

INTERNAL REVENUE BULLETIN



HIGHLIGHTS OF THIS ISSUE

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.

Bulletin No. 2021-3
January 19, 2021

ADMINISTRATIVE, EMPLOYMENT TAX

Notice 2021-7, page 482.

Notice 2021-7 provides temporary relief in response to the ongoing COVID-19 pandemic for employers using the automobile lease valuation rule to value an employee's personal use of an employer-provided automobile for purposes of income inclusion, employment tax, and reporting purposes. If certain requirements are met, employers that are using the automobile lease valuation rule may instead use the vehicle cents-per-mile valuation rule to determine the value of an employee's personal use of an employer-provided automobile beginning as of March 13, 2020. For 2021, employers may revert to the automobile lease valuation rule or continue using the vehicle cents-per-mile valuation rule provided certain requirements are met.

EMPLOYEE PLANS, INCOME TAX

T.D. 9932, page 345.

Section 162(m)(1) of the Internal Revenue Code generally limits to \$1,000,000 the allowable deduction for a taxable year for applicable employee remuneration paid by any publicly held corporation with respect to a covered employee. The final regulations provide guidance on the application of §162(m), as amended by section 13601 of Tax Cuts and Jobs Act (the Act). The Act made significant amendments to §162(m), and provided a transition rule applicable to certain outstanding arrangements (commonly referred to as the grandfather rule). The final regulations provide guidance on the amendments made by the Act to the definitions of publicly held corporation, covered employee, and applicable employee remuneration. Additionally, the final regulations provide guidance on the operation of the grandfather rule, including when a contract will be considered materially modified so that it is no longer grandfathered.

ESTATE TAX

REG-114615-16, page 489.

This guidance contains proposed regulations to establish a new user fee for authorized persons who wish to request the issuance of IRS Letter 627, also referred to as an estate tax closing letter. Pursuant to the guidelines in OMB Circular A-25, the IRS has calculated its cost of providing the estate tax closing letter to be \$67. REG-114615-16.

INCOME TAX

Notice 2021-2, page 478.

This notice provides the optional 2021 standard mileage rates for taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes. This notice also provides the amount taxpayers must use in calculating reductions to basis for depreciation taken under the business standard mileage rate, and the maximum standard automobile cost that may be used in computing the allowance under a fixed and variable rate plan. Additionally, this notice provides the maximum fair market value of employer-provided automobiles first made available to employees for personal use in calendar year 2021 for which employers may use the fleet-average valuation rule in § 1.61-21(d)(5)(v) of the Income Tax Regulations or the vehicle cents-per-mile valuation rule in § 1.61-21(e).

Notice 2021-5, page 479.

Beginning of Construction for Sections 45 and 48; Extension of Continuity Safe Harbor for Offshore Projects and Federal Land Projects. The notice extends the Continuity Safe Harbor applicable to the production tax credit for renewable energy facilities under section 45 and the investment tax credit for energy property under section 48 for Offshore and Federal

Land Projects. Specifically, the notice provides that if a qualified facility or an energy property construction project is an Offshore or Federal Land Project, the Continuity Safe Harbor is satisfied if a taxpayer places the qualified facility or energy property that is the subject of the project into service by the end of a calendar year that is no more than 10 calendar years after the calendar year during which construction of the project began.

Rev. Proc. 2021-9, page 485.

This revenue procedure provides a safe harbor that allows a trade or business that manages or operates a qualified residential living facility to be treated as a real property trade or business solely for purposes of qualifying as an electing real property trade or business under section 163(j)(7)(B) of the Internal Revenue Code.

T.D. 9939, page 376.

These final regulations provide guidance under section 274 of the Internal Revenue Code (Code) regarding certain amendments made to section 274 by the Tax Cuts and Jobs Act of 2017 (TCJA). These final regulations address the elimination of the deduction under section 274 for expenses related to certain transportation and commuting benefits provided by employers to their employees. The final regulations provide guidance to determine the amount of such expenses that is nondeductible and apply certain exceptions under section 274(e) that may allow such expenses to be deductible.

These final regulations affect taxpayers who pay or incur such expenses.

T.D. 9941, page 396.

This Treasury Decision provides final rules regarding the timing of income inclusion for accrual method taxpayers with an applicable financial statement, and the treatment of advance payments resulting from the 2017 enactment of the Tax Cuts and Jobs Act (TCJA). The Treasury Decision provides general rules on the timing of income inclusion, including key definitions and guidance on calculating the amount of the inclusion. The Treasury Decision also provides rules regarding cost offsets that apply in certain contexts.

T.D. 9942, page 450.

This document contains final regulations to implement legislative changes to sections 263A, 448, 460, and 471 of the Internal Revenue Code (Code) that simplify the application of those tax accounting provisions for certain businesses having average annual gross receipts that do not exceed \$25 million, adjusted for inflation. This document also contains final regulations regarding certain special accounting rules for long-term contracts under section 460 to implement legislative changes applicable to corporate taxpayers. The final regulations generally affect taxpayers with average annual gross receipts of not more than \$25 million (adjusted for inflation).

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.

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

Part I

26 CFR 1.162-33: Certain employee remuneration in excess of \$1,000,000 not deductible for taxable years beginning after December 31, 2017.

T.D. 9932

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Certain Employee Remuneration in Excess of \$1,000,000 under Internal Revenue Code Section 162(m)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document sets forth final regulations under section 162(m) of the Internal Revenue Code (Code), which for Federal income tax purposes limits the deduction for certain employee remuneration in excess of \$1,000,000. These final regulations implement the amendments made to section 162(m) by the Tax Cuts and Jobs Act and finalize the proposed regulations published on December 20, 2019. These final regulations affect publicly held corporations.

DATES: *Effective Date:* These regulations are effective on **December 30, 2020**.

Applicability Dates: For dates of applicability, see §1.162-33(h).

FOR FURTHER INFORMATION CONTACT: Ilya Enkishev at (202) 317-5600 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (“Treasury regulations”) (26 CFR part 1) under section 162(m)).

Section 162(m)(1) disallows a deduction by any publicly held corporation for applicable employee remuneration paid or otherwise deductible with respect to any covered employee to the extent that such remuneration for the taxable year exceeds \$1,000,000. Section 162(m) was added to the Code by section 13211(a) of the Omnibus Budget Reconciliation Act of 1993, Public Law 103-66. Proposed regulations under section 162(m) were published in the *Federal Register* on December 20, 1993 (58 FR 66310) (1993 proposed regulations). On December 2, 1994, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) issued amendments to the proposed regulations (59 FR 61884) (1994 proposed regulations). On December 20, 1995, the Treasury Department and the IRS issued final regulations under section 162(m) (TD 8650) (60 FR 65534) (1995 regulations).

Section 162(m) was amended by section 13601 of the Tax Cuts and Jobs Act (TCJA) (Pub. L. 115-97, 131 Stat. 2054, 2155 (2017)). Section 13601 of TCJA amended the definitions of covered employee, publicly held corporation, and applicable employee remuneration in section 162(m). Section 13601 also provided a transition rule applicable to certain outstanding compensatory arrangements (commonly referred to as the grandfather rule). On August 21, 2018, the Treasury Department and the IRS released Notice 2018-68 (2018-36 I.R.B. 418), which provides guidance on certain issues under section 162(m).

On December 20, 2019, the Treasury Department and the IRS published proposed regulations (REG-122180-18) relating to the amendments TCJA made to section 162(m) in the *Federal Register* (84 FR 70356) (the proposed regulations). The changes to section 162(m) made by section 13601 of TCJA and the initial guidance provided by Notice 2018-68 are described in detail in the preamble to the proposed regulations.

A public hearing was held on March 9, 2020. The Treasury Department and the IRS also received written comments with respect to the proposed regulations. All written comments received in response

to the proposed regulations are available at www.regulations.gov or upon request. After full consideration of the comments received on the proposed regulations and the testimony heard at the public hearing, this Treasury decision adopts the proposed regulations with modifications in response to certain comments and testimony, as described in the Summary of Comments and Explanation of Revisions section. Comments outside of the scope of the proposed regulations generally are not addressed in this preamble but may be considered in connection with future guidance projects.

Summary of Comments and Explanation of Revisions

I. Overview

Section 13601 of TCJA significantly amended section 162(m). Consistent with the proposed regulations, these final regulations add a section to the Treasury regulations to reflect these amendments. Amended section 162(m) applies to taxable years beginning after December 31, 2017, except to the extent transition and grandfather rules described in section VI of this preamble apply. Because the 1995 regulations continue to apply to deductions related to amounts of remuneration to which the grandfather rule applies, the 1995 regulations are retained as a separate section in the Treasury regulations under section 162(m).

These final regulations retain the basic approach and structure of the proposed regulations, with certain revisions (including revised examples). This Summary of Comments and Explanation of Revisions discusses those revisions, as well as comments received in response to the proposed regulations.

II. Publicly Held Corporation

A. In General

As amended by TCJA, section 162(m)(2) defines the term “publicly held corporation” as any corporation that is an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (Exchange Act)) of securities that are required to be reg-

istered under section 12 of the Exchange Act, or that is required to file reports under section 15(d) of the Exchange Act. These final regulations adopt the rule in the proposed regulations providing that, for ease of administration, a corporation is a publicly held corporation if, as of the last day of its taxable year, its securities are required to be registered under section 12 of the Exchange Act or it is required to file reports under section 15(d) of the Exchange Act.

These final regulations also adopt the rules set forth in the proposed regulations for determining whether a publicly traded partnership, a corporation that owns an entity that is disregarded as an entity separate from its owner within the meaning of §301.7701-2(c)(2)(i), or an S corporation (including an S corporation parent of a qualified subchapter S subsidiary (as defined in section 1361(b)(3)(B)) (QSub) is a publicly held corporation as defined in section 162(m)(2). Consistent with the proposed rules, these final regulations also provide that a real estate investment trust (REIT), as defined in section 856(a), that owns a qualified real estate investment trust subsidiary as defined in section 856(i)(2) (QRS), is a publicly held corporation if the QRS issues securities required to be registered under section 12(b) of the Exchange Act, or is required to file reports under section 15(d) of the Exchange Act.

B. Affiliated Groups

These final regulations adopt the rules set forth in the 1995 regulations and the proposed regulations providing that the term “publicly held corporation” includes an affiliated group of corporations (affiliated group), as defined in section 1504 (determined without regard to section 1504(b)), that includes one or more publicly held corporations, and that a subsidiary corporation that meets the definition of publicly held corporation is separately

subject to section 162(m). These final regulations also adopt the rules set forth in the proposed regulations providing that an affiliated group includes a parent corporation that is privately held if one or more of its subsidiary corporations is a publicly held corporation, and that an affiliated group may include more than one publicly held corporation as defined in section 162(m)(2).

In response to the proposed regulations, a commenter suggested that an affiliated group with more than one publicly held corporation should have only one set of covered employees for the affiliated group (instead of one set of covered employees for each separate publicly held corporation that is a member of the affiliated group). These final regulations do not adopt this suggestion because each corporation in an affiliated group is a separate taxpayer and section 162(m)(3) provides that each taxpayer that is a publicly held corporation has its own set of covered employees. Instead, as provided in the 1995 regulations and in the proposed regulations, these final regulations provide that, in an affiliated group, each corporation that is a publicly held corporation is separately subject to section 162(m) and, therefore, has its own set of covered employees.

These final regulations adopt the rules set forth in the 1995 regulations and the proposed regulations addressing situations in which a covered employee of a publicly held corporation that is a member of an affiliated group performs services for another member of the affiliated group. These final regulations provide that compensation¹ paid by all members of the affiliated group is aggregated and that any amount disallowed as a deduction by section 162(m) is prorated among the payor corporations in proportion to the amount of compensation paid to the covered employee by each corporation in the taxable year. For situations in which a covered employee is paid com-

ensation during a taxable year by more than one publicly held corporation that are members of the same affiliated group, these final regulations adopt the rules set forth in the proposed regulations providing that the amount of the deduction that is disallowed for compensation paid to a covered employee is determined separately with respect to each payor corporation that is a publicly held corporation. These final regulations clarify that compensation paid by a member of an affiliated group that is not a publicly held corporation to an employee who is a covered employee of two or more other members of the affiliated group is prorated for purposes of the determining the deduction disallowance among the members that are publicly held corporations of which the employee is a covered employee.

C. Foreign Private Issuers

Pursuant to the amended definition of publicly held corporation in section 162(m)(2), the proposed regulations provide that a foreign private issuer² (FPI) is a publicly held corporation if it is required to register securities under section 12 of the Exchange Act or file reports under section 15(d) of the Exchange Act. The legislative history to TCJA indicates that Congress intended section 162(m) to apply to FPIs.³

In response to Notice 2018-68, commenters suggested that the proposed regulations provide that section 162(m) does not apply to FPIs because FPIs are not required to disclose compensation of their officers on an individual basis under the Exchange Act, unless similar disclosure is required by their home country.⁴ The commenters asserted that determining compensation on an individual basis (in order to determine the three most highly compensated executive officers) would require the FPIs to expend significant time and money in adopting the necessary

¹ For simplicity, where possible, these final regulations use the term “compensation” instead of “applicable employee remuneration.” These terms have the same meaning in these final regulations.

² The term “foreign private issuer” is defined in 21 CFR 240.3b-4(c).

