inconsistent with sections 461 and 471. However, the Treasury Department and the IRS continue to study the commenters' proposal and request additional comments on this issue. Specifically, additional comments are requested regarding: the size of taxpayers likely to be affected; the industries likely to be affected; the number of taxpayers likely to be affected; the compliance burden and administrative complexity likely to be avoided; and the degree to which an over-time method under the New Standards accelerates or defers income relative to the all events test and the AFS income inclusion rule.

7. *Rules for Certain Debt Instruments*

A. Credit Card Fees and Other Fees

The Treasury Department and the IRS have treated certain credit card fees associated with pools of credit card receivables as creating or increasing original issue discount (OID) on those pools. See Revenue Procedure 2004-33 (2004-1 CB 989) (the IRS will not challenge the treatment of late fees as creating or increasing OID); Revenue Procedure 2005-47 (2005-2 CB 269) (the IRS will not challenge the treatment of cash advance fees as creating or increasing OID); Revenue Procedure 2013-26 (2013-22 IRB 1160) (safe harbor method of accounting for OID on a pool of credit card receivables for purposes of section 1272(a)(6)); and Chief Counsel Notice CC-2010-018 (Sept. 27, 2010) (as a result of the Tax Court's decision in *Capital One Financial Corp. and Subsidiaries v. Commissioner*, 133 T.C. 136 (2009), the IRS will no longer challenge or litigate the issue of whether interchange fee income creates or increases OID).

With the enactment of section 451(b), however, Congress expressed its intention to overturn the tax treatment of those credit card fees as OID, including the use of the OID timing rules, and subject them to the all events test. The Conference Report to the Act states, "[section 451(b)] directs accrual method taxpayers with an applicable financial statement to apply the income recognition rules under section 451 before applying the special rules under part V of subchapter P …" (which includes the OID rules). H.R. Rep. No. 115-466, at 428 (2017) (Conf. Rep.). In particular, the legislative history describes the treatment of credit card late fees, credit card cash advance fees, and interchange fees as creating or increasing OID for Federal tax purposes and lists these fees as examples of amounts to which section 451(b), as amended, would apply. Id. at 427, 429. These three credit card fees are not generally treated as discount for AFS purposes.

Congress clearly expressed its intention to overturn the tax treatment of credit card late fees, cash advance fees, and interchange fees (specified credit card fees) and to subject these fees to the all events test as modified by section 451(b). Id. at 429. The legislative history quoted in the preceding paragraph further suggests that Congress intended that other fees associated with a lending transaction that might otherwise be accounted for in calculating OID are to be subjected to the AFS income inclusion rule before the application of the OID rules. Based on the legislative history, however, taxpayers have stated that section 451(b) was not intended to affect the application of the general OID timing rules to OID other than with respect to items not treated as discount for financial reporting purposes, such as the specified credit card fees. Id. at 427-429. Moreover, taxpayers have stated that the application of section 451(b) to OID other than items not treated as discount for financial reporting purposes would result in significant administrative burden and very little additional tax revenue. The Treasury Department and the IRS agree with commenters on this issue. Therefore, in the absence of a clear indication in the legislative history that Congress intended for section 451(b) to override the general timing rules for OID, and in order to reduce administrative burden, the proposed section 451(b) regulations would not apply to determine the time at which OID generally is includible in income. See §1.451-3(c)(5)(ix) of the proposed regulations.

The proposed regulations contain two provisions that implement Congressional intent regarding the treatment of fees, including the specified credit card fees. First, under proposed §1.451-3(i), if a fee is not treated by a taxpayer as discount or as an adjustment to the yield of a debt instrument over the life of the instrument (such as points) in its AFS and the fee otherwise would be treated as creating or increasing OID for Federal income tax purposes (specified fee), then the rules in the proposed regulations under section 451(b) apply before the rules in sections 1271 through 1275 and the regulations thereunder. For example, proposed §1.451-3(i) applies to the specified credit card fees. Second, proposed §1.1275-2(l) includes a proposed amendment to the final regulations under section 1275 to clarify that an item of income that is subject to the timing rules in the proposed regulations under section 451(b) (such as the specified credit card fees) is not taken into account in determining the amount of OID (if any) on the debt instrument. Removing specified fees and specified credit card fees from the calculation of OID will permit taxpayers to apply only the rules of section 451(b) to these fees, without also having to apply the rules relevant to OID. In addition, the Treasury Department and the IRS propose to obsolete Revenue Procedure 2004-33, Revenue Procedure 2005-47, Revenue Procedure 2013-26, and Chief Counsel Notice CC-2010-018. The Treasury Department and the IRS request comments on the proposed obsolescence of these documents.

B. Market Discount

Taxpayers requested guidance as to whether market discount is includible in income under section 451(b). The Treasury Department and the IRS previously announced that proposed regulations would provide that accrued market discount is not includible in income under section 451(b). Notice 2018-80 (2018-42 IRB 609), issued September 27, 2018.

A bond is generally treated as having market discount when the principal amount of the bond exceeds the holder's basis immediately after it was acquired by the holder. Under section 1276(a), market discount is includible in income only upon disposition of a market discount bond at a gain or the receipt of a partial principal payment, unless the holder of the bond elects otherwise. In each case, the market discount inclusion is limited to accrued market discount as defined in section 1276(b). In general, the timing rules for income inclusion in section 1276 are a codification of the pre-1984 timing rules for market discount and confirm that the all events test generally does not determine when accrued market discount is includible in income. The proposed regulations therefore include the market discount rules on the list of special methods of accounting to which section 451(b) does not apply.

Statement of Availability of IRS Documents

The IRS notices, revenue rulings, and revenue procedures cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at http://www.irs.gov.

Proposed Applicability Date

These regulations are proposed generally to apply to taxable years beginning on or after the date the final regulations are published in the **Federal Register**. However, in the case of a specified fee (other than a specified credit card fee), proposed §1.451-3(i)(2) is proposed to apply for a taxpayer's first taxable year beginning one year after the date the Treasury decision adopting these regulations as final is published in the **Federal Register**. In general, this delayed effective date for specified fees is provided because the treatment of these fees is unclear for tax purposes (and in some cases for financial reporting purposes). This additional time will allow the Treasury Department and the IRS to determine the types of fees that should be subject to section 451(b), which will provide taxpayers with more certainty in complying with section 451(b) and will help to minimize controversies with the IRS with respect to fees.

Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, a taxpayer may rely on these proposed regulations (other than the proposed regulations relating to specified fees) for taxable years beginning after December 31, 2017, provided that the taxpayer: (1) applies all the applicable rules contained in these proposed regulations (other than those applicable to specified fees), and (2) consistently applies these proposed regulations to all items of income during the taxable year (other than specified fees). Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, in the case of specified credit card fees, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2018, provided that the taxpayer: (1) applies all the applicable rules contained in these proposed regulations for specified credit card fees, and (2) consistently applies these proposed regulations to all items of income during the taxable year (other than specified fees).

Special Analyses

I. *Regulatory Planning and Review*

Executive Orders 13771, 13563, and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits, including potential economic, environmental, public health and safety effects, distributive impacts, and equity. Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility. The Executive Order 13771 designation for any final rule resulting from the proposed regulation will be informed by comments received. The preliminary Executive Order 13771 designation for this proposed rule is regulatory.

The proposed regulation has been designated by the Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these proposed regulations as significant under section 1(b) of the MOA. Accordingly, these proposed regulations have been reviewed by OIRA.

1. Background

In plain language, section 451 of the Internal Revenue Code (the "Code") and the proposed regulations deal with differences between when income is recognized for Federal tax purposes and when it is recognized on businesses' financial accounting statements. The recently enacted section 451(b) more closely aligns the timing rules of the tax system with general financial accounting standards.

Under section 451(a) of the Code, any item of gross income is required to be included as income by the taxpayer ("recognized") when it is received by the taxpayer unless, under the taxpayer's method of accounting, the income is properly accounted for in a different period. For this purpose, businesses and individuals are generally required to use the accounting method that is used regularly to keep their financial records. This may be a cash receipts and disbursements accounting method, under which income is recognized when payment is actually or constructively received, or it may be an accounting system based on income and expense accrual principles. Certain corporations and some partnerships are required to use an accrual method, and generally taxpayers employing inventories in their trade or business must use an accrual method with regard to purchases and sales of inventory.

Current regulations require taxpayers using an accrual accounting method to report income in the taxable year in which all events that fix the right to receive such income have occurred, provided the amount can be determined with reasonable accuracy. Under IRS guidance, this "all events test" is met upon the earliest of when (i) payment is earned through performance by the taxpayer (e.g., provision of the contracted goods or services), (ii) payment is due to the taxpayer, or (iii) payment is received by the taxpayer.

In contrast, U.S. generally accepted accounting principles ("GAAP") and international financial reporting standards ("IFRS"), having different purposes from tax law, may often dictate alternative rules as regards the timing of revenue recognition. Differences between these financial accounting standards and the Code in the timing of revenue recognition may arise for a number of reasons. For example, under certain circumstances, financial accounting rules may require revenue to be recognized when the costs of providing goods or services pursuant to a contract are incurred, while the all events test may not be satisfied until the contract obligation is fulfilled. If meeting the taxpayer's performance obligation occurs over more than a single accounting period, then this timing pattern can result in a disparity between the year in which the associated revenue is booked for financial accounting purposes and the year in which the associated taxable gross income is recognized.