³ The legislative history to TCJA provides that the amendment to the definition of publicly held corporation under section 162(m) “extends the applicability of section 162(m) to include ... all foreign companies publicly traded through ADRs.” House Conf. Rpt. 115-466, 489 (2017). The Blue Book similarly states that “the provision extends the applicability of section 162(m) to include all foreign companies publicly traded through ADRs.” Staff of the Joint Committee on Taxation, General Explanation of Public Law 115-97 (Blue Book), at 261 (December 20, 2018).

⁴ Before TCJA, the IRS ruled in several private letter rulings that section 162(m), as in effect at that time, did not apply to FPIs because FPIs are not required to disclose compensation of their officers on an individual basis under the Exchange Act, and, therefore, did not have covered employees. A private letter ruling may be relied upon only by the taxpayer to whom the ruling was issued and does not constitute generally applicable guidance. See section 11.02 of Revenue Procedure 2020-1, 2020-01 I.R.B. 144. TCJA amended section 162(m) to provide that a requirement to disclose compensation is not determinative of whether an officer is a covered employee.

internal procedures to make the determination consistent with Exchange Act requirements that are inapplicable to them. The proposed regulations do not adopt these suggestions.

However, the preamble to the proposed regulations requested comments as to whether a safe harbor exemption from the definition of a publicly held corporation under section 162(m) was appropriate for FPIs that are not required to disclose compensation of their officers on an individual basis in their home countries and, if so, how such a safe harbor could be designed. In response to this request for comments a commenter suggested that these final regulations should exempt any FPI from the definition of publicly held corporation, unless the FPI is required to disclose compensation of its officers on an individual basis in its home country. Another commenter suggested that these final regulations should exclude FPIs from the definition of publicly held corporation because determining compensation on an individual basis (in order to determine the three most highly compensated executive officers) requires extensive calculations consistent with executive compensation disclosure rules under the Exchange Act that are not applicable to FPIs. The commenters did not provide any analysis in support of a safe harbor rule or address how a safe harbor could be designed and administered. These final regulations do not adopt these suggestions because the scope of the exemption suggested for FPIs from the definition of publicly held corporation is inconsistent with the statutory language and the legislative history. Rather, these final regulations adopt the rules set forth in the proposed regulations providing that a FPI is a publicly held corporation if it is required to register securities under section 12 of the Exchange Act or file reports under section 15(d) of the Exchange Act.

III. Covered Employee

A. In General

As amended by TCJA, section 162(m) (3) defines the term “covered employee”

as an employee of the taxpayer if (1) the employee is the principal executive officer (PEO) or principal financial officer (PFO) of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity, (2) the total compensation of the employee for the taxable year is required to be reported to shareholders under the Exchange Act by reason of the employee being among the three highest compensated officers for the taxable year (other than the PEO and PFO), or (3) the individual was a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016. TCJA also added flush language to provide that a covered employee includes any employee of the taxpayer whose total compensation for the taxable year places the individual among the three highest compensated officers for the taxable year (other than any individual who is the PEO or PFO of the taxpayer at any time during the taxable year, or was an individual acting in such a capacity) even if the compensation of the officer is not required to be reported to shareholders under the Exchange Act.

These final regulations adopt the rules set forth in the proposed regulations providing that a covered employee for any taxable year means any employee of the publicly held corporation who is among the three highest compensated executive officers for the taxable year, regardless of whether the executive officer is serving as an executive officer at the end of the publicly held corporation’s taxable year, and regardless of whether the executive officer’s compensation is subject to disclosure for the publicly held corporation’s last completed fiscal year under the applicable SEC rules. The determination that an officer is a covered employee because the officer is one of the three highest compensated executive officers, even if the officer’s compensation is not required to be disclosed under the SEC rules, is based on the flush language to section 162(m) (3), the legislative history,⁵ and the SEC executive compensation disclosure rules.⁶ These final regulations also adopt the rule in the proposed regulations providing that the amount of compensation used to iden-

tify the three most highly compensated executive officers is determined pursuant to the executive compensation disclosure rules under the Exchange Act, substituting the publicly held corporation’s taxable year for references to the corporation’s fiscal year for purposes of applying the disclosure rules under the Exchange Act.

In response to the proposed regulations, a commenter suggested that, with respect to the three highest compensated executive officers (other than the PEO and PFO), the term “covered employee” should include only executive officers whose compensation is required to be disclosed pursuant to the SEC executive compensation disclosure rules. These final regulations do not adopt this suggestion because it is inconsistent with the flush language of section 162(m)(3) providing that, even if the compensation of an executive officer is not required to be reported to shareholders under the Exchange Act, the officer is a covered employee if the officer’s total compensation for the taxable year, determined in accordance with the SEC disclosure rules, places the officer among the three highest compensated officers for the taxable year (other than the PEO and PFO).

Section 162(m)(3)(C) provides that the term “covered employee” includes any employee who was a covered employee of any predecessor of the publicly held corporation for any preceding taxable year beginning after December 31, 2016. The proposed regulations provide rules for determining the predecessor of a publicly held corporation for various corporate transactions. With respect to asset acquisitions, the proposed regulations provide that, if an acquiror corporation acquires at least 80% of the operating assets (determined by fair market value on the date of acquisition) of a publicly held target corporation, then the target corporation is a predecessor of the acquiror corporation. A commenter suggested that these final regulations clarify that the operating assets refer to gross operating assets instead of net operating assets. These final regulations adopt this suggestion.

The proposed regulations also provide rules for determining the covered employ-

⁵ See House Conf. Rpt. 115-466, 489 (2017).

⁶ 17 CFR 229.402(a)(3) (Item 402 of Regulation S-K).

ees of an owner of a disregarded entity, and an S corporation that owns a QSub. No comments were received with respect to these provisions of the proposed regulations. Accordingly, these final regulations adopt the rules set forth in the proposed regulations and, consistent with those rules, provide additional rules for purposes of determining the covered employees of a REIT that owns a QRS.

B. Covered Employees Limited to Executive Officers

Under the definition of covered employee in section 162(m)(3) as amended by TCJA, a PEO and PFO are covered employees by virtue of holding those positions or acting in those capacities. The three highest compensated officers (other than the PEO or PFO) are covered employees by reason of their compensation. Pursuant to section 162(m)(3)(B), the three highest compensated officers are determined based on the methods by which these officers are identified for purposes of the executive compensation disclosure rules under the Exchange Act. With respect to the three highest compensated officers for a taxable year, consistent with the disclosure rules under the Exchange Act, the proposed regulations provide that only an executive officer, as defined in 17 CFR 240.3b-7 (Rule 3b-7), may qualify as a covered employee. In relevant part, Rule 3b-7 provides that “[e]xecutive officers of subsidiaries may be deemed executive officers of the registrant if they perform...policy making functions for the registrant.” A commenter suggested that these final regulations provide that an executive officer of a subsidiary may be a covered employee of the publicly held corporation that is the registrant only if the officer is also an officer of that publicly held corporation. These final regulations do not adopt this suggestion because it is inconsistent with Rule 3b-7.

C. Covered Employees after Separation from Service

Section 162(m)(3)(C), as amended by TCJA, provides that a covered employee

includes “a covered employee of the taxpayer (or any predecessor) for any preceding taxable year beginning after December 31, 2016.” The legislative history to TCJA provides that:

if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died.

(House Conf. Rpt. 115-466, 489 (2017)). The Blue Book reiterated the legislative history in explaining the amended definition of covered employee. See Blue Book at page 260.

Consistent with section 162(m)(3)(C), as amended by TCJA, and the legislative history, the proposed regulations provide that a covered employee identified for taxable years beginning after December 31, 2016, will continue to be a covered employee for all subsequent taxable years, including years during which the individual is no longer employed by the corporation and years after the individual has died. A commenter suggested that, based on the statutory text of both section 162(m) and section 4960, which was enacted by TCJA, Congress intended the term “employee” in section 162(m) to be limited to a current employee. The commenter pointed out that section 4960(c)(2) provides, in relevant part, that “the term ‘covered employee’ means any employee (including any former employee)” and noted that the words “including any former employee” are absent from the definition of covered employee in section 162(m)(3). The commenter reasoned that, because Congress enacted section 4960 and amended the definition of covered employee in section 162(m) in the same legislation (TCJA), the absence of these words limits the definition of covered em-

ployee to a current employee for purposes of section 162(m).

The Treasury Department and the IRS have concluded that the better analysis is that Congress intended to apply both section 162(m) and section 4960 to current and former employees. Congress may accomplish the same objective in two separate legislative provisions without using identical statutory language. As explained in section III. D of the preamble to the proposed regulations, the reference to an employee in section 162(m) provides no indication that the term “employee” is limited to a current employee, since a reference in the Code to an “employee” has frequently been interpreted in regulations as a reference to both a current and a former employee.⁷ In addition, as previously noted, the legislative history to section 162(m) makes clear that Congress intended the term “covered employee” to include a former employee.⁸ Accordingly, these final regulations adopt the proposed regulations without change.

IV. Applicable Employee Remuneration

A. In General

Section 162(m)(4)(A) defines the term “applicable employee remuneration” with respect to any covered employee for any taxable year as the aggregate amount allowable as a deduction for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by such employee (whether or not during the taxable year). Section 162(m)(4)(F) provides that remuneration shall not fail to be applicable employee remuneration merely because it is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee. For simplicity, the proposed regulations and these final regulations use the term “compensation” instead of “applicable employee remuneration” wherever possible. Like the proposed regulations, these final regulations provide that compensation means the aggregate amount allowable as a de-

⁷See section III. D of the preamble to the proposed regulations. For example, under §1.105-11(c)(3)(iii), the nondiscrimination rules of section 105(h)(3) apply to former employees even though the Code uses only the term “employees.”

⁸House Conf. Rpt. 115-466, *supra*, at 489.

duction under chapter 1 of the Code for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by a covered employee, whether or not the services were performed during the taxable year, and that compensation includes an amount that is includible in the income of, or paid to, a person other than the covered employee, including after the death of the covered employee

B. Compensation Paid by a Partnership to a Covered Employee

Section 162(m)(1) provides that “[i]n the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee.” As explained in section IV. B of the preamble to the proposed regulations, this statutory provision serves as the basis for the rule in the proposed regulations that a publicly held corporation that holds a partnership interest must take into account its distributive share of the partnership’s deduction for compensation paid to the publicly held corporation’s covered employee and aggregate that distributive share with the corporation’s otherwise allowable deduction for compensation paid directly to that employee in applying the deduction limitation under section 162(m).

In response to this provision of the proposed regulations, commenters suggested that remuneration paid by a partnership is not compensation for purposes of section 162(m) because the partnership is neither a publicly held corporation nor a member of an affiliated group. Section 162(m) does not limit the application of section 162(m) in that manner. Rather, section 162(m) applies to all compensation, which includes “all amounts allowable as a deduction... for remuneration for services performed by such employee (whether or not during the taxable year).” While the comments suggest a reading of section 162(m)(1) that services must be performed in the employee’s capacity as an employee and must be performed for the publicly held corporation, neither of these requirements appear in the statute. In addition, adoption of the commenters’ suggestion could lead to the use of partnerships as a method of

avoiding application of section 162(m), a result that the Treasury Department and IRS conclude is not intended by the statute.

Commenters also suggested that remuneration paid by a partnership should be compensation for purposes of section 162(m) only if the publicly held corporation has an 80% or greater interest in the partnership because the definition of an affiliated group requires 80% ownership by vote and value among the members of the affiliated group. The Treasury Department and the IRS did not adopt this rule because the analogy to the affiliated group proffered by the commenters does not take into account that the tax treatment of a partner in a partnership differs from the tax treatment of a corporation that owns stock in another corporation. Although a consolidated group of corporations may obtain a tax result similar to a deduction flow through, a subsidiary’s compensation deduction does not flow through to the parent corporation in a non-consolidated group of corporations. In contrast, when a publicly held corporation is a partner in a partnership, a share of the partnership’s items of income, gain, loss, and deduction generally is allocated to the publicly held corporation in accordance with partnership agreement, subject to section 704. Furthermore, that allocation may occur regardless of the level of ownership by the publicly held corporation.

These final regulations adopt the provisions of the proposed regulations and provide that a publicly held corporation must take into account its distributive share of a partnership’s deduction for compensation paid to the publicly held corporation’s covered employee in determining the amount allowable to the corporation as a deduction for compensation under section 162(m). Consistent with an example in the proposed regulations and incorporated into these final regulations, these final regulations clarify that the publicly held corporation’s distributive share of the partnership’s deduction for compensation paid by the partnership to a covered employee in connection with the performance of services includes the partnership’s deduction for a payment to the covered employee for services under section 707(a) or section 707(c).

In response to a commenter’s request for clarification on the application of the rule that a publicly held corporation must take into account its distributive share of a partnership’s compensation payment to the publicly held corporation’s covered employee, the Treasury Department and the IRS confirm that these final regulations address only application of the section 162(m) compensation deduction limitation to the publicly held corporation’s distributive share of the payment. The commenter also noted that this partnership rule results in a different application of section 162(m) depending on whether a publicly held corporation’s covered employee receives compensation for services from a partnership in which the publicly held corporation is a partner or from a corporate subsidiary of the partnership. Assuming the partnership is respected for U.S. Federal income tax purposes, section 162(m) generally would not apply to compensation paid to a publicly held corporation’s covered employee by a corporate subsidiary of a partnership for services performed as an employee of the subsidiary because, in this circumstance, the corporate subsidiary would not be a member of the publicly held corporation’s affiliated group.