Congress enacted new section 451(b) in part because conformity in the timing of income recognition between the accrual system of accounting and the tax system ("book-tax conformity") will generally "promote simplification and reduced compliance costs." See Senate Budget Explanation of the Bill (2017-11-20) at p. 161.

Section 451(b) applies only to taxpayers that use the accrual method and have an Applicable Financial Statement ("AFS"). In plain language, an AFS is a financial statement certified as having been prepared under GAAP or IFRS. All publicly traded U.S. corporations possess an AFS, as do many privately held corporations and partnerships, which may have such certified accounting statements for credit purposes or for shareholder or partner reporting purposes. The income recognition rules for accrual-method taxpayers without an AFS and cash-method taxpayers are not altered by the enactment of section 451(b) or by the proposed regulations. The Treasury Department and the IRS project that there were approximately 3.1 million tax-reporting entities in taxable year 2016 that used an accrual method of accounting. They further project that fewer than 10 percent of these, or approximately 296,000 entities had an AFS, and thus could have been affected by section 451(b) and the proposed regulations had these been in effect in taxable year 2016.

For these taxpayers, Section 451(b) modifies the all-events test by stating that the test is not met for any item of income any later than when it is taken into account as revenue in an AFS or other designated financial statement (the "AFS income inclusion rule"). Thus, this new rule requires taxpayers to recognize income upon the earlier of when the all-events test is met or when the taxpayer includes the amount in revenue (broadly defined) in its AFS ("AFS income inclusion rule"). The AFS income inclusion rule operates only in one direction — to accelerate in time the recognition of gross income for tax purposes. This acceleration occurs in situations where income has been recognized for financial accounting purposes before the all events test has been satisfied.

2. Need for the proposed regulations

The proposed regulations deliver certainty and clarity to taxpayers affected by the Act's introduction of the new section 451(b) and allow them to comply with the new statutory provision with a higher level of confidence.

The Treasury Department and IRS published a Notice in April 2018, requesting public comments regarding the application of the AFS income inclusion rule, the meaning of various concepts and terms used in section 451(b), and other implementation issues not explicitly addressed in the statute. As explained earlier in this Preamble, the proposed regulations address the comments and questions subsequently raised by the public.

3. Overview of the proposed regulations

The proposed regulations include applicability and definitional guidance regarding section 451(b). Specifically, the proposed regulations: (1) clarify how the AFS inclusion rule applies to multi-year contracts; (2) describe and clarify the definition of an AFS for a group of entities; (3) define the meaning of the term revenue in an AFS; (4) define a transaction price and clarify how that price is to be allocated to separate performance obligations in a contract with multiple obligations; and (5) describe and clarify rules for transactions involving certain debt instruments.

4. *Economic analysis*

A. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

B. Summary of Economic Effects

The proposed regulations provide increased certainty, clarity, and consistency in the application of section 451(b) by providing definitions and clarifications regarding the statute's terms and rules. In the absence of such guidance, the chances that different taxpayers would interpret the statute differently would be exacerbated. Similarly situated taxpayers might interpret the statutory provisions pertaining to the recognition of income differently, with one taxpayer pursuing a project that another comparable taxpayer might decline to make because of different interpretations of how the income would be treated under section 451(b). If this second taxpayer's activity were more profitable, an economic loss arises. Even in situations where taxpayers would generally adopt similar interpretations of the Code under the baseline, the lack of guidance increases opportunities for that interpretation to differ from what Congress intended. In this case, guidance provides value by bringing economic decisions closer in line with Congressional intent. In the context of economic activity by businesses that are subject to section 451(b) or that interact with such businesses, the proposed regulations thus help to ensure that similar economic activities, representing similar timing of income, are taxed similarly, thereby improving U.S. economic performance.

The Treasury Department and the IRS have not undertaken quantitative estimates of these possible efficiency gains because any such quantitative estimates would be highly uncertain. For example, the proposed regulations include provisions to clarify how income should be included from multi-year contracts. The Treasury Department and the IRS do not have readily available data or models to determine how businesses might apply the AFS inclusion rule to multi-year contracts in the absence of the proposed regulations or under alternative regulatory approaches. Furthermore, even in the event that most businesses could be presumed to adopt a particular treatment under the baseline, the Treasury Department and the IRS further do not have readily available data or models of the volume or pattern of their multi-year contract payments and they thus cannot project with any degree of precision the differences in tax treatment taxpayers would experience between the proposed regulations and the baseline or alternative regulatory approaches. Such differences are a key component of the marginal effective tax rate that these contracts would experience, which in turn would determine how economic activity would be affected by the proposed regulations relative to the baseline or alternative regulatory approaches.

The Treasury Department and the IRS further project that issuance of the proposed regulations will reduce compliance and enforcement costs relative to the baseline because the enhanced certainty and clarity they provide should make it easier for businesses to calculate their tax liability relative to the baseline. Greater efficiencies should also result from the promulgation of the proposed regulations, relative to the baseline, by reducing taxpayer disputes with the IRS that otherwise would have to be dealt with through sub-regulatory guidance or resolved through increased litigation. By providing greater certainty of how the law will be applied, the Treasury Department and the IRS project that the proposed regulations will reduce these implementation costs. The Treasury Department and the IRS have not made a quantitative estimate of the reduction in compliance and enforcement costs resulting from the proposed regulations. They have not made such an estimate in part because models of compliance cost are not currently available to provide a reasonably precise estimate of compliance costs in the absence of the proposed regulations.

With these limitations in mind, part II.4.C of this Special Analyses section explains the rationale behind the approaches taken by the proposed regulations and qualitatively evaluates the alternatives considered.

The Treasury Department and the IRS solicit comments on the economic effects of the proposed regulations.

C. Economic Effects of Specific Provisions

The proposed regulations embody certain regulatory decisions that reflect the regulatory discretion of the Treasury Department and the IRS. These decisions specify more fully how the AFS income inclusion rule is to be implemented.

The Treasury Department and IRS solicit comments on the economics of each of the items discussed below and of any other items of the proposed regulations not discussed in this section. The Treasury Department and the IRS particularly solicit comments that provide data, other evidence, or models that could enhance the rigor of the process by which the final regulations might be developed.

i. Application of the AFS Income Inclusion Rule to Multi-year Contracts

The proposed regulations clarify how section 451(b) applies to multi-year contracts. The Treasury Department and the IRS considered two alternative approaches for such contracts: (i) an annualized approach and (ii) a cumulative approach. Under an annualized approach, for each year under the contract a taxpayer would compare the income included as revenue in its AFS for that year and the gross income recognized under the all events test for that same year to determine its gross income inclusion, with the proviso that the total amount of gross income recognized under the contract is not to exceed the total contract price. In contrast, under a cumulative approach, in each year a taxpayer would compare the cumulative amount of revenue included in its AFS up to and including that year with the cumulative amount of gross income recognized under the all events test up to and including that year.

Example 4 of the proposed regulations, the summary table of which is reproduced in the first three rows of the following table, shows the treatment of gross income under a cumulative approach. The fourth row in this table shows the treatment of gross income under the annualized approach.

	2018	*2019*	*2020*	*2021*	*Total*
Payments	$25x	$25x	$25x	$25x	$100x
AFS Revenue	$50x	$0x	$20x	$30x	$100x
Gross Income (cumulative)	$50x	$0x	$25x	$25x	$100x
Gross Income (annualized)	$50x	$25x	$25x	$0x	$100x

An annualized approach could accelerate the recognition of taxable income to a greater degree than what is reflected in revenue for AFS purposes. In this example, such an approach would ignore in 2019 the fact that cumulative AFS revenue of $50x had been recognized as taxable gross income in 2018. Accordingly, the annualized approach would require that an additional $25x of income be recognized in 2019, since a payment of that amount was received in that year. In effect, an annualized approach would accelerate the recognition of $25x from 2021 to 2019 relative to gross income recognition under the cumulative AFS income inclusion rule.

The Treasury Department and IRS concluded that the extent of acceleration of income that may occur when using an annualized approach would be excessive relative to the cumulative approach when considered against the intents and purposes of the statute. The proposed regulations therefore adopt the cumulative approach.

ii. Applicable Financial Statement covering a group of entities

The proposed regulations provide rules for taxpayers whose financial results are included on an AFS covering a group of entities. These rules specify that, if a taxpayer's financial results are reported on the AFS for a group of entities, the taxpayer's AFS is the group's AFS. However, if the taxpayer also reports financial results on a separate AFS that is of equal or higher priority, then the separate AFS is the taxpayer's AFS. The rules also specify how a taxpayer using a group AFS is to determine the amount of revenue allocated to the taxpayer. The Treasury Department and the IRS considered as an alternative not providing substantive rules on how taxpayers should apply the AFS income inclusion rule when their financial results are included in an AFS for a group of entities. This alternative was rejected because it would have increased compliance burdens and potentially led to similarly situated taxpayers applying the AFS income inclusion rule differently.

The Code does not specify how the AFS income inclusion rule is to function whenever the AFS accounting period and the taxable year do not coincide. The proposed regulations do not adopt a single, one-size-fits-all approach, but rather provide taxpayers three separate options for addressing this situation. A change from one option to another, however, would be considered a change in method of accounting requiring the permission of the IRS. By providing taxpayers with several options, the proposed regulations will minimize taxpayer compliance costs when dealing with non-congruent tax and financial accounting periods relative to an alternative approach of specifying a single option, with no significant revenue implications or effects on economic decisions.

iii. Revenue in an AFS

The proposed regulations describe and clarify the definition of revenue to broadly include all items of income under section 61. Because this definition of revenue is based on tax principles, there may be items of revenue included in this definition that adjust retained earnings on financial statements but are not reflected in the revenue line on such financial statements. The Treasury Department and the IRS considered and rejected a narrower definition of revenue or a definition that was tied to the AFS definition of revenue. The definition of revenue advanced in the proposed regulations is consistent with the current application of the all events test under §1.451-1(a) and ensures that all financial statement items are taken into account for tax purposes. In contrast, a narrow definition of revenue would allow, or even encourage, taxpayers to avoid the AFS income inclusion rule by not classifying an item as revenue on their financial statement.

iv. Allocation of Transaction Price

Section 451(b)(4) specifies that, in the case of a contract which contains multiple performance obligations, the allocation of the transaction price to each obligation is determined using the allocation used in the AFS. The Code, however, does not define either transaction price or performance obligation, thus the proposed regulation defines these terms. The proposed regulations clarify that a transaction price does not include amounts collected on behalf of third parties. Transaction price also does not include amounts that are contingent on the occurrence or non-occurrence of a future event. Without these exclusions, section 451(b) could be used to override other provisions of the Code concerning the definition of what constitutes gross income. This result would be at odds with the purpose of section 451, which is not to determine the existence or the amount of gross income, but rather to determine the timing of its recognition. Consequently, alternatives to these rules were not considered here.

Amounts included in the transaction price for an AFS are presumed to be not contingent, unless the taxpayer demonstrates otherwise. The Treasury Department and the IRS project that this rule will lead to reduced compliance burden for taxpayers, and reduced administrative costs for taxpayers and IRS and should lead to fewer taxpayer disputes on this issue relative to an alternative presumption regarding possible contingent amounts.

v. Rules for certain debt instruments

Section 451(b)(2) states that the AFS inclusion rule does not apply to items of gross income for which a taxpayer uses a special method of accounting provided under the Code. However, the Code does not apply this exception to special accounting rules that apply to original issue discount ("OID"), market discount, and certain other items with respect to debt instruments under part V of Subchapter P of the Code.

The proposed regulations implement this provision regarding special methods of accounting, and clarify the effect of section 451(b) on the excepted Subchapter P rules.

The proposed regulations implement this provision by providing a non-exhaustive list of special methods of accounting, and by clarifying how section 451(b) applies to certain credit card receivables. The proposed regulations specifically except from section 451(b) the timing rules for accrued market discount on bonds and the general OID timing rules, as well as the timing rules for OID determined with respect to special debt instruments (contingent payment and variable rate debt instruments, certain hedged debt instruments, and inflation-indexed debt instruments). Nevertheless, following the legislative history of the Act (see Conference Report, p. 276), the proposed regulations provide that credit card late fees, credit card cash advance fees, and interchange fees are subject to the AFS income inclusion rule. The proposed regulations further specify that if these credit card fees are subject to a taxpayer's AFS, they are not to be taken into account in determining whether a debt instrument associated with them has OID. Existing rules continue to apply to these items for taxpayers not possessing an AFS. The Treasury Department and the IRS expect that this treatment will provide a straightforward application of section 451(b) consistent with Congressional intent without unnecessarily complicating OID calculations and adding to taxpayer compliance burdens.

The Treasury Department and the IRS considered and rejected a broader application of the AFS income inclusion rule to include all amounts determined under the OID and market discount accounting methods, even in cases where the items are treated as discount or as an adjustment to the yield of a debt instrument over the life of the instrument in its AFS for financial reporting purposes. The proposed regulations do not subject these amounts to the AFS income inclusion rule because these special accounting methods do not generally rely on the all events test to determine the timing of income inclusion and these current special accounting methods provide workable income-recognition timing rules that appropriately measure income. The Treasury Department and the IRS expect that subjecting these items to the AFS income inclusion rule of section 451(b) would disrupt and complicate current tax accounting practices with no general economic benefit.

II. *Paperwork Reduction Act*

These proposed regulations do not impose any additional information collection requirements in the form of reporting, recordkeeping requirements or third-party disclosure requirements. However, because section 451(b) and the proposed regulations provide methods of accounting affecting the timing of income inclusion, the consent of the Commissioner under section 446(e) is required before using such method. The IRS expects that these taxpayers will request this consent by filing Form 3115, *Application for Change in Accounting Method*. Filing of Form 3115 (for taxpayers who are required to do so or who elect certain methods of accounting described in the proposed regulations) is the sole collection of information requirement imposed by the statute and the proposed regulations. See subsequent paragraphs for a description of taxpayers who would be required to change the method of accounting under the statute and the proposed regulations.

For purposes of the Paperwork Reduction Act, the reporting burden associated with these collections of information will be reflected in the IRS Form 3115 Paperwork Reduction Act Submissions (OMB control number 1545-0074 for individual income tax returns; OMB control number 1545-0123 for business taxpayers). On December 17, 2018, the Treasury Department and the IRS published Revenue Procedure 2018-60, 2018-51 IRB 1045, which provides procedures for taxpayers to make a change in method of accounting to comply with section 451(b)(1)(A) and/or (b)(4). Taxpayers are able to request these section 451 changes using reduced filing requirements, such as by filing a short Form 3115, or for certain taxpayers, by using a streamlined method change procedure that involves not filing a Form 3115. See also the revenue procedure accompanying these regulations for similar simplified method change procedures to make a change in method of accounting to comply with these proposed regulations.

In 2018, the IRS released and invited comment on a draft of Form 3115 in order to give members of the public the opportunity to benefit from certain specific provisions made to the Code. The IRS received no comments on the forms during the comment period. Consequently, the IRS made the forms available in January 2019 for use by the public. The IRS notes that Form 3115 applies to changes of accounting methods generally and is therefore broader than section 451(b).

Additionally, proposed §1.451-3(h) provides additional methods of accounting that require a taxpayer to request consent of the Commissioner under section 446(e) before using such method. Under proposed §1.451-3(h)(4)(iii), for a taxpayer with a financial accounting year that is different from its tax accounting year, a change in the method by which the taxpayer computes its revenue is a change in method of accounting. Under proposed §1.451-3(h)(5), a restatement of an AFS that changes the timing of which an item of income, or portion thereof, is taken into account in revenue on the AFS is also a change in method of accounting. The Treasury Department and the IRS expect that taxpayers will request this consent by filing Form 3115.

For a taxpayer with an AFS required to comply with section 451(b) and/or proposed §1.451-3, a change in the taxpayer's revenue recognition policies for financial accounting purposes requires the taxpayer to seek the consent of the Commissioner under section 446(e) to use the method for Federal income tax purposes. See proposed §1.451-3(l). The reporting burden associated with the collection of information for a statement in lieu of the Form 3115 will be reflected in the Paperwork Reduction Act Submission associated with Revenue Procedure 2018-31, 2018-22 IRB 637 (or successor) (OMB control number 1545-1551). See the revenue procedure accompanying these proposed regulations.

The current status of the Paperwork Reduction Act submissions that will be revised as a result of the information collections in the proposed regulations is provided in the accompanying table. As described above, the reporting burdens associated with the information collections in the proposed regulations are included in the aggregated burden estimates for OMB control numbers 1545-0074 (in the case of individual filers of Form 3115), 1545-0123 (in the case of business filers of Form 3115), and 1545-1551 (in the case of filers subject to Revenue Procedure 2018-31). The overall burden estimates associated with the OMB control numbers below are aggregate amounts that relate to the entire package of forms associated with the applicable OMB control number and will in the future include, but not isolate, the estimated burden of the tax forms that will be created or revised as a result of the information collections in the proposed regulations. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by the proposed regulations. These burdens have been reported for other income tax regulations that rely on the same information collections and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burdens imposed by tax provisions prior to the Act. No burden estimates specific to the forms affected by the proposed regulations are currently available. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations. For the OMB control numbers discussed in the preceding paragraphs, the Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Those estimates capture both changes made by the Act and those that arise out of discretionary authority exercised in the proposed regulations (when final) and other regulations that affect the compliance burden for that form.

The Treasury Department and IRS request comment on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. In addition, when available, drafts of IRS forms are posted for comment at https://apps.irs.gov/app/picklist/list/draftTaxForms.htm. IRS forms are available at https://www.irs.gov/forms-instructions. Forms will not be finalized until after they have been approved by OMB under the PRA.