In recognition of the prior lack of clarity in this area, the proposed regulations provide a special applicability date for this rule, as well as limited transition relief applicable to arrangements in which a publicly held corporation holds a partnership interest. Specifically, to ensure that compensation agreements were not formed or otherwise structured to circumvent the rule regarding partnerships after publication of the proposed regulations and prior to the publication of these final regulations, the proposed regulations set forth a special applicability date that would apply the rule to any deduction for compensation paid by a partnership that is otherwise allowable for a taxable year ending on or after December 20, 2019 (the publication date of the proposed regulations), but would not apply the rule to compensation paid pursuant to a written binding contract in effect on December 20, 2019 that is not materially modified after that date.

Commenters requested additional transition relief for this rule. A commenter suggested a transition relief period of

7 years from the date of publication of these final regulations.⁹ Other commenters suggested that transition relief should apply for taxable years beginning before the publication of these final regulations. In the alternative, these commenters suggested transition relief for compensation arrangements in effect on December 22, 2017 (the date of TJCA enactment), regardless of whether the partnership is obligated to pay the amount of compensation under applicable law, which would provide for more expansive transition relief than set forth in the proposed regulations.

As the preamble to the proposed regulations explains, the transition relief for this definition of compensation must be designed to ensure that compensation agreements are not formed or otherwise structured to circumvent the proposed rules after publication of the proposed regulations and prior to the publication of these final regulations. In consideration of commenters' requests for additional transition relief, these final regulations modify the applicability date of the definition of compensation under § 1.162-33(c)(3)(ii) to provide additional limited transition relief. Under these final regulations, the definition of compensation under § 1.162-33(c)(3)(ii) includes an amount equal to a publicly held corporation's distributive share of a partnership's deduction for compensation expense attributable to the compensation paid by the partnership after December 18, 2020, the date on which these final regulations were made publicly available on the IRS website at <http://www.irs.gov>. Because the date that these final regulations are made publicly

available is prior to the date that they are published in the *Federal Register*, using the earlier date for the expiration of the additional transition relief is appropriate to ensure that compensation is not paid to circumvent these final regulations. In addition, these final regulations continue to provide that this aspect of the definition of compensation does not apply to compensation paid after December 30, 2020 if the compensation is paid pursuant to a written binding contract that is in effect on December 20, 2019, and that is not materially modified after that date.

C. Compensation for Services in a Capacity other than as a Common Law Employee

The proposed regulations provide that compensation subject to section 162(m) includes remuneration for services performed by a covered employee in any capacity, including as a common law employee, a director, or an independent contractor. As explained in section IV. C of the preamble to the proposed regulations, this rule is based on the lack of a specific limitation in the statutory language regarding the capacity in which the covered employee must perform the services for which remuneration is paid, and it is supported by the legislative history to the enactment of section 162(m) in 1993¹⁰ and the preamble to the 1993 proposed regulations.¹¹

In response to the proposed regulations, commenters suggested that, based on the language of section 162(m)(4)(A), compensation subject to section 162(m) should include only compensation for

services performed by a covered employee as an employee of the publicly held corporation. The commenters reasoned that, because section 162(m)(4)(A) uses the phrase "for remuneration for services performed by such *employee*" (emphasis added) in defining compensation subject to section 162(m), only compensation for services provided as an employee is subject to section 162(m).¹²

While the statute may be read in the manner suggested by the commenters, there is nothing in the language that compels this reading, nor does the legislative history to the enactment of section 162(m) suggest that compensation subject to section 162(m) was intended to include only compensation for services as an employee. Section 162(m)(4)(A), which was not amended by TCJA, provides that "the term 'applicable employee remuneration' means, with respect to any covered employee for any taxable year, the aggregate amount allowable as a deduction under this chapter for such taxable year...for remuneration for services performed by such employee (whether or not during the taxable year)." The legislative history provides that section 162(m) "applies to all compensation...regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned."¹³ Consistent with this legislative history, the 1995 regulations defined the term compensation as "the aggregate amount allowable as a deduction...for remuneration for services performed by a covered employee, whether or not the services were performed during the taxable year."¹⁴ Thus,

⁹This commenter also suggested a transition relief period of 10 years for taxpayers that, prior to the IRS first announcing the no-rule position on this issue in Revenue Procedure 2010-3, received private letter rulings providing that section 162(m) did not limit the deduction of the publicly held corporation for compensation paid to a covered employee by a partnership in which the publicly held corporation held a partnership interest. The IRS announced the no-rule position in 2010 in section 5.06 of Revenue Procedure 2010-3, 2010-1 I.R.B. 110, which provided that "[w]hether the deduction limit under § 162(m) applies to compensation attributable to services performed for a related partnership" was an area under study in which rulings or determination letters will not be issued until the IRS resolves the issue through publication of a revenue ruling, revenue procedure, regulations, or otherwise.

¹⁰The legislative history to the enactment of section 162(m) provides that:

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned.

House Conf. Rpt. 103-213, 585 (1993).

¹¹The preamble to the 1993 proposed regulations provides that, "[t]he deduction limit of section 162(m) applies to any compensation that could otherwise be deducted in a taxable year, except for enumerated types of payments set forth in section 162(m)(4)" (58 FR 66310, 66310).

¹²In suggesting that the statute should be read to exclude payments for services performed as an independent contractor from compensation subject to section 162(m), commenters point to a private letter ruling issued in 1997 (PLR 9745002). In the letter ruling, based on the facts presented, the IRS ruled that, for purposes of section 162(m), compensation excludes consulting fees for services performed by a covered employee as an independent contractor. A private letter ruling may be relied upon only by the taxpayer to whom the ruling was issued and does not constitute generally applicable guidance. See section 11.02 of Revenue Procedure 2020-1, 2020-01 I.R.B. 144.

¹³House Conf. Rpt. 103-213, 585 (1993).

¹⁴Section 1.162-27(c)(3)(i). The preamble to the 1993 proposed regulations reiterates this principle, as quoted earlier.

neither the statute nor the 1995 regulations specifically limit the compensation subject to section 162(m) to remuneration paid to the covered employee for services as an employee.

Commenters also suggested that section 162(m) does not apply to compensation for services as an independent contractor because by excluding from the definition of compensation payments that may be made only to an employee, section 162(m)(4)(C) indicates that compensation subject to section 162(m) is limited to compensation for services as an employee. Section 162(m)(4)(C) excludes from the definition of compensation: “(i) any payment referred to in so much of section 3121(a)(5) as precedes subparagraph (E) thereof, and (ii) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from gross income under this chapter.”

Section 162(m)(4)(i), by cross-referencing sections 3121(a)(5)(A)-(D), generally excludes from compensation contributions by an employer on an employee’s behalf to certain types of qualified retirement plans and payments from those types of plans to the employee. Thus, contributions to these arrangements for which an employer would otherwise have a deduction available will not be treated as compensation and the deduction will not be limited by section 162(m). Section 162(m)(4)(C)(ii) serves a similar function by excluding from compensation (and thus not limiting the compensation deduction) certain employee benefits that would be excludible from the employee’s income. These exclusions of benefit payments from the definition of “applicable employee remuneration” reflect only that an individual must be an active employee of the publicly held corporation (or a predecessor) at some point in order to become a covered employee, and that the individual typically would participate in these types of employee benefit arrangements as an employee (often continuing participation that started before the individual became a covered employee).

Importantly, the TCJA amendments to section 162(m) changed the context in which the question as to whether non-employee compensation is subject to the deduction limitation is analyzed. Prior to TCJA, the section 162(m) deduction limitation could be avoided by ensuring that any compensation in excess of \$1,000,000 paid to a covered employee qualified as performance-based compensation or was paid to the covered employee after separation from service or after termination of the individual’s status as a covered employee. For example, if a PEO ceased serving as PEO or as an executive officer but continued as an employee of the publicly held corporation for later taxable years, the former PEO could be compensated without taking into account the potential for a limitation on the deduction due to section 162(m).

The TCJA amendment of section 162(m) eliminates the exclusion from the deduction limitation for compensation paid after the individual is no longer a covered employee. Under the amended section 162(m) rules, once an individual is identified as a covered employee, the individual continues to be a covered employee, and all compensation paid to that individual is subject to the deduction limitation, even after the individual is no longer employed by the publicly held corporation. As explained in the legislative history, this result was intended.¹⁵

The commenters’ suggestion that section 162(m) does not apply to compensation for services as an independent contractor would lead to uncertainty and administrative burdens for both the taxpayer and the IRS, as well as to the potential for abusive arrangements structured to avoid the application of section 162(m) to covered employees who have terminated employment (or who have purportedly terminated employment). Given that the amendments to section 162(m) no longer limit the deduction disallowance to taxable years in which a covered employee is employed on the last day of the taxable year, and the lack of statutory language or legislative history specifically indicating an intent to restrict the deduction limitation to

compensation earned by the individual in the capacity as an employee, the Treasury Department and the IRS have determined that the more appropriate construction of the statutory language defining “applicable employee remuneration” is to include all compensation paid to a covered employee regardless of the capacity in which the covered employee performed services to earn that compensation.

V. Privately Held Corporations that Become Publicly Held

These final regulations adopt the rules set forth in the proposed regulations providing that, in the case of a privately held corporation that becomes a publicly held corporation, section 162(m) limits the deduction for any compensation that is otherwise deductible for the taxable year ending on or after the date that the corporation becomes a publicly held corporation, and that a corporation is considered to become publicly held on the date that its registration statement becomes effective under the Securities Act or the Exchange Act. These final regulations also adopt the transition relief set forth in the proposed regulations providing that a privately held corporation that becomes a publicly held corporation on or before December 20, 2019, generally may rely on the transition rules provided in §1.162-27(f)(1) and (2) of the 1995 regulations.¹⁶ In response to a question from a commenter, these final regulations clarify that a subsidiary that is a member of an affiliated group may rely on transition relief provided in §1.162-27(f)(4) of the 1995 regulations if it becomes a separate publicly held corporation (for example, in a spin-off transaction) on or before December 20, 2019.

Consistent with comments received prior to issuance of the proposed regulations, a commenter suggested that these final regulations should continue to provide transition relief similar to that provided in §1.162-27(f)(1) and (2) of the 1995 regulations for privately held corporations that become publicly held after December 20, 2019. Those sections of the 1995 regulations were formulated based on the

¹⁵ House Conf. Rpt. 115-466, 489 (2017).

¹⁶ Specifically, a privately held corporation that becomes a publicly held corporation before December 20, 2019, may rely on the transition rules provided in §1.162-27(f)(1) until the earliest of the events described in §1.162-27(f)(2). As provided in the 1995 regulations, a corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, thus, may not rely on the transition relief provided in §1.162-27(f)(1).

legislative history to the enactment of section 162(m) and were intended to permit a transition period to meet the shareholder approval requirement for qualified performance-based compensation so that the resulting compensation would not be subject to the deduction limitation under section 162(m). TCJA eliminated the exclusion from the definition of compensation for qualified performance-based compensation. Thus, a transition period to accommodate a shareholder approval process is no longer needed. There is no indication in the language of the amended section 162(m) or the legislative history to the amendments that the transition period was intended be extended even though the original basis for its adoption no longer exists. Accordingly, the suggestion is not adopted in these final regulations.

VI. Grandfather Rule

A. In General

Section 13601(e) of TCJA generally provides that the amendments to section 162(m) apply to taxable years beginning after December 31, 2017. However, it further provides that those amendments do not apply to compensation that is payable pursuant to a written binding contract that was in effect on November 2, 2017, and that was not modified in any material respect on or after that date (the grandfather rule).

As discussed in section VI. A of the preamble to the proposed regulations, the text of section 13601(e) of TJCA is almost identical to the text of pre-TCJA section 162(m)(4)(D), which provided a transition rule in connection with the enactment of section 162(m) in 1993 (the 1993 grandfather rule). Under the 1993 grandfather rule, section 162(m) did not apply to compensation payable under a written binding contract that was in effect on February 17, 1993, and that was not modified thereafter in any material respect before the compensation was paid. Section 1.162-27(h) provides guidance on the definitions of written binding contract and material modification for purposes of applying the 1993 grandfather rule. The proposed regulations adopt those definitions for purposes of the grandfather rule under section 13601(e) of TCJA. These

final regulations adopt the provisions of the proposed regulations and retain these definitions, including that compensation is payable under a written binding contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated under applicable law to pay the compensation if the employee performs services or satisfies the applicable vesting conditions. Section 162(m), as amended, applies to any amount of compensation that exceeds the amount that applicable law obligates the corporation to pay under a written binding contract that was in effect on November 2, 2017.

In response to the proposed regulations, a commenter requested that these final regulations adopt a safe harbor based on Generally Acceptable Accounting Principles (GAAP). The same suggestion had been made prior to issuance of the proposed regulations, and section VI. A of the preamble to the proposed regulations describes a number of issues with a GAAP safe harbor and asks for comments on how and whether these issues could be addressed. The commenter did not address any of these issues related to the formulation and application of a GAAP safe harbor. Accordingly, these final regulations do not adopt a GAAP safe harbor rule.

Another commenter suggested a safe harbor that would grandfather an amount of compensation paid pursuant to a compensation arrangement that satisfied three requirements on or before November 2, 2017: (1) the arrangement was memorialized in some form of media (for example, presentation slides or spreadsheet); (2) the arrangement was communicated to its participants (for example, disseminated in hard copy, electronically, or via presentation format); and (3) participants in the arrangement had a reasonable expectation that they were eligible to receive compensation pursuant to the arrangement. This suggested safe harbor would require an intensive facts and circumstances analysis and raise administrability issues about how to determine the participants' expectations regarding the compensation arrangement and whether those expectations were reasonable. Furthermore, the suggested safe harbor arguably is inconsistent with the statutory language that grandfathers an amount of compensation only if the corporation was obligated to

pay it under applicable law pursuant to a written binding contract in effect on November 2, 2017, and not, for example, if an employee merely had a reasonable expectation of payment (without regard to the corporation's obligation under applicable law). For these reasons, these final regulations do not adopt this safe harbor.