<table>
<tr><th>Form/
Revenue Procedure</th><th>Type of Filer</th><th>OMB Number(s)</th><th>Status</th></tr>
<tr><td rowspan="6">Form 3115</td><td>All other Filers (mainly trusts and estates) (Legacy system)</td><td>1545-2070</td><td>Published in the Federal Register on 2/15/17. Public comment period closed on 4/17/17.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2017/02/15/2017-02985/proposed-information-collection-comment-request</td></tr>
<tr><td>Business (NEW Model)</td><td>1545-0123</td><td>Published in the Federal Register on 10/8/18. Public comment period closed on 12/10/18.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd</td></tr>
<tr><td>Individual (NEW Model)</td><td>1545-0074</td><td>Limited scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 2019.</td></tr>
<tr><td colspan="3">Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031</td></tr>
<tr><td rowspan="2">Revenue Procedure 2018-31</td><td>IRS Research estimates</td><td>1545-1551</td><td>Published in the Federal Register on 8/31/16. Public Comment period closed on 9/30/16.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2016/08/31/2016-20993/submission-for-omb-review-comment-request</td></tr>
</table>

D. Regulatory Flexibility Act

It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6).

New section 451(b) of the Act requires that an item of income be included in gross income for tax purposes no later than when the item is counted as revenue in an applicable financial statement. This typically moves the recognition of income forward by a year or two compared to previous law. These proposed regulations provide general guidance on the rule, including the scope of the rule, exceptions to the rule, definitions of key terms, and examples demonstrating applicability of the rule.

The Treasury Department and the IRS have estimated the number of small business entities that may be affected by the statute and these proposed regulations. The statute and proposed regulations affect only those business entities that (i) use an accrual method of accounting, and (ii) have an applicable financial statement.

Regarding an accrual method of accounting, many small business entities use the cash receipts and disbursements method of accounting (cash method), as opposed to an accrual method, and thus are not subject to this provision. The percent of returns that use an accrual method of accounting, by entity types and for entities with gross receipts not greater than $25 million, are shown in the accompanying table.

Total returns and returns using accrual method of accounting (Taxable year 2016)			
Entities with gross receipts not greater than $25 million			
Entity	Total returns (thousands)	Returns using an accrual method of accounting (thousands)	Percent of returns using accrual method of accounting
C corporations	1,567	700	45
S corporations	4,551	1,140	25
Partnerships	3,743	860	23
Sole proprietors and LLCs	25,524	358	1
All entities	35,385	3,058	9
Source: Internal Revenue Service, Statistics of Income.			

The Treasury Department and the IRS next examined the second condition, that only entities with an Applicable Financial Statement ("AFS") are affected by the statute and the proposed regulations. The Treasury Department and the IRS do not have readily available data to measure the prevalence of entities with an AFS. However, Schedule M-3, which is used to reconcile an entity's net income or loss for tax purposes with its book income or loss, reports whether an entity has a certified audited income statement. Unfortunately for the current exercise, the Schedule M-3 is required to be filed only by entities possessing at least $10 million of assets. Nevertheless, it is this population that is far more likely to possess an AFS. Furthermore, data are currently available only for electronic filers.

For taxable year 2016, approximately 87 percent of accrual-method entities filing Forms 1120, 1120-S, and 1065 with gross receipts of $25 million or less were filers of electronic tax forms. About 11 percent, or 265,000 of these returns, included a Schedule M-3. About 40 percent of the returns with Schedule M-3, or 106,000, indicated they had a certified audited income statement.[2] Based on the assumption that filers of paper tax forms have the same incidence as electronic filers and that entities that do not file a Schedule M-3 generally do not have an AFS, then the Treasury Department and the IRS estimate that roughly 122,000 (=106,000/0.87) entities with gross receipts of $25 million or less are accrual-method entities that have an AFS. If 5 percent of entities that do not file a Schedule M-3 also have an AFS then approximately 247,000 entities with gross receipts of $25 million or less are potentially affected by the proposed regulations. These estimates of affected filing entities are reproduced in the following table.

[1] Data are based on estimates from the IRS's Research, Applied Analytics and Statistics Division using data from the Compliance Data Warehouse.

Corporation and Partnership Returns Using An Accrual Method of Accounting Taxable year 2016 (Thousands of returns)			
Entities with gross receipts not greater than $25 million			
	E-Filed Returns	Paper-Filed Returns	Total Returns
Returns	2,441	361	2,802
Returns with a Schedule M-3	265	*39**	*374**
Returns with a Schedule M-3 and an audited income statement	106	*16**	*122**
Returns without a Schedule M-3	2,176	*322**	*2,498**
Returns without a Schedule M-3, but with an audited income statement	*109***	*16***	*125***
Returns with an audited income statement	*215***	*32***	*247***

*Estimates are obtained by assuming paper-filed returns are similar to e-filed returns as regards the incidence of a filing entity having a Schedule M-3 and an audited income statement.

**Estimates are obtained by assuming that 5% of returns without a Schedule M-3 have an audited income statement. This compares with approximately 40% of returns with a Schedule M-3 having such a statement.

Source: Non-italic entries are estimates taken from the IRS's Research, Applied Analytics and Statistics Division using data from the Compliance Data Warehouse. The total number of accrual method returns of corporations and partnerships (2,802,000) differs slightly from that reported in the earlier table (2,700,000) due to the use of different data sources for the two estimates. Italicized entries are additional estimates obtained in the manner indicated in the table notes.

This rule would not have a significant economic impact on small entities affected. The costs to comply with these proposed regulations are not significant. Taxpayers needing to make method changes pursuant to section 451(b) or the proposed regulations will be required to file a Form 3115. The Treasury Department and the IRS have provided streamlined procedures for certain taxpayers to change their method of accounting to comply with section 451(b), and plan to provide streamlined procedures for taxpayers to change to the methods of accounting described in these proposed regulations. See Revenue Procedure 2018-60, and the revenue procedure accompanying these regulations. Under the streamlined procedures, certain taxpayers would either complete only a portion of the Form 3115 or would not complete the Form 3115 at all to comply with section 451(b). The streamlined method change procedures are available to taxpayers (other than a tax shelter) who satisfy the gross receipts test under section 448(c) and for taxpayers making such a method change which results in a zero section 481(a) adjustment. (For tax years beginning in 2018, an entity satisfied the gross receipts test if its average annual gross receipts was $25 million or less. For tax years beginning in 2019, this threshold increased to $26 million or less.) In addition, the Treasury Department and the IRS plan to issue a streamlined procedure, using a short Form 3115, for taxpayers using a section 451(b) method who have a change in their AFS for revenue recognition that requires a method change for tax purposes. See the revenue procedure accompanying these regulations.

As noted in the revenue procedure accompanying these regulations, the estimated cumulative annual reporting and/or recordkeeping burden for the statutory method changes described under OMB control number 1545-1551, before publication of the revenue procedure, is 27,336 respondents, and a total annual reporting and/or recordkeeping burden of 30,580 hours. The estimated annual burden per respondent/recordkeeper under OMB control number 1545-1551 before publication of this revenue procedure varies from 1/6 hour to 8½ hours, depending on individual circumstances, with an estimated average of 1¼ hours. The estimated cumulative annual reporting and/or recordkeeping burden for the method changes described under OMB control number 1545-1551 after that revenue procedure is accounted for is 27,346 respondents, and a total annual reporting and/or recordkeeping burden is 31,479 hours, leaving the average reporting and recordkeeping burden essentially unchanged. These burdens are essentially unaffected by these proposed regulations.

Notwithstanding this certification, the Treasury Department and the IRS invite comments from the public about the impact of this proposed rule on small entities.

Pursuant to section 7805(f), these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "**ADDRESSES**" heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at *http://www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Charles Gorham, IRS Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

* * * * *

Section 1.451-3 also issued under 26 U.S.C. 451(b)(1)(A)(ii) and (b)(3)(C).

* * * * *

§1.446-1 [Amended]

Par. 2. Section 1.446-1 is amended by adding "(See §1.451-1 for rules relating to the taxable year of inclusion.)" between the first and second sentences of paragraph (c)(1)(ii)(A).

Par. 3. Section 1.446-2 is amended by removing "or" at the end of paragraph (a)(2)(i)(E), removing the period at the end of paragraph (a)(2)(i)(F) and adding in its place "; or" and adding paragraph (a)(2)(i)(G).

The addition reads as follows:

§1.446-2 Method of accounting for interest.

(a) * * *

(2) * * *

(i) * * *

(G) Section 1.451-3(i) (special ordering rule for specified fees).

* * * * *

§1.451-1 [Amended]

Par. 4. Section 1.451-1 is amended by:

a. Adding "(the all events test)" to the end of the second sentence of paragraph (a);
b. Redesignating paragraphs (b) through (g) as (d) through (i); and
c. Adding new paragraphs (b) and reserved (c).

The additions read as follows:

§1.451-1 General rule for taxable year of inclusion.

* * * * *

(b) *Special rule for timing of income inclusion for taxpayers with an applicable financial statement using an accrual method of accounting*. For the timing of income inclusion with respect to taxpayers with an applicable financial statement using an accrual method of accounting, see also §1.451-3.

(c) [Reserved]

* * * * *

Par. 5. Section 1.451-3 is added to read as follows:

§1.451-3 Timing of income inclusion for taxpayers with an applicable financial statement using an accrual method of accounting.

(a) *Table of contents*. This paragraph (a) lists captioned paragraphs contained in §1.451-3.

§1.451-3 Timing of income inclusion for taxpayers with an applicable financial statement using an accrual method of accounting.

(4) Computation of revenue when the AFS covers mismatched reportable periods.

(i) In general.

(ii) Permissible methods to determine revenue.

(iii) Method of accounting.

(5) Restatement of AFS.

(i) Special ordering rule for certain items of income with respect to debt instruments

(1) In general.

(2) Specified fees.

(3) Example.

(j) Treatment of adjustments to deferred revenue in an AFS

(1) In general.

(2) Example.

(k) Cumulative rule for multi-year contracts.

(l) Methods of accounting

(1) In general.

(2) Transition rule for changes in method of accounting

(i) In general.

(ii) Special rules for OID.

(iii) Qualified change in method of accounting.

(m) Examples.

(1) Example 1. Mismatched reportable periods.

(2) Example 2. Provision of installation services.

(3) Example 3. Provision of goods.

(4) Example 4. Provision of services included in AFS without deferral of advance payments under section 451(c)(1)(B).

(5) Example 5. Provision of services included in AFS with deferral of advance payments under section 451(c)(1)(B).

(6) Example 6. Sale of goods with AFS revenue adjustments.

(7) Example 7. Chargebacks.

(8) Example 8. Sale of property using a special method of accounting.

(9) Example 9. Non-recognition provisions not changed for Federal income tax purposes.

(n) Applicability date

(1) In general.

(2) Delayed application with respect to certain fees.

(3) Early application of this section.

(i) In general.

(ii) Certain fees.

(A) Specified credit card fees.

(B) Specified fees.

(b) *General rule*. If a taxpayer has an applicable financial statement (AFS), the all events test under §1.451-1(a) with respect to any item of gross income, or portion thereof, is met no later than when that item, or portion thereof, is taken into account as revenue in the taxpayer's AFS (the AFS income inclusion rule). Except as provided in paragraph (i) of this section for certain items of income with respect to debt instruments, the AFS income inclusion rule does not apply to any item of gross income, or portion thereof, when the timing of income for that item, or portion thereof, is determined using a special method of accounting, as defined in paragraph (c)(5) of this section. If a special method of accounting is used, income is taken into account as prescribed by that special method of accounting. See, however, paragraph (d) of this section for exceptions for taxpayers without an AFS and income in connection with a mortgage servicing contract.

(c) *Definitions*. For purposes of this section, the following definitions apply:

(1) *Applicable financial statement*. Subject to the rules in paragraph (c)(1)(iv) of this section, *applicable financial statement* (AFS) means the taxpayer's financial statement listed in paragraphs (c)(1)(i) through (iii) of this section that has the highest priority, including priority within paragraphs (c)(1)(i)(B) and (c)(1)(ii)(B) of this section. The financial statements are, in order of descending priority:

(i) *GAAP Statements*. A financial statement that is certified as being prepared in accordance with generally accepted accounting principles (GAAP) and is:

(A) A Form 10-K (or successor form), or annual statement to shareholders, filed with the United States Securities and Exchange Commission (SEC);

(B) An audited financial statement of the taxpayer that is used for:

(*1*) Credit purposes;

(*2*) Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or

(*3*) Any other substantial non-tax purpose; or

(C) A financial statement, other than a tax return, filed with the Federal government or any Federal agency, other than the SEC or the Internal Revenue Service;

(ii) *IFRS Statements*. A financial statement that is certified as being prepared in accordance with international financial reporting standards (IFRS) and is:

(A) Filed by the taxpayer with an agency of a foreign government that is equivalent to the SEC, and has reporting standards not less stringent than the standards required by the SEC;

(B) An audited financial statement of the taxpayer that is used for:

(*1*) Credit purposes;

(*2*) Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or

(*3*) Any other substantial non-tax purpose; or

(C) A financial statement, other than a tax return, filed with the Federal government or any Federal agency, other than the SEC or the Internal Revenue Service, or a foreign government or agency of a foreign government, other than an agency that is equivalent to the SEC or the Internal Revenue Service; or

(iii) *Other Statements*. A financial statement, other than a tax return, filed with the Federal government or any Federal agency, a state government or state agency, or a self-regulatory organization (for example, a financial statement filed with a state agency that regulates insurance companies or the Financial Industry Regulatory Authority). Additional financial statements included in this paragraph (c)(1)(iii) may be provided in guidance published in the Internal Revenue Bulletin (see §601.601(d) of this chapter).

(iv) *Additional rules for determining priority*. If a taxpayer restates revenue in an AFS prior to the date that the taxpayer files its Federal income tax return for such taxable year, for purposes of determining priority, the restated AFS must be used instead of the original AFS. A taxpayer with different financial accounting and taxable years that is required to file both annual financial statements and periodic financial statements covering less than a year with a government agency must use the annual statement filed with the agency to determine priority.

(2) *Equity method*. *Equity method* means a method of accounting for financial accounting purposes under which an investment is initially recorded at cost and subsequently increased or decreased in carrying value by the investor's pro-

portionate share of income and losses and such income or losses are reported as separate items on the investor's statement of income.

(3) *Performance obligation*. *Performance obligation* means a promise in a contract with a customer to transfer to the customer either a good or service, or a combination of both, that is distinct; or a series of distinct goods or services, or a combination of both, that are substantially the same and that have the same pattern of transfer to the customer.

(4) *Revenue*. *Revenue* means all transaction price amounts includible in gross income under section 61. The characterization of a transaction price in the AFS is not determinative of whether it is taken into account as revenue in a taxpayer's AFS. For example, any transaction price amount that is reported as other comprehensive income in an AFS is taken into account as revenue in an AFS.

(5) *Special method of accounting*. *Special method of accounting* means a method of accounting permitted or required under any provision of the Code, the Income Tax Regulations, or other guidance published in the Internal Revenue Bulletin (see §601.601(d) of this chapter) under which an item of income is taken into account in a taxable year other than the taxable year in which the all events test is met. See, however, paragraph (i) of this section relating to certain items of income with respect to debt instruments. The following are examples of special methods of accounting to which the AFS income inclusion rule generally does not apply:

(i) The crop method of accounting under sections 61 and 162;

(ii) Methods of accounting provided in sections 453 through 460;

(iii) Methods of accounting for hedging transactions under §1.446-4;

(iv) Methods of accounting for REMIC inducement fees under §1.446-6;

(v) Methods of accounting for gain on shares in a money market fund under §1.446-7;

(vi) Methods of accounting for certain rental payments under section 467;

(vii) The mark-to-market method of accounting under section 475;

(viii) Timing rules for income and gain associated with a transaction that is integrated under §1.988-5, and income and gain under the nonfunctional currency contingent payment debt instrument rules in §1.988-6;

(ix) Except as otherwise provided in paragraph (i) of this section, timing rules for original issue discount (OID) under section 811(b)(3) or 1272 (and the regulations under section 1272), income under the contingent payment debt instrument rules in §1.1275-4, income under the variable rate debt instrument rules in §1.1275-5, income and gain associated with a transaction that is integrated under §1.1275-6, and income under the inflation-indexed debt instrument rules in §1.1275-7;

(x) Timing rules for de minimis OID under §1.1273-1(d) and for de minimis market discount (as defined in section 1278(a)(2)(C));

(xi) Timing rules for accrued market discount under sections 1276 and 1278(b); and

(xii) Methods of accounting provided in sections 1502 and 1503 and the regulations thereunder, including the method of accounting relating to intercompany transactions under §1.1502-13.

(6) *Transaction price*. The transaction price means the gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes in exchange for transferring promised goods, services, or other property, including amounts referred to in paragraph (i) of this section, but not including:

(i) Amounts collected on behalf of third parties (for example, some sales taxes) that are otherwise not income to the taxpayer;

(ii) Increases in consideration to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event (for example, bonuses contingent on performance and insurance contract commissions contingent on renewal) for the period in which the amount is contingent. Amounts included in the transaction price for AFS purposes are presumed to not be contingent on the occurrence or nonoccurrence of a future event, unless, upon examination of all the facts and circumstances existing at the end of the taxable year, it can be established to the satisfaction of the Commissioner that the amount is contingent on the occurrence or nonoccurrence of a future event. An amount included in the transaction price for AFS purposes that is actually or constructively received, that is due and payable, or for which the taxpayer has an enforceable right to payment for performance completed to date, however, will not be treated as contingent on the occurrence or nonoccurrence of a future event; or

(iii) Reductions for amounts subject to section 461, including allowances, adjustments, rebates, chargebacks, refunds, rewards (for example, estimated redemption costs associated with loyalty programs), and amounts included in costs of goods sold.

(d) *Exceptions to the AFS income inclusion rule*. The AFS income inclusion rule does not apply unless all of the taxpayer's taxable year is covered by an AFS. In addition, the AFS income inclusion rule does not apply to any item of income in connection with a mortgage servicing contract.

(e) *No change in the treatment of a transaction*. Except as provided in paragraph (i)(2) of this section, the AFS income inclusion rule does not change the treatment of a transaction for Federal income tax purposes. The following are examples of transactions where the treatment for AFS purposes does not change the treatment of the transaction for Federal income tax purposes:

(1) A transaction treated as a lease, license, or similar transaction for Federal income tax purposes that is treated as a sale or financing for AFS purposes, and vice versa;

(2) 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;

(3) Asset sale and liquidation treatment under section 336(e) or 338(h)(10);

(4) A distribution of a corporation or the allocable share of partnership items or an income inclusion under section 951, 951A, or 1293(a) for Federal income tax purposes that is accounted for under the equity method for AFS purposes;

(5) A distribution of previously taxed earnings and profits of a foreign corporation; and

(6) A deposit or conduit payment for Federal income tax purposes that is treated as revenue for AFS purposes.