B. Compensation Subject to Negative Discretion

These final regulations adopt the rule set forth in the proposed regulations providing that a provision in a compensation agreement that purports to provide the employer with the discretion to reduce or eliminate a compensation payment (negative discretion) is taken into account only to the extent the corporation has the right to exercise the negative discretion under applicable law (for example, applicable state contract law). If a compensation arrangement allows the corporation to exercise negative discretion, compensation payable under the arrangement is not grandfathered to the extent the corporation is not obligated to pay it under applicable law.

In response to the proposed regulations, a commenter suggested that negative discretion provisions should be disregarded in determining whether compensation is grandfathered because numerous performance-based compensation arrangements provide corporations with such discretion. However, the practice of including negative discretion provisions in compensation arrangements is based on a well-known and longstanding regulatory provision, and Congress could have provided for a grandfather rule that addressed performance-based compensation arrangements that include a negative discretion provision, but it did not. Instead, the grandfather rule refers only to compensation paid pursuant to a legally binding contract in effect on the transition date. Thus, whether a performance-based compensation arrangement that includes a negative discretion provision is a legally binding contract is determined based on applicable law.

Another commenter suggested that a corporation should be deemed not to have a right to exercise negative discretion if the terms of the agreement provide

that the corporation may not exercise this discretion if doing so would result in the payment of compensation that would not be deductible by reason of section 162(m). Whether a compensation agreement that includes a negative discretion provision of this sort would be a written binding contract that permitted the exercise of the negative discretion after the amendments to section 162(m) or rather obligated the employer to pay the compensation because the section 162(m) amendments negated the employer's ability to exercise the negative discretion must be determined based on applicable law. Accordingly, these final regulations do not provide a separate standard for purposes of applying the grandfather rule to compensation agreements that include this type of negative discretion provision (or any other type of negative discretion provision).

C. Recovery of Compensation

The proposed regulations provide that, if the corporation is obligated or has discretion to recover compensation paid in a taxable year only upon the future occurrence of a condition that is objectively outside of the corporation's control, then the corporation's right to recovery is disregarded for purposes of determining the grandfathered amount for the taxable year. The proposed regulations also provide that, if the condition occurs, then only the amount the corporation is obligated to pay under applicable law remains grandfathered, taking into account the occurrence of the condition. After further consideration, the Treasury Department and the IRS recognize that the corporation's right to recover compensation is a contractual right that is separate from the corporation's binding obligation under the contract (as of November 2, 2017) to pay the compensation. Accordingly, these final regulations provide that the corporation's right to recover compensation does not affect the determination of the amount of compensation the corporation has a written binding contract to pay under applicable law as of November 2, 2017, whether or not the corporation exercises its discretion to recover any compensation in the event the condition arises in the future.

D. Account and Nonaccount Balance Plans

The proposed regulations include examples illustrating the application of the grandfather rule to account and nonaccount balance nonqualified deferred compensation (NQDC) plans. In response to comments, these final regulations clarify the application of the grandfather rule to compensation payable under these plans by providing detailed rules and thus eliminate the need to retain certain examples in these final regulations. Specifically, with respect to an account balance plan, these final regulations provide that the grandfathered amount under an account balance plan is the amount that the corporation is obligated to pay pursuant to the terms of the plan as of November 2, 2017, as determined under applicable law. If the corporation is obligated to pay the employee the account balance that is credited with earnings and losses and has no right to terminate or materially amend the contract, then the grandfathered amount would be the account balance as of November 2, 2017, plus any additional contributions and earnings and losses that the corporation is obligated to credit under the plan, through the date of payment. These final regulations provide an analogous rule for nonaccount balance plans.

If the terms of the account balance plan that is a written binding contract as of November 2, 2017, provide that the corporation may terminate the plan and distribute the account balance to the employee, then the grandfathered amount is the account balance determined as if the corporation had terminated the plan on November 2, 2017, or, if later, the earliest possible date the plan could be terminated (termination date). Furthermore, whether additional contributions and earnings and losses credited to the account balance after the termination date, through the earliest possible date the account balance could have been distributed to the employee, are grandfathered depends on whether the terms of the plan require the corporation to make those contributions or credit those earnings and losses through the earliest possible date the account balance could be distributed if it were terminated as of the termination date. These final regulations provide an

analogous rule for nonaccount balance plans.

If the terms of the account balance plan provide that the corporation may not terminate the contract, but may discontinue future contributions to the account balance and distribute the account balance in accordance with the terms of the plan, then the grandfathered amount is the account balance determined as if the corporation had exercised the right to discontinue contributions on November 2, 2017 or, if later, the earliest permissible date the corporation could exercise that right in accordance with the terms of the plan (the freeze date). Furthermore, if the plan required the crediting of earnings and losses on the account balance after the freeze date through the payment date, then those earnings and losses credited to the grandfathered account balance are also grandfathered. These final regulations provide an analogous rule for nonaccount balance plans.

Alternatively, whether the terms of the account balance plan provide that the corporation may terminate the plan or, instead, may discontinue future contributions, the corporation may elect to treat the account balance as of the termination date (or freeze date, if applicable) as the grandfathered amount regardless of when the amount is paid and regardless of whether it has been credited with earnings or losses prior to payment. These final regulations provide an analogous rule for nonaccount balance plans. These final regulations adopt this alternative grandfather rule that disregards earnings and losses in order to minimize the administrative burden of tracking the earnings, losses and new contributions (if made) on an account balance plan or the increase or decrease in a nonaccount balance benefit after November 2, 2017. With respect to an account balance plan, the Treasury Department and IRS understand that this grandfather rule may result in contributions made after November 2, 2017, not being subject to the section 162(m) limitation if the contributions offset losses; however, the Treasury Department and IRS concluded that under many common arrangements the continuous separate tracking of earnings, losses, and contributions on the November 2, 2017, account balance through the payment date would be burdensome to

administer while having a limited, if any, impact on the available deduction.

E. Ordering Rule for Payments

Consisting of Grandfathered and Non-Grandfathered Amounts Deductible for Taxable Years Ending Prior to December 20, 2019

These final regulations adopt the ordering rule set forth in the proposed regulations for identifying the grandfathered amount when payment under a grandfathered arrangement is made in a series of payments. Pursuant to the ordering rule, the grandfathered amount is allocated to the first otherwise deductible payment paid under the arrangement. If the grandfathered amount exceeds the payment, then the excess is allocated to the next otherwise deductible payment paid under the arrangement. This process is repeated until the entire grandfathered amount has been paid.

For example, assume an employer maintains a nonaccount balance NQDC plan (payable as an annuity) as of November 2, 2017, and that the grandfathered amount is \$2,000,000. Further assume that additional benefits accrue under the plan after November 2, 2017, with the result that the employee's benefit is payable as an annual annuity of \$1,500,000 commencing at the employee's retirement for the employee's life. Under these final regulations, the entire \$1,500,000 paid in the first year is grandfathered. In the second year, only \$500,000 of the \$1,500,000 payment is grandfathered; the remaining \$1,000,000 paid in the second year is not grandfathered. For subsequent taxable years, none of the \$1,500,000 payments are grandfathered.

A commenter suggested that for payments otherwise deductible for taxable years ending prior to the date the proposed regulations were published (December 20, 2019), it would be a reasonable good faith interpretation of the statute if the grandfathered amount were allocated to the last otherwise deductible payment or to each payment on a pro rata basis. The Treasury Department and the IRS agree and these final regulations permit the grandfathered amount to be allocated to the last otherwise deductible payment or to each payment on a pro rata basis for taxable

years ending before December 20, 2019. However, these final regulations provide that the ordering rule requiring the grandfathered amount to be allocated to the first otherwise deductible payment paid under the arrangement must be used for taxable years ending on or after December 20, 2019, regardless of the method used to allocate the grandfathered amount for taxable years ending prior to that date.

F. Grandfathered Amount Limited to a Particular Plan or Arrangement

These final regulations provide that the grandfathered amount payable under a plan or arrangement applies solely to the amounts paid under that plan or arrangement. Regardless of whether all of the grandfathered amount is paid to the employee, no portion of that grandfathered amount may be treated as a grandfathered amount under any other separate plan or arrangement in which the employee is a participant. If, for example, all or a portion of a grandfathered amount is forfeited because the employee died before being paid the entire amount, then any unpaid portion of the grandfathered amount may not be applied as a grandfathered amount to payments under any other separate plan or arrangement in which the employee participated.

G. Material Modification

1. In General

These final regulations adopt the rules set forth in the proposed regulations related to material modifications. A material modification occurs when a contract is amended to increase the amount of compensation payable to the employee. If a written binding contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Accordingly, if a contract is materially modified, amounts received by an employee under the contract before the material modification are not affected, but amounts received after the material modification are treated as paid pursuant to a new contract, rather than as grandfathered. The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment

of additional compensation, results in a material modification if the facts and circumstances demonstrate that the compensation under the supplement is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract.

If a written binding contract in effect on November 2, 2017, is subsequently modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable to the employee under the contract will not be treated as resulting in a material modification if the additional amount is based on either a reasonable rate of interest or a predetermined actual investment (whether or not assets associated with the original amount are actually invested therein) such that the amount payable by the employer at the later date will be based on the rate of interest or the actual rate of return on the investment (including any decrease, as well as any increase, in the value of the investment). However, the additional amount paid will not be treated as a grandfathered amount. Additionally, a modification of the contract after November 2, 2017, to offer an additional or substitute a predetermined actual investment as an investment alternative under the arrangement is not a material modification.

A commenter suggested that these final regulations provide that the deferral of a grandfathered amount after November 2, 2017, but prior to September 10, 2018 (the publication date of Notice 2018-68), is not a material modification even if the earnings on the deferred amount are not based on either a reasonable rate of interest or a predetermined actual investment because taxpayers were not aware prior to the publication of the notice that this deferral would constitute a material modification. The grandfather rule described in section 13601(e) of TCJA and its legislative history, including the definition and the resulting impact of a material modification, is almost identical to the statutory language and legislative history to the grandfather rule provided when section 162(m) was enacted in 1993. The 1995 final regulations interpreting the original grandfather rule in the 1993 legislation provided that a deferral of payment of compensation will

not be treated as a material modification if any additional amount paid were determined based on a reasonable rate of interest or one or more predetermined actual investments, and there is no indication in the grandfather rule in section 13601 of TCJA or its legislative history of an intent to adopt a different grandfather rule.¹⁷ Therefore, these final regulations do not adopt the commenter's suggestion.

2. Extension of an Exercise Period for a Non-Statutory Stock Option

Commenters asked if extending the exercise period for a non-statutory stock option¹⁸ is a material modification. The grandfather rule in the proposed regulations provides that compensation attributable to the exercise of an option is grandfathered only if, as of November 2, 2017, pursuant to terms of the option and under applicable law, the employer is obligated to transfer the option's underlying shares of stock to the employee upon exercise of the option.

The Treasury Department and the IRS recognize that, for bona fide business reasons, an employer may want to extend an exercise period of a stock option or a stock appreciation right (SAR). This often occurs when a stock option or SAR grant agreement provides that the exercise period will terminate immediately or within a short period following the employee's separation from service, but the employer later decides to waive that termination or otherwise extend the exercise period for some period of time upon the employee's separation from service. These concerns led to treating certain extensions of stock options or SARs as not being material modifications in the regulations under section 409A. For the same reasons, these final regulations incorporate the section 409A regulatory provisions and provide that, if compensation attributable to the exercise of a non-statutory stock option or a SAR is grandfathered and the exercise

period of the option or SAR is extended, then all compensation attributable to the exercise of the option or the SAR is grandfathered if the extension complies with §1.409A-1(b)(5)(v)(C)(I).¹⁹

VII. Coordination with Section 409A

Section 409A addresses NQDC arrangements and sets forth certain requirements that must be met to avoid current income inclusion, a 20% additional income tax on the amount includible in income per section 409A(a)(1)(B)(i)(II), and a second additional income tax based on the tax benefit received due to the deferral per section 409A(a)(1)(B)(i)(I). Recognizing that the TCJA amendments to section 162(m) required coordination with the section 409A rules in certain circumstances, the preamble to the proposed regulations provided that certain modifications would be made to the regulations under section 409A and that taxpayers may rely on the preamble until this guidance is issued. Commenters suggested additional modifications to the rules and regulations under section 409A to provide further coordination between sections 162(m) and 409A. Until guidance under section 409A is issued, taxpayers may continue to rely on the preamble to the proposed regulations. The Treasury Department and the IRS will continue to consider whether additional guidance under section 409A is appropriate.

VIII. Applicability Dates

A. General Applicability Date

Generally, these final regulations apply to taxable years beginning on or after December 30, 2020. However, taxpayers may choose to apply these final regulations to a taxable year beginning after December 31, 2017, provided the taxpayer applies these final regulations in their entirety and in a consistent manner to that taxable year and

all subsequent taxable years. See section 7805(b)(7). Like the proposed regulations, these final regulations generally do not expand the definition of "covered employee" as provided in Notice 2018-68 and do not narrow the application of the definition of "written binding contract" as provided in Notice 2018-68. With respect to the limited number of changes that do affect these definitions, a special applicability date has been provided as described in section VIII. B of this preamble. Accordingly, taxpayers may not rely on Notice 2018-68 for taxable years ending on or after December 20, 2019, the publication date of the proposed regulations.