(f) *No change to exclusion provisions and the treatment of non-recognition* *transactions*. The AFS income inclusion rule does not change the applicability of any exclusion provision, or the treatment of non-recognition transactions, in the Code, the Income Tax Regulations, or other guidance published in the Internal Revenue Bulletin (see §601.601(d) of this chapter). The following are examples of exclusion provisions and non-recognition transactions that are not affected by the AFS income inclusion rule:

(1) Any non-recognition transaction, within the meaning of section 7701(a)(45), (for example, a liquidation described in sections 332 and 337, an exchange described in section 351, a distribution described in section 355, a reorganization described in section 368, a contribution described in section 721, or transactions described in sections 1031 through 1045); and

(2) Items specifically excluded from income under sections 101 through 140.

(g) *Contracts with multiple performance obligations*—(1) *In general*. For purposes of this section, if a taxpayer's contract with a customer has more than one performance obligation, transaction price is allocated to performance obligations as transaction price is allocated to performance obligations in the taxpayer's AFS.

(2) *Example*. Taxpayer A, a manufacturer and servicer of airplane parts, is a calendar-year accrual method taxpayer with an AFS. In 2018, A enters into a $100x contract to sell airplane parts and to service those parts, as necessary, in 2018, 2019, and 2020. For AFS purposes, A allocates $40x of the total contract price to the delivery of parts in 2018, $10x to the provision of services in 2018, $20x to the provision of services in 2019, and $30x to the provision of services in 2020. In 2018, A delivers parts and provides services. On its 2018 AFS, A includes the $40x for the delivery of parts and the $10x for the provision of services in revenue. Under paragraph (g)(1) of this section, because the contract involves multiple performance obligations, A must use its transaction price AFS allocation to determine whether income from the sale of airplane parts and services are included in revenue in its AFS for purposes of this section. Accordingly, under the AFS income inclusion rule in paragraph (b) of this section, for the $40x sale of airplane parts and the $10x provision of services in 2018 the all events test is not met any later than A's 2018 taxable year.

(h) *Additional AFS issues*—(1) *AFS covering groups of entities*—(i) *In general*. For purposes of this section, if a taxpayer's financial results are reported on the AFS for a group of entities, the taxpayer's AFS is the group's AFS. However, if the taxpayer's financial results are also reported on a separate AFS that is of equal or higher priority to the group's AFS under paragraph (c)(1) of this section, then the taxpayer's AFS is the separate AFS.

(ii) *Example*. Taxpayer B, a reseller of computers and electronics, is a calendar-year accrual method taxpayer. In 2018, B's financial results are included in its parent corporation's consolidated Form 10-K filed with the SEC, but it files a separate Federal income tax return. Under paragraph (h)(1) of this section, because its financial results are reported on the AFS for its parent corporation, B must use its parent corporation's consolidated Form 10-K as its AFS. Accordingly, under the AFS income inclusion rule in paragraph (b) of this section, for the sale of computers and electronics the all events test is not met any later than when the sale is included in its parent corporation's consolidated Form 10-K.

(2) *Separately stated items*. If a group's AFS is treated as the taxpayer's AFS, the taxpayer must look to any separately stated items to determine the amount of revenue allocated to the taxpayer.

(3) *Non-separately stated items*. If a group's AFS does not separately state items, the portion of the revenue allocable to the taxpayer is determined by relying on the source documents that were used to create the group's AFS.

(4) *Computation of revenue when the AFS covers mismatched reportable periods*—(i) *In general*. If a taxpayer's AFS is prepared on the basis of a financial accounting year that differs from the taxpayer's taxable year, the taxpayer must use one of the permissible methods listed in paragraph (h)(4)(ii) of this section to determine revenue for purposes of the AFS income inclusion rule.

(ii) *Permissible methods to determine revenue*. For purposes of paragraph (h)(4)(i) of this section, a taxpayer must use one of the following methods to determine revenue for the taxable year in order to apply the AFS income inclusion rule:

(A) The taxpayer computes revenue by using the accounting principles used to create its AFS to determine whether an item would be included in revenue in an AFS for the taxable year as if its financial reporting period was the same as its taxable year, for example, by conducting an interim closing of its books.

(B) The taxpayer computes revenue by including a pro rata portion of the revenue for each financial accounting year that includes any part of the taxpayer's taxable year. If the taxpayer's AFS for part of the taxable year is not available by the due date of the return (with extension), the taxpayer must make a reasonable estimate of revenue for the pro rata portion of the taxable year for which an AFS is not yet available. See §1.451-1(a) for adjustments after actual amounts are determined.

(C) If a taxpayer's financial accounting year ends five or more months after the end of its taxable year, the taxpayer computes revenue for Federal income tax purposes based on the revenue reported on the AFS prepared for the financial accounting year ending within the taxpayer's taxable year. For purposes of this paragraph (h)(4)(ii)(C), if a taxpayer uses a 52-53 week year for financial accounting or Federal income tax purposes, the last day of such year shall be deemed to occur on the last day of the calendar month ending closest to the end of such year.

(iii) *Method of accounting*. A change in the method of computing revenue under this paragraph (h)(4) is a change in method of accounting under section 446. A taxpayer may change its method of accounting only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations.

(5) *Restatement of AFS*. If a taxpayer restates revenue on an AFS and such restatement changes the timing of when an item of income, or a portion thereof, is taken into account as revenue on the AFS, the change constitutes a change in method of accounting under section 446. A taxpayer may change its method of accounting only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations. If a taxpayer restates revenue on an AFS to correct an error or the restatement results in a change in the estimate of the taxpayer's pro rata portion of revenue under paragraph (h)(4)(ii)(B) of this section, see §1.451-1(a).

(i) *Special ordering rule for certain items of income with respect to debt instruments*—(1) *In general*. If an item of income, or portion thereof, with respect to a debt instrument is described in paragraph (i)(2) of this section, the rules of this section apply before the rules in sections 1271 through 1275 and §§1.1271-1 through 1.1275-7 (OID rules). Therefore, an item of income, or portion thereof, described in paragraph (i)(2) of this section may not be taken into income later than when that item, or portion thereof, is taken into account as revenue in the taxpayer's AFS, regardless of whether the timing of income inclusion for that item is normally determined using a special method of accounting. See also §1.1275-2(l) for the treatment of the items described in paragraph (i)(2) of this section under the OID rules.

(2) *Specified fees*. Paragraph (i)(1) of this section applies to fees (specified fees) that are not treated as discount or as an adjustment to the yield of a debt instrument over the life of the instrument (such as points) in the taxpayer's AFS and, but for paragraph (i) of this section and §1.1275-2(l), would be treated as creating or increasing OID for Federal income tax purposes. For example, the following specified fees (specified credit card fees) are described in this paragraph (i)(2):

(i) A payment of additional interest or a similar charge provided with respect to amounts that are not paid when due on a credit card account (for example, credit card late fees);

(ii) Amounts charged under a credit card agreement when the cardholder uses the credit card to conduct a cash advance transaction (for example, credit card cash advance fees); and

(iii) Amounts a credit or debit card issuer is entitled to upon a purchase of goods or services by one of its cardholders (for example, interchange fees, which are sometimes labeled merchant discount in certain private label credit card transactions).

(3) *Example*. Taxpayer C, a credit card issuer, is a calendar-year accrual method taxpayer with an AFS. In 2019, a cardholder uses C's credit card to purchase $100 of merchandise from a merchant and the cardholder earns a reward of 1% of the purchase price of $100 ($1) as part of C's cardholder loyalty program. Upon purchase, C becomes entitled to an interchange fee equal to 2% of the purchase price of $100 ($2). In 2019, C reports the $2 of interchange fees as revenue in its AFS. C's $2 of interchange fees is described in paragraph (i)(2)(iii) of this section. Under paragraph (i)(1) of this section, C must apply the rules in this section before applying the OID rules. See also §1.1275-2(l). Therefore, C's $2 of interchange fees is included in taxable income in 2019, the year it is included as revenue in C's AFS. Under paragraph (c)(6)(iii) of this section, the $2 of interchange revenue is not reduced by the $1 reward. Even if C reports interchange fees net of rewards in its AFS for 2019 ($2 of interchange fee minus $1 reward liability), under paragraph (c)(6) of this section, C includes $2 of interchange revenue in taxable income in 2019. See §§162 and 461(h) for the treatment of the reward by C.

(j) *Treatment of adjustments to deferred revenue in an AFS*—(1) *In general*. For purposes of this section, if a taxpayer treats an item of income as deferred revenue in its AFS and writes down or adjusts that item, or portion thereof, to an equity account (for example, retained earnings) or otherwise writes down or adjusts that item of deferred revenue in a subsequent taxable year, revenue for that subsequent taxable year includes that item, or portion thereof, that is written down or adjusted.

(2) *Example*. Taxpayer D, a remanufacturer of industrial equipment, is a calendar-year accrual method taxpayer with an AFS. In 2018, D enters into a contract with a customer to remanufacture equipment in 2019 and 2020 for $100x. The contract is not a long-term contract under section 460. In its 2018 AFS, D treats the $100x as deferred revenue. In 2019, all the stock of D is acquired by an unrelated third party. In its 2019 AFS, D adjusts deferred revenue to $90x (the expected cost to provide the services) by charging $10x ($100x - $90x = $10x) to retained earnings. In its 2019 AFS, D includes $50x of the $90x of deferred revenue in revenue. Under paragraph (j)(1) of this section, D's adjustment to deferred revenue in 2019 is treated as revenue under paragraph (c)(4) of this section in 2019. Therefore, under the AFS income inclusion rule in paragraph (b) of this section, D is treated as including $60x ($50x + $10x = $60x) in revenue in its 2019 AFS, and the all events test is met for that $60x no later than D's 2019 taxable year.

(k) *Cumulative rule for multi-year contracts*. In the case of a multi-year contract, a taxpayer must take into account the cumulative amounts included in income in prior taxable years on the contract, if any, in order to determine the amount to be included for the taxable years remaining in the contract. For purposes of this paragraph (k), multi-year contract means a contract that spans more than one taxable year.

(l) *Methods of accounting*—(1) *In general*. A change in the method of recognizing revenue in an AFS that changes or could change the timing of the recognition of income for Federal income tax purposes is a change in method of accounting under section 446. A taxpayer may change its method of accounting only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations. Accordingly, a taxpayer that changes the method of accounting used to recognize revenue in its AFS is required to secure consent of the Commissioner before computing income using this new method for Federal income tax purposes.

(2) *Transition rule for changes in method of accounting*—(i) *In general*. Except as provided in paragraph (l)(2)(ii) of this section, a taxpayer that makes a qualified change in method of accounting for the taxpayer's first taxable year beginning after December 31, 2017, is treated as making a change in method initiated by the taxpayer for purposes of section 481(a)(2). A taxpayer obtains the consent of the Commissioner to make a qualified change in method of accounting by using the applicable administrative procedures that govern voluntary automatic changes in method of accounting under section 446(e). See section §1.446-1(e)(3).

(ii) *Special rules for OID and specified fees*. The rules of paragraph (l)(2)(i) of this section apply to a qualified change in method of accounting required under section 451(b) and paragraph (i) of this section for the taxpayer's first taxable year beginning after December 31, 2018, if the change relates to a specified credit card fee (as defined in paragraph (i)(2) of this section). The rules of paragraph (l)(2)(i) of this section apply to a qualified change in method of accounting required under section 451(b) and paragraph (i) of this section for the taxpayer's first taxable year beginning one year after the date the Treasury decision adopting these regulations as final is published in the **Federal Register**, if the change relates to a specified fee (as defined in paragraph (i)(2) of this section) other than a specified credit card fee. For purposes of this paragraph (l)(2)(ii), the section 481(a) adjustment period for any adjustment under section 481(a) for a qualified change in method of accounting required under section 451(b) and paragraph (i) of this section is six taxable years.

(iii) *Qualified change in method of accounting*. For purposes of paragraph (l)(2) of this section, a qualified change in method of accounting means any change in method of accounting that is required by section 13221 of the Tax Cuts and Jobs Act, Public Law No. 115-97 (131 Stat. 2054) (TCJA), or was prohibited under the Internal Revenue Code of 1986 prior to TCJA section 13221 and is now permitted as a result of TCJA section 13221.

(m) *Examples*. The following examples illustrate the provisions of this section:

(1) *Example 1. Mismatched reportable periods*. Taxpayer A is a calendar-year accrual method taxpayer with an AFS. For AFS purposes, A's financial results are reported on a June 30 fiscal year. Using the method described in paragraph (h)(4)(ii)(A) of this section, for the taxable year 2018, A uses the financial results reported on its June 30, 2018, AFS to determine whether an item of income was taken into account as revenue in A's AFS from January 1, 2018, through June 30, 2018, and uses its June 30, 2019, AFS to determine whether an item of income is taken into account as revenue in A's AFS from July 1, 2018, through December 31, 2018.

(2) *Example 2. Provision of installation services*. Taxpayer B is a calendar-year accrual method taxpayer with an AFS. In 2018, B enters into a contract with a customer to provide manufacturing equipment installation services for $100,000. Throughout the contract, the customer retains control of the equipment. B has an enforceable right to payment for services partially performed. The contract is not a long-term contract under section 460. B begins providing the installation services in 2018 and completes the installation services in 2019. Under the contract, B bills the customer $50,000 in 2018 when installation begins. B includes $60,000 in revenue in its 2018 AFS and $40,000 in revenue in its 2019 AFS. Under the AFS income inclusion rule in paragraph (b) of this section, because $60,000 of revenue from the installation services is included in B's 2018 AFS, the all events test for that $60,000 of income is met in B's 2018 taxable year.

(3) *Example 3. Provision of goods*. Taxpayer C is a calendar-year accrual method taxpayer with an AFS. In 2018, C enters into a contract with a customer to provide 50 customized computers for $80,000. Under the contract, C can bill $80,000 after the customer accepts delivery of the computers. However, because of the customization, the contract provides that C can be paid for work performed to date, even if the contract is not completed for reasons other than C's failure to perform. C delivers all of the computers in 2018. Customer accepts delivery of the computers and C bills the customer in 2019. C includes all $80,000 in revenue in its 2018 AFS. Under the AFS income inclusion rule in paragraph (b) of this section, because $80,000 of revenue from the provision of goods is included in C's 2018 AFS, the all events test for that $80,000 of income is met in C's 2018 taxable year. Under paragraph (c)(6)(ii) of this section, the limitation on C's ability to bill until after the customer accepts delivery of the computers is not a future event that restricts C's enforceable right to payment for the goods.

(4) *Example 4. Provision of services included in AFS without deferral of advance payments under section 451(c)(1)(B)*. Taxpayer D, an engineering services provider, is a calendar-year accrual method taxpayer with an AFS. In 2018, D enters into a contract with a customer to provide services for four years for a total of $100x. Under the contract, D receives $25x each year of the contract. D does not elect to defer advance payments under section 451(c)(1)(B). For AFS purposes, D reports $50x, $0, $20x, and $30x of revenue from the contract in 2018, 2019, 2020, and 2021, respectively. Under paragraph (g)(1) of this section, the allocation of the transaction price in D's AFS is used to determine when all or part of that item is taken into account for purposes of paragraph (b) of this section. In 2018, D includes all of the $25x payment in income from the contract under the all events test. In addition, under paragraph (b) of this section, because $50x of revenue from the provision of services is included in D's 2018 AFS, the all events test for that portion of the provision of services is not met later than D's 2018 taxable year. Therefore, D must include the additional $25x ($50x – $25x = $25x) reported on the AFS as income in 2018. In 2019, under paragraph (k) of this section, D includes $0 of the $25x payment in income from the contract because the payment received in 2019 relates to income included in 2018. In 2020, D includes all of the $25x payment in income from the contract under the all events test. In 2021, D includes the remaining $25x payment in income under the contract under the all events test. This example is summarized in the table below:

	2018	2019	2020	2021	Total
Payments	$25x	$25x	$25x	$25x	$100x
AFS Revenue	$50x	$0	$20x	$30x	$100x
Income	$50x	$0	$25x	$25x	$100x

(5) *Example 5. Provision of services included in AFS with deferral of advance payments under section 451(c)(1)(B)*. The facts are the same as in *Example 4* in paragraph (m)(4) of this section, except D elects to defer advance payments under section 451(c)(1)(B). Under paragraph (g)(1) of this section, the allocation of the transaction price in D's AFS is used to determine when all or part of that item is taken into account for purposes of paragraph (b) of this section. In 2018, D includes all of the $25x payment in income from the contract under the all events test. In addition, under paragraph (b) of this section, because $50x of revenue from the provision of services is included in D's 2018 AFS, the all events test for that portion of the provision of services is not met later than D's 2018 taxable year. Therefore, D must include an additional $25x ($50x – $25x = $25x) of income in 2018. In 2019, under paragraph (k) of this section, D includes $0 of the $25x payment in income from the contract because the payment received in 2019 relates to income included in 2018. In 2020, D includes $20x of the $25x payment in income from the contract under the deferral method for advance payments under section 451(c)(1)(B). In 2021, D includes the $5x that was deferred in 2020 under the deferral method for advance payments under section 451(c)(1)(B) and the remaining $25x payment in income under the contract under the all events test. This example is summarized in the table below:

	2018	2019	2020	2021	Total
Payments	$25x	$25x	$25x	$25x	$100x
AFS Revenue	$50x	$0	$20x	$30x	$100x
Income	$50x	$0	$20x	$30x	$100x