B. Special Applicability Dates

These final regulations include special applicability dates covering certain aspects of the following provisions of these final regulations:

1. Definition of covered employee.
2. Definition of predecessor of a publicly held corporation.
3. Definition of compensation.
4. Application of section 162(m) to a deduction for compensation otherwise deductible for a taxable year ending on or after a privately held corporation becomes a publicly held corporation.
5. Definitions of written binding contract and material modification.

First, the definition of covered employee applies to taxable years ending on or after September 10, 2018, the publication date of Notice 2018-68, which provided guidance on the definition of covered employee. Notice 2018-68 also provided that the Treasury Department and the IRS anticipate that the guidance in the notice will be incorporated into future regulations that, with respect to the issues addressed in the notice, will apply to any taxable year ending on or after September 10, 2018. These final regulations adopt the definition of covered employee in Notice 2018-68 as anticipated, and according-

¹⁷ Section 1.162-27(h)(iii)(B) provides that if the contract is modified to defer the payment of compensation, any compensation paid in excess of the amount that was originally payable to the employee under the contract will not be treated as a material modification if the additional amount is based on either a reasonable rate of interest or one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of the specific investment (including any decrease as well as any increase in the value of the investment).

¹⁸ A non-statutory stock option is an option other than an incentive stock option described in section 422 or a stock option granted under an employee stock purchase plan described in section 423.

¹⁹ Section 1.409A-1(b)(5)(v)(C)(I) describes the following requirements for an extension: (1) at the time of the extension, the exercise price is greater than the underlying stock's fair market value and (2) the exercise period is extended to a date no later than the earlier of the latest date upon which the stock right could have expired by its original terms or the 10th anniversary of the original date of grant.

ly the definition of covered employee in these final regulations applies to taxable years ending on or after September 10, 2018. The Treasury Department and the IRS recognize, however, that the rules under §1.162-33(c)(2)(i)(B), related to a corporation whose fiscal year and taxable year do not end on the same date, were not addressed in Notice 2018-68 but were discussed initially in the proposed regulations. Accordingly, these final regulations provide that, for a corporation the fiscal and taxable years of which do not end on the same date, the rule requiring the determination of the three most highly compensated executive officers to be made pursuant to the rules under the Exchange Act applies to taxable years ending on or after December 20, 2019.

Second, the provisions defining a predecessor corporation of a publicly held corporation apply to corporate transactions that occur on or after December 30, 2020. These final regulations also include a special applicability date for corporations that change from being a publicly held corporation to a privately held corporation, and, later, back to a publicly held corporation on or after December 30, 2020.

If a corporate transaction occurs before December 30, 2020, then taxpayers may apply either the definition of predecessor of a publicly held corporation in §1.162-33(c)(2)(ii) of these final regulations or a reasonable good faith interpretation of the term “predecessor” in section 162(m)(3)(C) with respect to such transaction. However, with respect to any of the following corporate transactions occurring after December 20, 2019, and before December 30, 2020, excluding target corporations from the definition of the term “predecessor” is not a reasonable good faith interpretation of the statute: (1) a publicly held target corporation the stock or assets of which are acquired by another publicly held corporation in a transaction to which section 381(a) applies, and (2) a publicly held target corporation, at least 80% of the total voting power of the stock of which, and at least 80% of the total value of the stock of which, are acquired by a publicly held acquiring corporation (including an affiliated group). No inference is intended regarding whether the treatment of a target corporation as other than a “predecessor”

in any other situation is a reasonable good faith interpretation of the statute.

Third, as discussed in section IV. B. of this preamble, these final regulations modify the proposed applicability date for the definition of compensation under §1.162-33(c)(3)(ii). Under these final regulations, the definition of compensation under §1.162-33(c)(3)(ii) includes an amount equal to the publicly held corporation’s distributive share of a partnership’s deduction for compensation expense only if the deduction is attributable to compensation paid by the partnership after December 18, 2020 (the date that these final regulations were made publicly available on the IRS website at <http://www.irs.gov>). However, these final regulations continue to provide a transition rule so that this aspect of the definition of compensation related to the distributive share of a partnership’s deduction for compensation expense does not apply to compensation paid after **December 30, 2020** if the compensation is paid pursuant to a written binding contract that is in effect on December 20, 2019, and that is not materially modified after that date.

Fourth, the guidance on the applicability of section 162(m)(1) to the deduction for any compensation otherwise deductible for a taxable year ending on or after the date when a corporation becomes a publicly held corporation applies to corporations that become publicly held after December 20, 2019. A corporation that was not a publicly held corporation and then becomes a publicly held corporation on or before December 20, 2019, may rely on the transition relief provided in §1.162-27(f)(1) until the earliest of the events provided in §1.162-27(f)(2). Furthermore, a subsidiary corporation that is a member of an affiliated group (as defined in §1.162-27(c)(1)(ii)) may rely on the transition relief provided in §1.162-27(f)(4) if it becomes a separate publicly held corporation (whether in a spin-off transaction or otherwise) on or before December 20, 2019.

Fifth, the definitions of written binding contract and material modification in these final regulations apply to taxable years ending on or after September 10, 2018, the publication date of Notice 2018-68, which provided guidance defining these terms. Notice 2018-68 also provided that the

Treasury Department and IRS anticipated that the guidance in the notice would be incorporated into future regulations that, with respect to the issues addressed in the notice, would apply to any taxable year ending on or after September 10, 2018. Because these final regulations adopt the definitions of the terms “written binding contract” and “material modification” that were included in Notice 2018-68, the guidance on these definitions in these final regulations applies to taxable years ending on or after September 10, 2018.

Effect on Other Documents

Section 4.01(13) of Revenue Procedure 2020-3, 2020-1 I.R.B. 131 (providing that “[w]hether the deduction limit under § 162(m) applies to compensation attributable to services performed for a related partnership” is an area in which rulings or determination letters will not ordinarily be issued) is obsolete as of **December 30, 2020**.

Statement of Availability of IRS Documents

The IRS Notices, Revenue Rulings, and Revenue Procedures cited in this document 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 Analyses

I. Regulatory Planning and Review

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Department of the Treasury and the Office of Management and Budget regarding review of tax regulations.

II. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6), it is hereby certified that these final regulations would not have a significant economic

impact on a substantial number of small entities. This certification is based on the fact that section 162(m)(1) applies only to publicly held corporations (for example, corporations that list securities on a national securities exchange and are rarely small entities) and only impacts those publicly held corporations that compensate certain executive officers in excess of \$1 million in a taxable year. Pursuant to section 7805(f), the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

III. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain 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 section, of \$100 million in 1995 dollars, update annually for inflation. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private section in excess of that threshold.

IV. 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 final 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.

Drafting Information

The principal author of these regulations is Ilya Enkishev, Office of Associate Chief Counsel (Employee Benefits,

Exempt Organizations, and Employment Taxes). However, other personnel from the Treasury Department and the IRS participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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 * * *

Par. 2. Section 1.162-27 is amended by revising the section heading and paragraphs (a) and (j)(1) to read as follows:

§1.162-27 Certain employee remuneration in excess of \$1,000,000 not deductible for taxable years beginning on or after January 1, 1994, and for taxable years beginning prior to January 1, 2018.

(a) *Scope.* This section provides rules for the application of the \$1 million deduction limitation under section 162(m)(1) for taxable years beginning on or after January 1, 1994, and beginning prior to January 1, 2018, and, as provided in paragraph (j) of this section, for taxable years beginning after December 31, 2017. For rules concerning the applicability of section 162(m)(1) to taxable years beginning after December 31, 2017, see §1.162-33. Paragraph (b) of this section provides the general rule limiting deductions under section 162(m)(1). Paragraph (c) of this section provides definitions of generally applicable terms. Paragraph (d) of this section provides an exception from the deduction limitation for compensation payable on a commission basis. Paragraph (e) of this section provides an exception for qualified performance-based compensation. Paragraphs (f) and (g) of this section provide special rules for corporations that become publicly held corporations and payments that are subject to section

280G, respectively. Paragraph (h) of this section provides transition rules, including the rules for contracts that are grandfathered and not subject to section 162(m)(1). Paragraph (j) of this section contains the effective date provisions, which also specify when these rules apply to the deduction for compensation otherwise deductible in a taxable year beginning after December 31, 2017. For rules concerning the deductibility of compensation for services that are not covered by section 162(m)(1) and this section, see section 162(a)(1) and §1.162-7. This section is not determinative as to whether compensation meets the requirements of section 162(a)(1). For rules concerning the deduction limitation under section 162(m)(6) applicable to certain health insurance providers, see §1.162-31.

(j) * * *

(1) *In general.* Section 162(m) and this section apply to the deduction for compensation that is otherwise deductible by the corporation in taxable years beginning on or after January 1, 1994, and beginning prior to January 1, 2018. Section 162(m) and this section also apply to compensation that is a grandfathered amount (as defined in §1.162-33(g)) at the time it is paid to the covered employee or otherwise deductible. For examples of the application of the rules of this section to grandfathered amounts paid during or otherwise deductible for taxable years beginning after December 31, 2017, see §1.162-33(g). *****

Par. 3. Section 1.162-33 is added to read as follows:

§1.162-33 Certain employee remuneration in excess of \$1,000,000 not deductible for taxable years beginning after December 31, 2017.

(a) *Scope.* This section provides rules for the application of the \$1 million deduction limitation under section 162(m)(1) for taxable years beginning after December 31, 2017. For rules concerning the applicability of section 162(m)(1) to taxable years beginning on or after January 1, 1994, and prior to January 1, 2018, see §1.162-27. Paragraph (b) of this section provides the general rule limiting deductions under section 162(m)(1). Paragraph

(c) of this section provides definitions of generally applicable terms. Paragraph (d) of this section provides rules for determining when a corporation becomes a publicly held corporation. Paragraph (e) of this section provides rules for payments that are subject to section 280G (golden parachute payments). Paragraph (f) of this section provides a special rule for coordination with section 4985 (stock compensation of insiders in expatriated corporations). Paragraph (g) of this section provides transition rules addressing the amendments made by Public Law 115-97, including the rules for contracts that are grandfathered. Paragraph (h) of this section sets forth the effective date provisions. For rules concerning the deductibility of compensation for services that are not covered by section 162(m)(1) and this section, see section 162(a)(1) and §1.162-7. This section is not determinative as to whether compensation meets the requirements of section 162(a)(1). For rules concerning the deduction limitation under section 162(m)(6) applicable to certain health insurance providers, see §1.162-31. For purposes of this section, references to an amount being paid to an employee refer to the event that otherwise would result in the availability of a deduction to the employer with respect to such amount, whether that results from an actual payment in cash, transfer of property, or other event.

(b) *Limitation on deduction.* Section 162(m)(1) precludes a deduction under chapter 1 of the Internal Revenue Code by any publicly held corporation for compensation paid to any covered employee to the extent that the compensation for the taxable year exceeds \$1,000,000.

(c) *Definitions*—(1) *Publicly held corporation*—(i) *General rule.* A publicly held corporation means any corporation that issues securities required to be registered under section 12 of the Exchange Act or that is required to file reports under section 15(d) of the Exchange Act. In addition, a publicly held corporation means any S corporation (as defined in section 1361(a)(1)) that issues securities that are required to be registered under section 12(b) of the Exchange Act, or that is required to file reports under section 15(d) of the Exchange Act. For purposes of this section, whether a corporation is publicly

held is determined based solely on whether, as of the last day of its taxable year, the securities issued by the corporation are required to be registered under section 12 of the Exchange Act or the corporation is required to file reports under section 15(d) of the Exchange Act. Whether registration under the Exchange Act is required by rules other than those of the Exchange Act is irrelevant to this determination. A publicly traded partnership that is treated as a corporation under section 7704 (or otherwise) is a publicly held corporation if, as of the last day of its taxable year, its securities are required to be registered under section 12 of the Exchange Act or it is required to file reports under section 15(d) of the Exchange Act.

(ii) *Affiliated groups*—(A) *In general.* A publicly held corporation includes an affiliated group of corporations (affiliated group), as defined in section 1504 (determined without regard to section 1504(b)), that includes one or more publicly held corporations (as defined in paragraph (c)(1)(i) of this section). In the case of an affiliated group that includes two or more publicly held corporations as defined in paragraph (c)(1)(i) of this section, each member of the affiliated group that is a publicly held corporation as defined in paragraph (c)(1)(i) of this section is separately subject to this section, and, due to having at least one member that is a publicly held corporation, the affiliated group as a whole is subject to this section. Thus, for example, assume that a publicly held corporation (as defined in paragraph (c)(1)(i) of this section) is a wholly-owned subsidiary of another publicly held corporation (as defined in paragraph (c)(1)(i) of this section), which is a wholly-owned subsidiary of a privately held corporation. In this case, the two subsidiaries are separately subject to this section, and all three corporations are members of an affiliated group that is subject to this section. If an individual is a covered employee of both subsidiaries, each subsidiary has its own \$1 million deduction limitation with respect to that covered employee. Furthermore, each subsidiary has its own set of covered employees as defined in paragraphs (c)(2)(i) through (iv) of this section (although the same individual may be a covered employee of both subsidiaries).

(B) *Proration of amount disallowed as a deduction.* If, in a taxable year, a covered employee (as defined in paragraphs (c)(2)(i) through (v) of this section) of one member of an affiliated group is paid compensation by more than one member of the affiliated group, compensation paid by each member of the affiliated group is aggregated with compensation paid to the covered employee by all other members of the affiliated group (excluding compensation paid by any other publicly held corporation in the affiliated group, as defined in paragraph (c)(1)(i) of this section, of which the individual is also a covered employee as defined in paragraphs (c)(2)(i) through (v) of this section). In the event that, in a taxable year, a covered employee (as defined in paragraphs (c)(2)(i) through (v) of this section) is paid compensation by more than one publicly held corporation in an affiliated group and is also a covered employee of more than one publicly held payor corporation (as defined in paragraph (c)(1)(i) of this section) in the affiliated group, the amount disallowed as a deduction is determined separately with respect to each publicly held corporation of which the individual is a covered employee. Any amount disallowed as a deduction by this section must be prorated among the payor corporations (excluding any other publicly held payor corporation of which the individual is also a covered employee) in proportion to the amount of compensation paid to the covered employee (as defined in paragraphs (c)(2)(i) through (v) of this section) by each such corporation in the taxable year. For purposes of this paragraph (c)(1)(ii)(B), the amount of compensation treated as paid by a payor corporation that is not a publicly held corporation (as defined in paragraph (c)(1)(i) of this section) is determined by prorating the amount actually paid by that payor corporation in proportion to the total amount paid by all of the publicly held corporations of which the individual is a covered employee (as defined in paragraph (c)(2)(i) through (v) of this section). This process is repeated for each publicly held payor corporation of which the individual is a covered employee.

(iii) *Disregarded entities.* For purposes of paragraph (c)(1) of this section, a publicly held corporation includes a corporation that owns an entity that is disregarded

as an entity separate from its owner within the meaning of §301.7701-2(c)(2)(i) of this chapter if the disregarded entity issues securities required to be registered under section 12(b) of the Exchange Act, or is required to file reports under section 15(d) of the Exchange Act.

(iv) *Qualified subchapter S subsidiaries.* For purposes of paragraph (c)(1) of this section, a publicly held corporation includes an S corporation that owns a qualified subchapter S subsidiary as defined in section 1361(b)(3)(B) (QSub) if the QSub issues securities required to be registered under section 12(b) of the Exchange Act, or is required to file reports under section 15(d) of the Exchange Act.

(v) *Qualified real estate investment trust subsidiaries.* For purposes of paragraph (c)(1) of this section, a publicly held corporation includes a real estate investment trust as defined in section 856(a) that owns a qualified real estate investment trust subsidiary as defined in section 856(i)(2) (QRS), if the QRS issues securities required to be registered under section 12(b) of the Exchange Act or is required to file reports under section 15(d) of the Exchange Act.

(vi) *Examples.* The following examples illustrate the provisions of this paragraph (c)(1). For each example, assume that no corporation is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii) of this section. Furthermore, for each example, unless provided otherwise, a reference to a publicly held corporation means a publicly held corporation as defined in paragraph (c)(1)(i) of this section. Additionally, for each example, assume that the corporation is a calendar-year taxpayer and has a fiscal year ending December 31 for reporting purposes under the Exchange Act. The examples in this paragraph (c)(1)(vi) are not intended to provide guidance on the legal requirements of the Securities Act and Exchange Act and the rules thereunder (17 CFR part 240).

(A) *Example 1 (Corporation required to file reports under section 15(d) of the Exchange Act)*—(1) *Facts.* Corporation Z plans to issue debt securities in a public offering registered under the Securities Act. Corporation Z is not required to file reports under section 15(d) of the Exchange Act for any other class of securities and does not have another class of securities required to be registered under section 12 of the Exchange Act. On April 1, 2021, the SEC declares effective the Securities Act registration statement for

Corporation Z's debt securities. As a result, Corporation Z is required to file reports under section 15(d) of the Exchange Act, and this requirement continues to apply as of December 31, 2021.

(2) *Conclusion.* Corporation Z is a publicly held corporation for its 2021 taxable year because it is required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(B) *Example 2 (Corporation not required to file reports under section 15(d) of the Exchange Act)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(vi)(A) of this section (*Example 1*), except that, on January 1, 2022, pursuant to section 15(d) of the Exchange Act, Corporation Z's obligation to file reports under section 15(d) is automatically suspended for the fiscal year ending December 31, 2022, because Corporation Z meets the statutory requirements for an automatic suspension. As of December 31, 2022, Corporation Z is not required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporation Z is not a publicly held corporation for its 2022 taxable year because it is not required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(C) *Example 3 (Corporation not required to file reports under section 15(d) of the Exchange Act)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(vi)(B) of this section (*Example 2*), except that, on January 1, 2022, pursuant to section 15(d) of the Exchange Act, Corporation Z's obligation to file reports under section 15(d) is not automatically suspended for the fiscal year ending December 31, 2022. Instead, on May 2, 2022, Corporation Z is eligible to suspend its section 15(d) reporting obligation under 17 CFR 240.12h-3 (Rule 12h-3 under the Exchange Act) and files Form 15, Certification and Notice of Termination of Registration under Section 12(g) of the Securities Exchange Act of 1934 or Suspension of Duty to File Reports under Sections 13 and 15(d) of the Securities Exchange Act of 1934, (or its successor) to suspend its section 15(d) reporting obligation for its fiscal year ending December 31, 2022. As of December 31, 2022, Corporation Z is not required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporation Z is not a publicly held corporation for its 2022 taxable year because it is not required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year. If Corporation Z had not utilized Rule 12h-3 to suspend its section 15(d) reporting obligation, Corporation Z would be a publicly held corporation for its 2022 taxable year because it would have been required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(D) *Example 4 (Corporation required to file reports under section 15(d) of the Exchange Act)*—(1) *Facts.* Corporation Y is a wholly-owned subsidiary of Corporation X, which is required to file reports under the Exchange Act. Corporation Y issued a class of debt securities in a public offering registered under the Securities Act, and therefore is required to file reports under section 15(d) of the Exchange Act for its fiscal year ending December 31, 2020. Corporation Y has no other class of securities registered under the Exchange Act. In its Form 10-K, Annual Report Pursuant to section 13 or section 15(d) of

the Securities Exchange Act of 1934, (or its successor) for the 2020 fiscal year, Corporation Y may omit Item 11, Executive Compensation (required by Part III of Form 10-K), which requires disclosure of compensation of certain executive officers, because it is wholly-owned by Corporation X and the other conditions of General Instruction I to Form 10-K are satisfied.

(2) *Conclusion.* Corporation Y is a publicly held corporation for its 2020 taxable year because it is required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(E) *Example 5 (Corporation not required to file reports under section 15(d) of the Exchange Act and not required to register securities under section 12 of the Exchange Act)*—(1) *Facts.* Corporation A has a class of securities registered under section 12(g) of the Exchange Act. For its 2020 taxable year, Corporation A is a publicly held corporation. On September 30, 2021, Corporation A is eligible to terminate the registration of its securities under section 12(g) of the Exchange Act pursuant to 17 CFR 240.12g-4(a)(2) (Rule 12g-4(a)(2) under the Exchange Act), but does not terminate the registration of its securities prior to December 31, 2021. Because Corporation A did not issue securities in a public offering registered under the Securities Act, Corporation A is not required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporation A is not a publicly held corporation for its 2021 taxable year because, as of the last day of its taxable year, the securities issued by Corporation A are not required to be registered under section 12 of the Exchange Act and Corporation A is not required to file reports under section 15(d) of the Exchange Act.

(F) *Example 6 (Corporation required to file reports under section 15(d) of the Exchange Act)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(vi)(E) of this section (*Example 5*), except that Corporation A previously issued a class of securities in a public offering registered under the Securities Act. Furthermore, on October 1, 2021, Corporation A terminates the registration of its securities under section 12(g) of the Exchange Act. Because Corporation A issued a class of securities in a public offering registered under the Securities Act and is not eligible to suspend its reporting obligation under section 15(d) of the Exchange Act, as of December 31, 2021, Corporation A is required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporation A is a publicly held corporation for its 2021 taxable year because it is required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(G) *Example 7 (Corporation not required to file reports under section 15(d) of the Exchange Act and not required to register securities under section 12 of the Exchange Act)*—(1) *Facts.* On November 1, 2021, Corporation B is an issuer with only one class of equity securities. On November 5, 2021, Corporation B files a registration statement for its equity securities under section 12(g) of the Exchange Act. Corporation B's filing of its registration statement is voluntary because the Exchange Act does not require Corporation B to register its class of securities under section 12(g) of the Exchange Act based on the number and composition of its record holders.

On December 1, 2021, the SEC declares effective the Exchange Act registration statement for Corporation B's securities. As of December 31, 2021, Corporation B continues to have its class of equity securities registered voluntarily under section 12 of the Exchange Act. Corporation B is not required to file reports under section 15(d) of the Exchange Act because it did not register any class of securities in a public offering under the Securities Act.

(2) *Conclusion.* Corporation B is not a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, the securities issued by Corporation B are not required to be registered under section 12 of the Exchange Act and Corporation B is not required to file reports under section 15(d) of the Exchange Act.

(H) *Example 8 (Corporation not required to file reports under section 15(d) of the Exchange Act and not required to register securities under section 12 of the Exchange Act)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(vi)(G) of this section (*Example 7*), except that, on December 31, 2022, because of a change in circumstances, Corporation B must register its class of equity securities under section 12(g) of the Exchange Act within 120 days of December 31, 2022. On February 1, 2023, the SEC declares effective the Exchange Act registration statement for Corporation B's securities.

(2) *Conclusion.* Corporation B is not a publicly held corporation for its 2022 taxable year because, as of the last day of that taxable year, Corporation B is not required to file reports under section 15(d) of the Exchange Act and the class of equity securities issued by Corporation B is not yet required to be registered under section 12 of the Exchange Act.

(I) *Example 9 (Securities of foreign private issuer in the form of ADRs traded in the over-the-counter market)*—(1) *Facts.* For its fiscal and taxable years ending December 31, 2021, Corporation W is a foreign private issuer. Because Corporation W has not registered an offer or sale of securities under the Securities Act, it is not required to file reports under section 15(d) of the Exchange Act. Corporation W qualifies for an exemption from registration of its securities under section 12(g) of the Exchange Act pursuant to 17 CFR 240.12g3-2(b) (Rule 12g3-2(b) under the Exchange Act). Corporation W wishes to have its securities traded in the U.S. in the over-the-counter market in the form of ADRs. Because Corporation W qualifies for an exemption pursuant to Rule 12g3-2(b), Corporation W is not required to register its securities underlying the ADRs under section 12 of the Exchange Act; however, the depositary bank is required to register the ADRs under the Securities Act. Even though the depositary bank is required to register the ADRs under the Securities Act, the registration of the ADRs does not result in either the depositary bank or Corporation W being required to file reports under section 15(d) of the Exchange Act. On February 3, 2021, the SEC declares effective the Securities Act registration statement for the ADRs. On February 4, 2021, Corporation W's ADRs begin trading in the over-the-counter market. On December 31, 2021, the securities of Corporation W are not required to be registered under section 12 of the Exchange Act because Corporation W qualifies for an exemption pursuant to Rule 240.12g3-2(b). Furthermore, on December 31, 2021, Corporation W is

not required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporation W is not a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, the securities underlying the ADRs are not required to be registered under section 12 of the Exchange Act and Corporation W is not required to file reports under section 15(d) of the Exchange Act. The result would be the same if Corporation W had its securities traded in the over-the-counter market other than in the form of ADRs.

(J) *Example 10 (Securities of foreign private issuer in the form of ADRs quoted on Over the Counter Bulletin Board)*—(1) *Facts.* The facts are the same as in paragraph (c)(1)(vi)(I) of this section (*Example 9*), except that Corporation W has its securities quoted on the Over the Counter Bulletin Board (OTCBB) in the form of ADRs. Because Corporation W qualifies for an exemption pursuant to 17 CFR 240.12g3-2(b) (Rule 12g3-2(b) under the Exchange Act), Corporation W is not required to register its securities underlying the ADRs under section 12 of the Exchange Act. However, the depositary bank is required to register the ADRs under the Securities Act. In addition, section 6530(b)(1) of the OTCBB Rules requires that a foreign equity security may be quoted on the OTCBB only if the security is registered with the SEC pursuant to section 12 of the Exchange Act and the issuer of the security is current in its reporting obligations. To comply with the OTCBB Rules, on February 5, 2021, Corporation W files a registration statement for its class of securities underlying the ADRs under section 12(g) of the Exchange Act. On February 26, 2021, the SEC declares effective the Exchange Act registration statement for Corporation W's securities. As of December 31, 2021, Corporation W is subject to the reporting obligations under section 12 of the Exchange Act as a result of the section 12 registration.

(2) *Conclusion.* Corporation W is not a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, its ADRs and the securities underlying the ADRs are not required by the Exchange Act to be registered under section 12 and Corporation W is not required to file reports under section 15(d) of the Exchange Act. The Securities Act requirement applicable to the bank pursuant to the OTCBB rules is irrelevant. The result would be the same if Corporation W had its securities traded on the OTCBB other than in the form of ADRs.