(6) *Example 6. Sale of goods with AFS revenue adjustments*. Taxpayer E, a manufacturer of automobile parts, is a calendar-year accrual method taxpayer with an AFS. E normally sells parts for $10 per part with a 2% bonus if the parts are delivered on time. Traditionally, 5% of parts sold are returned. In 2018, E enters a contract to sell 1,000 parts to a customer for $10 per part, for a total of $10,000 (1,000 x $10 = $10,000). The contract also provides that E will receive a 2% bonus if it delivers all the parts to the customer by February 1, 2019. E delivers 500 parts to the customer on December 31, 2018. On December 31, 2018, the additional 500 parts were scheduled for shipment to the customer on January 4, 2019. For AFS purposes, E expects to earn the 2% bonus and to have 5% of the parts returned. In its 2018 AFS, E reports $4,850 ($5,000 + $100 - $250 = $4,850) of revenue from the contract, including a $100 (2% x $5,000 = $100) adjustment for the expected bonus and a $250 (5% x $5,000 = $250) adjustment for anticipated returns. Under paragraph (c)(6)(iii) of this section, E's transaction price does not include anticipated returns. See §1.461-4(g)(3) for rules on when the return liability is incurred. Under paragraph (c)(6)(ii) of this section, the performance bonus is presumed not to be contingent on the occurrence or nonoccurrence of a future event. However, at the end of the year, all parts have yet to be delivered within the February 1, 2019 deadline. Under the contract, E has no right to payment of the bonus at the end of the year. Therefore, the presumption is rebutted. In addition, under paragraph (g)(1) of this section, the allocation of the transaction price in E's AFS is used to determine when all or part of that item is taken into account for purposes of paragraph (b) of this section. Accordingly, under paragraph (b) of this section, because $5,000 of revenue from the sale of parts is taken into account in E's 2018 AFS, the all events

test for $5,000 of income allocated to those parts is met in E's 2018 taxable year.

(7) *Example 7. Chargebacks*. Taxpayer F, a manufacturer of pharmaceuticals, is a calendar-year accrual method taxpayer with an AFS. In addition to billing the wholesaler for the sale of the pharmaceutical at the wholesale acquisition cost under the contract, F generally credits or pays wholesalers a chargeback of 40% of the wholesale acquisition cost for sales made by those wholesalers to qualifying customers. In 2018, F enters into a contract to sell 1,000 units to W, a wholesaler, for $10 per unit, totaling $10,000 (1,000 x $10 = $10,000). The contract also provides that F will issue a 40% chargeback for sales by W to certain qualifying customers. F delivers 600 units to W on December 31, 2018, and bills W $6,000 under the contract. For AFS purposes, F adjusts its revenue by 40% for all sales to W for anticipated chargebacks. As such, in its 2018 AFS, F reports $3,600 ($6,000 - $2,400 = $3,600) of revenue from the contract with W, decreasing revenue by $2,400 (40% x $6,000 = $2,400) for anticipated chargeback claims. For Federal income tax purposes, under paragraph (c)(6)(iii) of this section, F's 2018 revenue is $6,000 because F's revenue is not reduced for anticipated chargebacks.

(8) *Example 8. Sale of property using a special method of accounting*. Taxpayer G, a provider of financial services, is a calendar-year accrual method taxpayer with an AFS. In 2018, G sells a building for $100x, payable in five annual payments of $20x starting in 2018. In its 2018 AFS, G reports all $100x of revenue from the sale of the building. For Federal income tax purposes, G uses the installment method under section 453 for the sale of the building. Under paragraph (c)(5) of this section, the installment method under section 453 is a special method of accounting because it requires income to be taken into account in a taxable year other than the taxable year in which the all events test is met. Therefore, under paragraph (b) of this section, this section does not apply to G's sale of the building because it is using a special method of accounting and the income is taken into account as prescribed in section 453.

(9) *Example 9. Non-recognition provisions not changed for Federal income tax purposes*. Taxpayer H (Distributing) is a calendar-year accrual method C corporation with an AFS. On December 31, 2018, Distributing (i) contributes assets to a wholly owned subsidiary (Controlled) in exchange for Controlled stock and $100x, and (ii) distributes all of Controlled's stock pro rata to its shareholders. The transaction qualifies as a reorganization under section 368(a)(1)(D) and a distribution to which section 355 applies (D reorganization). Distributing's realized gain on the transferred assets for book and tax purposes is $150x. On January 15, 2019, in pursuance of the plan of reorganization, Distributing distributes the $100x to its shareholders. Consequently, no gain to Distributing is recognized under section 361(b)(1)(A). On Distributing's 2018 AFS, Distributing recognizes revenue of $150x related to the D reorganization. Under paragraph (f) of this section, nothing in section 451(b) or this section changes the applicability of any deferral, non-recognition, or exclusion provision of the Code, the Income Tax Regulations, or other guidance published in the Internal Revenue Bulletin. Section 361 provides that Distributing does not recognize any gain from the D reorganization. Pursuant to paragraph (f) of this section, nothing in section 451(b) or this section would change the result that Distributing does not recognize gain on Distributing's (i) contribution of assets to Controlled, (ii) receipt of Controlled stock and cash, and (iii) distribution of Controlled stock and cash to Distributing's shareholders.

(10) *Example 10. Insurance contract renewals*. The taxpayer, an insurance agent, is engaged by an insurance carrier to sell insurance. By written binding contract between the taxpayer and the insurance carrier, the taxpayer is entitled to receive a $50 commission from the insurance carrier at the time a policy is sold to a customer. The written binding contract also provides that the taxpayer is entitled to receive an additional $25 commission each time a policy is renewed. The taxpayer sells 1,000 one-year policies in year one, of which 800 are renewed in year two and 700 are renewed in year three. The taxpayer does not have any ongoing obligation to provide additional services to the insurance carrier or the customers after the initial sale of the policy. The taxpayer includes $86,000 in revenue in its AFS for year one, which includes $50,000 of consideration for policies sold in year one and an estimate of $36,000 of consideration for the policies expected to be renewed in years two and three. Under paragraph (c)(6)(ii) of this section, because the taxpayer is able to demonstrate by written binding contract that the amounts related to future insurance contract renewals are contingent on the occurrence of a future event (that is the customer contract renewal), the taxpayer's transaction price from commissions is $50,000 ($50 * 1,000) in year one, $20,000 ($25 * 800) in year two, and $17,500 ($25 * 700) in year three.

(n) *Applicability date*—(1) *In general*. Except as provided in paragraph (n)(2) of this section, these regulations are proposed to apply for taxable years beginning after the date the Treasury decision adopting these regulations as final is published in the **Federal Register**.

(2) *Delayed application with respect to certain fees*. Notwithstanding paragraph (n)(1) of this section, paragraph (i)(2) of this section is proposed to apply to specified fees (as defined in paragraph (i)(2) of this section) other than specified credit card fees (as defined in paragraph (i)(2) of this section) for taxable years beginning one year after the date the Treasury decision adopting these regulations as final is published in the **Federal Register**.

(3) *Early application of this section*—(i) *In general*. Except as provided in paragraph (n)(3)(ii) of this section, until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2017, if the taxpayer applies all the applicable rules contained in these proposed regulations (other than those applicable to specified fees), and consistently applies these proposed regulations to all items of income during the taxable year (other than specified fees).

(ii) *Certain fees*—(A) *Specified credit card fees*. Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, in the case of a specified credit card fee, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2018, if the taxpayer applies all the applicable rules contained in these proposed regulations for a specified credit card fee, and consistently applies these proposed regulations to all items of income during the taxable year (other than specified fees that are not specified credit card fees).

(B) *Specified fees*. Paragraph (n)(3)(i) of this section does not apply to specified fees that are not specified credit card fees.

Par. 6. Section 1.1275-2 is amended by adding paragraph (l) to read as follows:

§1.1275-2 Special rules relating to debt instruments.

* * * * *

(l) *OID rule for income item subject to section 451(b)*—(1) *In general*. Notwithstanding any other rule in sections 1271 through 1275 and §§1.1271-1 through 1.1275-7, if, and to the extent, a taxpayer's item of income with respect to a debt instrument is subject to the timing rules in §1.451-3(i) (including credit card late fees, credit card cash advance fees, or interchange fees), then the taxpayer does not take the item into account to determine whether the debt instrument has any OID. As a result, the taxpayer does not treat the item as creating or increasing any OID on the debt instrument.

(2) *Applicability dates*—(i) *In general*. Except as provided in paragraphs (l)(2)(ii) and (iii) of this section, paragraph (l)(1) of this section applies for taxable years beginning after the date the Treasury decision adopting these regulations as final is published in the **Federal Register**.

(ii) *Early adoption*. Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2018, for a specified credit card fee as defined in §1.451-3(i)(2), if applied consistently to all specified credit card fees subject to §1.451-3(i).

(iii) *Applicability date for purposes of accounting method changes*. Paragraph (l)(1) of this section will not apply for purposes of applying section 13221(e) of the Tax Cuts and Jobs Act, Public Law No. 115-97 (131 Stat. 2054) to determine the section 481(a) adjustment period for any adjustment under section 481(a) for a qualified change in method of accounting required under section 451(b) and §1.451-3(i) for the items subject to §1.451-3(i).

Kirsten Wielobob,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on September 5, 2019, 4:15 p.m., and published in the issue of the Federal Register for September 9, 2019, 84 F.R. 47191)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–27 through 2018–52 is in Internal Revenue Bulletin 2018–52, dated December 27, 2018.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2018–27 through 2018–52 is in Internal Revenue Bulletin 2018–52, dated December 27, 2018.

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