(K) *Example 11 (Securities of foreign private issuer in the form of ADRs listed on a national securities exchange without a capital raising transaction)*—(1) *Facts.* For its fiscal and taxable years ending December 31, 2021, Corporation V is a foreign private issuer. Corporation V wishes to list its securities on the New York Stock Exchange (NYSE) in the form of ADRs without a capital raising transaction. Under the Exchange Act, Corporation V is required to register its securities underlying the ADRs under section 12(b) of the Exchange Act. Because the ADRs and the deposited securities are separate securities, the depositary bank is required to register the ADRs under the Securities Act. On February 2, 2021, the SEC declares effective Corporation V's registration statement under section 12(b) of the Exchange Act in connection with the underlying se-

curities, and the depositary bank's registration statement under the Securities Act in connection with the ADRs. On March 1, 2021, Corporation V's securities begin trading on the NYSE in the form of ADRs. As of December 31, 2021, Corporation V is not required to file reports under section 15(d) of the Exchange Act; however, the securities underlying the ADRs are required to be registered under section 12(b) of the Exchange Act.

(2) *Conclusion.* Corporation V is a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, the securities underlying the ADRs are required to be registered under section 12 of the Exchange Act. The result would be the same if Corporation V had its securities listed on the NYSE other than in the form of ADRs. The result also would be the same if Corporation V had wished to raised capital during its 2021 taxable year and been required to register the offer of securities underlying the ADRs under the Securities Act and to register the class of those securities under section 12(b) of the Exchange Act, and the depositary bank was required to register the ADRs under the Securities Act.

(L) *Example 12 (Foreign private issuer incorporates subsidiary in the United States to issue debt securities and subsequently issues a guarantee)*—(1) *Facts.* For its fiscal and taxable years ending December 31, 2021, Corporation T is a foreign private issuer. Corporation T wishes to access the U.S. capital markets. Corporation T incorporates Corporation U, a wholly-owned subsidiary, in the U.S. to issue debt securities. On January 15, 2021, the SEC declares effective Corporation U's Securities Act registration statement. To enhance Corporation U's credit and the marketability of Corporation U's debt securities, Corporation T issues a guarantee of Corporation U's securities and, as required, registers the guarantee under the Securities Act on Corporation U's registration statement. On December 31, 2021, Corporations T and U are required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Corporations T and U are publicly held corporations for their 2021 taxable years because they are required to file reports under section 15(d) of the Exchange Act as of the last day of their taxable years.

(M) *Example 13 (Affiliated group comprised of two corporations, one of which is a publicly held corporation)*—(1) *Facts.* Employee D, a covered employee of Corporation N, receives compensation from, Corporations N and O, members of an affiliated group. Corporation N, the parent corporation, is a publicly held corporation. Corporation O is a direct subsidiary of Corporation N and is a privately held corporation. The total compensation paid to Employee D from the affiliated group members is \$3,000,000 for the taxable year, of which Corporation N pays \$2,100,000 and Corporation O pays \$900,000.

(2) *Conclusion.* Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m)(1), \$2,000,000 of the aggregate compensation paid is nondeductible. Corporations N and O each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Corporation N has a nondeductible

compensation expense of \$1,400,000 (\$2,100,000 x \$2,000,000/\$3,000,000). Corporation O has a nondeductible compensation expense of \$600,000 (\$900,000 x \$2,000,000/\$3,000,000).

(N) *Example 14 (Affiliated group comprised of two corporations, one of which is a publicly held corporation)*—(1) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(M) of this section (*Example 13*), except that Corporation O is a publicly held corporation, Corporation N is a privately held corporation, and Employee D is a covered employee of Corporation O (instead of Corporation N).

(2) *Conclusion*. The result is the same as in paragraph (c)(1)(vi)(M) of this section (*Example 13*). Even though subsidiary Corporation O is the publicly held corporation, Corporations N and O still comprise an affiliated group. Accordingly, \$2,000,000 of the aggregate compensation paid is nondeductible, and Corporations N and O each are treated as paying a ratable portion of the nondeductible compensation.

(O) *Example 15 (Affiliated group comprised of two publicly held corporations)*—(1) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(M) of this section (*Example 13*), except that Corporation O is a publicly held corporation. As in paragraph (c)(1)(vi)(M) of this section (*Example 13*), Employee D is not a covered employee of Corporation O.

(2) *Conclusion*. The result is the same as in paragraph (c)(1)(vi)(M) of this section (*Example 13*). Even though Corporations N and O each are publicly held corporations, Corporations N and O comprise an affiliated group for purposes of prorating the amount disallowed as a deduction. Accordingly, \$2,000,000 of the aggregate compensation paid is nondeductible, and Corporations N and O each are treated as paying a ratable portion of the nondeductible compensation.

(P) *Example 16 (Affiliated group comprised of two publicly held corporations)*—(1) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(O) of this section (*Example 15*), except that Employee D also is a covered employee of Corporation O.

(2) *Conclusion*. Corporations N and O each are publicly held corporations and separately subject to this section, but also comprise an affiliated group. Because Employee D is a covered employee of both Corporations N and O, each of which is a separate publicly held corporation, the determination of the amount disallowed as a deduction is made separately for each publicly held corporation. Corporation N has a nondeductible compensation expense of \$1,100,000 (the excess of \$2,100,000 over \$1,000,000), and Corporation O has no nondeductible compensation expense because the amount it paid to Employee D did not exceed \$1,000,000.

(Q) *Example 17 (Affiliated group comprised of three corporations, one of which is a publicly held corporation)*—(1) *Facts*. Employee C, a covered employee of publicly held parent Corporation P, receives compensation from Corporations P, Q, and R, members of an affiliated group. Corporation Q is a direct subsidiary of Corporation P, and Corporation R is a direct subsidiary of Corporation Q. Corporations Q and R both are privately held. The total compensation paid to Employee C from the affiliated group members is \$3,000,000 for the taxable year, of which Corporation P pays \$1,500,000, Corporation Q pays \$900,000, and Corporation R pays \$600,000.

(2) *Conclusion*. Because the compensation paid by affiliated group members is aggregated for purposes of section 162(m)(1), \$2,000,000 of the aggregate compensation paid is nondeductible. Corporations P, Q, and R each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. The nondeductible compensation expense for Corporation P is \$1,000,000 (\$1,500,000 x \$2,000,000/\$3,000,000); for Corporation Q is \$600,000 (\$900,000 x \$2,000,000/\$3,000,000); and for Corporation R is \$400,000 (\$600,000 x \$2,000,000/\$3,000,000).

(R) *Example 18 (Affiliated group comprised of three corporations, one of which is a publicly held corporation)*—(1) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(Q) of this section (*Example 17*), except that Corporation Q is a publicly held corporation and Corporation P is a privately held corporation, and Employee C is a covered employee of Corporation Q (instead of Corporation P).

(2) *Conclusion*. The result is the same as in paragraph (c)(1)(vi)(Q) of this section (*Example 17*). Even though Corporation Q, the subsidiary, is the publicly held corporation, Corporations P, Q, and R comprise an affiliated group. Accordingly, \$2,000,000 of the aggregate compensation paid is nondeductible, and Corporations P, Q, and R each are treated as paying a ratable portion of the nondeductible compensation.

(S) *Example 19 (Affiliated group comprised of three corporations, two of which are publicly held corporations)*—(1) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(R) of this section (*Example 18*), except that Corporation R also is a publicly held corporation. As in paragraph (c)(1)(vi)(R) of this section (*Example 18*), Corporation Q is a publicly held corporation, Corporation P is a privately held corporation, and Employee C is a covered employee of Corporation Q but not a covered employee of Corporation R.

(2) *Conclusion*. The result is the same as in paragraph (c)(1)(vi)(R) of this section (*Example 18*). Even though Corporation R also is a publicly held corporation, Corporations P, Q, and R comprise an affiliated group. Accordingly, \$2,000,000 of the aggregate compensation paid is nondeductible, and Corporations P, Q, and R each are treated as paying a ratable portion of the nondeductible compensation.

(T) *Example 20 (Affiliated group comprised of three publicly held corporations)*—(1) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(Q) of this section (*Example 17*), except that Corporations Q and R also are publicly held corporations, and Employee C is a covered employee of both Corporations P and Q but is not a covered employee of Corporation R.

(2) *Conclusion*. Even though Corporations P, Q, and R each are publicly held corporations, they comprise an affiliated group. Because Employee C is a covered employee of both Corporations P and Q, the determination of the amount disallowed as a deduction is separately prorated among Corporations P and R and among Corporations Q and R. For each separate calculation of the total amount of the disallowed deduction and the proration of the disallowed deduction, the amount paid by Corporation R is taken into account in proportion to the

total compensation paid by Corporations P and Q. With respect to Corporations P and R, \$875,000 of the aggregate compensation is nondeductible (the excess of \$1,875,000 (the sum of the compensation paid by Corporation P (\$1,500,000) and the portion of compensation paid by Corporation R that is treated as allocable to Employee C being a covered employee of Corporation P (\$600,000 x \$1,500,000/(\$1,500,000 + \$900,000) = \$375,000) over the \$1,000,000 deduction limitation). Corporations P and R each are treated as paying a ratable portion of the nondeductible compensation. Corporation P has a nondeductible compensation expense of \$700,000 (\$1,500,000 x \$875,000/\$1,875,000), and Corporation R has a nondeductible compensation expense of \$175,000 (\$375,000 x \$875,000/\$1,875,000). For Corporations Q and R, \$125,000 of the aggregate compensation is nondeductible (the excess of \$1,125,000 (the sum of the compensation paid by Corporation Q (\$900,000) and the portion of compensation paid by Corporation R that is treated as allocable to Employee C being a covered employee of Corporation Q (\$600,000 x \$900,000/(\$1,500,000 + \$900,000) = \$225,000) over the \$1,000,000 deduction limitation). Corporation Q has a nondeductible compensation expense of \$100,000 (\$900,000 x \$125,000/\$1,125,000), and Corporation R has a nondeductible compensation expense of \$25,000 (\$225,000 x \$125,000/\$1,125,000). The total nondeductible compensation expense for Corporation R is \$200,000.

(U) *Example 21 (Affiliated group comprised of three publicly held corporations)*—(1) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(T) of this section (*Example 20*), except that Employee C does not receive any compensation from Corporation R.

(2) *Conclusion*. Even though Corporations P, Q, and R each are publicly held corporations and separately subject to this section, they comprise an affiliated group. Because Employee C is a covered employee of, and receives compensation from, both Corporations P and Q, each of which is a separate publicly held corporation, the determination of the amount disallowed as a deduction is made separately for Corporations P and Q. Corporation P has a nondeductible compensation expense of \$500,000 (the excess of \$1,500,000 over \$1,000,000), and Corporation Q has no nondeductible compensation expense because the amount it paid to Employee C was below \$1,000,000.

(V) *Example 22 (Affiliated group comprised of three corporations, one of which is a publicly held corporation)*—(1) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(Q) of this section (*Example 17*), except that Corporation R is a direct subsidiary of Corporation P (and not a direct subsidiary of Corporation Q).

(2) *Conclusion*. The result is the same as in paragraph (c)(1)(vi)(Q) of this section (*Example 17*). Corporations P, Q, and R comprise an affiliated group. Accordingly, \$2,000,000 of the aggregate compensation paid is nondeductible, and Corporations P, Q, and R each are treated as paying a ratable portion of the nondeductible compensation.

(W) *Example 23 (Affiliated group comprised of three publicly held corporations)*—(1) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(V) of

this section (*Example 22*), except that Corporations Q and R also are publicly held corporations, and Employee C is a covered employee of both Corporations P and Q but not of Corporation R.

(2) *Conclusion.* The result is the same as in paragraph (c)(1)(vi)(V) of this section (*Example 22*). Even though Corporations P, Q, and R each are publicly held corporations, they comprise an affiliated group. Because Employee C is a covered employee of both Corporations P and Q, the amount disallowed as a deduction is prorated separately among Corporations P and R and among Corporations Q and R.

(X) *Example 24 (Disregarded entity)*—(1) *Facts.* Corporation G is privately held for its 2020 taxable year. Entity H, a limited liability company, is wholly-owned by Corporation G and is disregarded as an entity separate from its owner under §301.7701-2(c)(2)(i) of this chapter. As of December 31, 2020, Entity H is required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion.* Because Entity H is required to file reports under section 15(d) of the Exchange Act and is disregarded as an entity separate from its owner, Corporation G is a publicly held corporation for its 2020 taxable year. The result would be the same if Corporation G was a REIT under section 856(a) and Entity H was a QRS under section 856(i)(2).

(2) *Covered employee*—(i) *General rule.* Except as provided in paragraph (c)(2)(vi) of this section, with respect to a publicly held corporation as defined in paragraph (c)(1) of this section (without regard to paragraph (c)(1)(ii) of this section), for the publicly held corporation's taxable year, a covered employee means any of the following—

(A) The principal executive officer (PEO) or principal financial officer (PFO) of the publicly held corporation serving at any time during the taxable year, including individuals acting in either such capacity.

(B) The three highest compensated executive officers of the publicly held corporation for the taxable year (other than the principal executive officer or principal financial officer, or an individual acting in such capacity), regardless of whether the executive officer is serving at the end of the publicly held corporation's taxable year, and regardless of whether the executive officer's compensation is subject to disclosure for the last completed fiscal year under the executive compensation disclosure rules under the Exchange Act. For purposes of this paragraph (c)(2)(i)(B), the term "executive officer" means an executive officer as defined in 17 CFR 240.3b-7. The amount of compensation used to identify the three most highly compensated executive officers for the taxable year is determined

pursuant to the executive compensation disclosure rules under the Exchange Act (using the taxable year as the fiscal year for purposes of making the determination), regardless of whether the corporation's fiscal year and taxable year end on the same date.

(C) Any individual who was a covered employee of the publicly held corporation (or any predecessor of a publicly held corporation, within the meaning of paragraph (c)(2)(ii) of this section) for any preceding taxable year beginning after December 31, 2016. For taxable years beginning prior to January 1, 2018, covered employees are identified in accordance with the rules in §1.162-27(c)(2).

(ii) *Predecessor of a publicly held corporation*—(A) *Publicly held corporations that become privately held.* For purposes of this paragraph (c)(2)(ii), a predecessor of a publicly held corporation includes a publicly held corporation that, after becoming a privately held corporation, again becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the corporation's U.S. Federal income tax return (disregarding any extensions) for the last taxable year for which the corporation was previously publicly held.

(B) *Corporate reorganizations.* A predecessor of a publicly held corporation includes a publicly held corporation the stock or assets of which are acquired in a corporate reorganization (as defined in section 368(a)(1)).

(C) *Corporate divisions.* A predecessor of a publicly held corporation includes a publicly held corporation that is a distributing corporation (within the meaning of section 355(a)(1)(A)) that distributes the stock of a controlled corporation (within the meaning of section 355(a)(1)(A)) to its shareholders in a distribution or exchange qualifying under section 355(a)(1) (corporate division). The rule of this paragraph (c)(2)(ii)(C) applies only with respect to covered employees of the distributing corporation who begin performing services for the controlled corporation (or for a corporation affiliated with the controlled corporation that receives stock of the controlled corporation in the corporate division) within the period beginning 12 months before and ending 12 months after the distribution.

(D) *Affiliated groups.* A predecessor of a publicly held corporation includes any other publicly held corporation that becomes a member of its affiliated group (as defined in paragraph (c)(1)(ii) of this section).

(E) *Asset acquisitions.* If a publicly held corporation, including one or more members of an affiliated group as defined in paragraph (c)(1)(ii) of this section (acquiror), acquires at least 80% of the gross operating assets (determined by fair market value on the date of acquisition) of another publicly held corporation (target), then the target is a predecessor of the acquiror. For an acquisition of assets that occurs over time, only assets acquired within a 12-month period are taken into account to determine whether at least 80% of the target's gross operating assets were acquired. However, this 12-month period is extended to include any continuous period that ends on, or begins on, any day during which the acquiror has an arrangement to purchase, directly or indirectly, assets of the target. A shareholder's additions to the assets of target made as part of a plan or arrangement to avoid the application of this subsection to acquiror's purchase of target's assets are disregarded in applying this paragraph (c)(2)(ii)(E). This paragraph (c)(2)(ii)(E) applies only with respect to the target's covered employees who begin performing services for the acquiror (or a corporation affiliated with the acquiror) within the period beginning 12 months before and ending 12 months after the date of the transaction as defined in paragraph (c)(2)(ii)(I) of this section (incorporating any extensions to the 12-month period made pursuant to this paragraph).

(F) *Predecessor of a predecessor.* For purposes of this paragraph (c)(2)(ii), a predecessor of a corporation includes each predecessor of the corporation and the predecessor or predecessors of any prior predecessor or predecessors.

(G) *Corporations that are not publicly held at the time of the transaction and sequential transactions*—(1) *Predecessor corporation is not publicly held at the time of the transaction.* This paragraph (c)(2)(ii)(G)(1) applies if a corporation that was previously publicly held (the first corporation) would be a predecessor to another corporation (the second corpo-

ration) under the rules of this paragraph (c)(2)(ii) but for the fact that the first corporation is not a publicly held corporation at the time of the relevant transaction (or transactions). If this paragraph (c)(2)(ii)(G)(1) applies, the first corporation is a predecessor of a publicly held corporation if the second corporation is a publicly held corporation at the time of the relevant transaction (or transactions) and the relevant transaction (or transactions) take place during a taxable year ending before the 36-month anniversary of the due date for the first corporation's U.S. Federal income tax return (excluding any extensions) for the last taxable year for which the first corporation was previously publicly held.

(2) *Second corporation is not publicly held at the time of the transaction.* This paragraph (c)(2)(ii)(G)(2) applies if a corporation that is publicly held (the first corporation) at the time of the relevant transaction (or transactions) would be a predecessor to another corporation (the second corporation) under the rules of this paragraph (c)(2)(ii) but for the fact that the second corporation is not a publicly held corporation at the time of the relevant transaction (or transactions). If this paragraph (c)(2)(ii)(G)(2) applies, the first corporation is a predecessor of a publicly held corporation if the second corporation becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the first corporation's U.S. Federal income tax return (excluding any extensions) for the first corporation's last taxable year in which the transaction is taken into account.

(3) *Neither corporation is publicly held at the time of the transaction.* This paragraph (c)(2)(ii)(G)(3) applies if a corporation that was previously publicly held (the first corporation) would be a predecessor to another corporation (the second corporation) under the rules of this paragraph (c)(2)(ii) but for the fact that neither the first corporation nor the second corporation is a publicly held corporation at the time of the relevant transaction (or transactions). If this paragraph (c)(2)(ii)(G)(3) applies, the first corporation is a predecessor of a publicly held corporation if the second corporation becomes a publicly held corporation for a taxable year ending

before the 36-month anniversary of the due date for the first corporation's U.S. Federal income tax return (excluding any extensions) for the last taxable year for which the first corporation was previously publicly held.

(4) *Sequential transactions.* If a corporation that was previously publicly held (the first corporation) would be a predecessor to another corporation (the second corporation) under the rules of this paragraph (c)(2)(ii) but for the fact that the first corporation is (or its assets are) transferred to one or more intervening corporations prior to being transferred to the second corporation, and if each intervening corporation would be a predecessor of a publicly held corporation with respect to the second corporation if the intervening corporation or corporations were publicly held corporations, then paragraphs (c)(2)(ii)(G)(1) through (3) of this section also apply without regard to the intervening corporations.

(H) *Elections under sections 336(e) and 338.* For purposes of this paragraph (c)(2), if a corporation makes an election to treat as an asset purchase either the sale, exchange, or distribution of stock pursuant to regulations under section 336(e) (§§1.336-1 through 1.336-5) or the purchase of stock pursuant to regulations under section 338 (§§1.338-1 through 1.338-11, 1.338(h)(10)-1, and 1.338(i)-1), the corporation that issued the stock is treated as the same corporation both before and after such transaction.

(I) *Date of transaction.* For purposes of this paragraph (c)(2)(ii), the date that a transaction is treated as having occurred is the date on which all events necessary for the transaction to be described in the relevant provision in this paragraph (c)(2)(ii) have occurred.

(J) *Publicly traded partnership.* For purposes of applying this paragraph (c)(2)(ii), a publicly traded partnership is a predecessor of a publicly held corporation if under the same facts and circumstances a corporation substituted for the publicly traded partnership would be a predecessor of the publicly held corporation, and at the time of the transaction the publicly traded partnership is treated as a publicly held corporation as defined in paragraph (c)(1)(i) of this section. In making this determination, the rules in paragraphs (c)(2)

(ii)(A) through (I) of this section apply by analogy to publicly traded partnerships.

(iii) *Disregarded entities.* If a publicly held corporation under paragraph (c)(1) of this section owns an entity that is disregarded as an entity separate from its owner under §301.7701-2(c)(2)(i) of this chapter, then the covered employees of the publicly held corporation are determined pursuant to paragraphs (c)(2)(i) and (ii) of this section. The executive officers of the entity that is disregarded as an entity separate from its corporate owner under §301.7701-2(c)(2)(i) of this chapter are neither covered employees of the entity nor of the publicly held corporation unless they meet the definition of covered employee in paragraphs (c)(2)(i) and (ii) of this section with respect to the publicly held corporation, in which case they are covered employees for its taxable year.

(iv) *Qualified subchapter S subsidiaries.* If a publicly held corporation under paragraph (c)(1) of this section owns an entity that is a QSub under section 1361(b)(3)(B), then the covered employees of the publicly held corporation are determined pursuant to paragraphs (c)(2)(i) and (ii) of this section. The executive officers of the QSub are neither covered employees of the QSub nor of the publicly held corporation unless they meet the definition of covered employee in paragraphs (c)(2)(i) and (ii) of this section with respect to the publicly held corporation, in which case they are covered employees for the taxable year of the publicly held corporation.

(v) *Qualified real estate investment trust subsidiaries.* If a publicly held corporation under paragraph (c)(1) of this section owns an entity that is a QRS under section 856(i)(2), then the covered employees of the publicly held corporation are determined pursuant to paragraphs (c)(2)(i) and (ii) of this section. The executive officers of the QRS are neither covered employees of the QRS nor of the publicly held corporation unless they meet the definition of covered employee in paragraphs (c)(2)(i) and (ii) of this section with respect to the publicly held corporation, in which case they are covered employees for the taxable year of the publicly held corporation.

(vi) *Covered employee of an affiliated group.* A person who is identified as a covered employee in paragraphs (c)(2)

(i) through (v) of this section for a publicly held corporation's taxable year is also a covered employee for the taxable year of an affiliated group treated as a publicly held corporation pursuant to paragraph (c)(1)(ii) of this section (treatment of an affiliated group).

(vii) *Examples.* The following examples illustrate the provisions of this paragraph (c)(2). For each example, assume that the corporation has a taxable year that is a calendar year and has a fiscal year ending December 31 for reporting purposes under the Exchange Act. Also, for each example, unless provided otherwise, assume that none of the employees were covered employees for any taxable year preceding the first taxable year set forth in that example (since being a covered employee for a preceding taxable year would provide a separate, independent basis for classifying that employee as a covered employee for a subsequent taxable year).

(A) *Example 1 (Covered employees of members of an affiliated group)—(1) Facts.* Corporations A, B, and C are direct wholly-owned subsidiaries of Corporation D. Corporations D and A are each publicly held corporations as of December 31, 2020. Corporations B and C are not publicly held corporations for their 2020 taxable years. Employee E served as the PEO of Corporation D from January 1, 2020, to March 31, 2020. Employee F served as the PEO of Corporation D from April 1, 2020, to December 31, 2020. Employee G served as the PEO of Corporation A for its entire 2020 taxable year. Employee H served as the PEO of Corporation B for its entire 2020 taxable year. Employee I served as the PEO of Corporation C for its entire 2020 taxable year. From April 1, 2020, through September 30, 2020, Employee E served as an advisor (not as a PEO) to Employee I and received compensation from Corporation C for these services. In 2020, all four corporations paid compensation to their respective PEOs.

(2) *Conclusion (Employees E and F).* Because both Employees E and F served as the PEO of Corporation D during its 2020 taxable year, both Employees E and F are covered employees of Corporation D for its 2020 and subsequent taxable years.

(3) *Conclusion (Employee G).* Because Employee G served as the PEO of Corporation A, Employee G is a covered employee of Corporation A for its 2020 and subsequent taxable years.

(4) *Conclusion (Employee H).* Even though Employee H served as the PEO of Corporation B, Employee H is not a covered employee of Corporation B for its 2020 taxable year, because Corporation B is considered a publicly held corporation solely by reason of being a member of an affiliated group as defined in paragraph (c)(1)(ii) of this section.

(5) *Conclusion (Employee I).* Even though Employee I served as the PEO of Corporation C, Em-

ployee I is not a covered employee of Corporation C for its 2020 taxable year, because Corporation C is considered a publicly held corporation solely by reason of being a member of an affiliated group as defined in paragraph (c)(1)(ii) of this section.

(B) *Example 2 (Covered employees of a publicly held corporation)—(1) Facts.* Corporation J is a publicly held corporation. Corporation J is not a smaller reporting company or emerging growth company for purposes of reporting under the Exchange Act. For 2020, Employee K served as the sole PEO of Corporation J and Employees L and M both served as the PFO of Corporation J at separate times during the year. Employees N, O, and P were, respectively, the first, second, and third highest compensated executive officers of Corporation J for 2020 other than the PEO and PFO, and all three retired before December 31, 2020. Employees Q, R, and S were, respectively, Corporation J's fourth, fifth, and sixth highest compensated executive officers other than the PEO and PFO for 2020, and all three were serving as of December 31, 2020. On March 1, 2021, Corporation J filed its Form 10-K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 with the SEC. With respect to Item 11, Executive Compensation (as required by Part III of Form 10-K, or its successor), Corporation J disclosed the compensation of Employee K for serving as the PEO, Employees L and M for serving as the PFO, and Employees Q, R, and S pursuant to 17 CFR 229.402(a)(3)(iii) (Item 402 of Regulation S-K). Corporation J also disclosed the compensation of Employees N and O pursuant to 17 CFR 229.402(a)(3)(iv) (Item 402 of Regulation S-K).

(2) *Conclusion (Employee K).* Because Employee K served as the PEO during 2020, Employee K is a covered employee for Corporation J's 2020 taxable year.

(3) *Conclusion (Employees L and M).* Because Employees L and M served as the PFO during 2020, Employees L and M are covered employees for Corporation J's 2020 taxable year.

(4) *Conclusion (Employees N, O, P, Q, R, and S).* Even though the executive compensation disclosure rules under the Exchange Act require Corporation J to disclose the compensation of Employees N, O, Q, R, and S for 2020, Corporation J's three highest compensated executive officers who are covered employees for its 2020 taxable year are Employees N, O, and P, because these are the three highest compensated executive officers other than the PEO and PFO for 2020.

(C) *Example 3 (Covered employees of a smaller reporting company)—(1) Facts.* The facts are the same as in paragraph (c)(2)(vii)(B) of this section (Example 2), except that Corporation J is a smaller reporting company or emerging growth company for purposes of reporting under the Exchange Act. With respect to Item 11, Executive Compensation, Corporation J disclosed the compensation of Employee K for serving as the PEO, Employees Q and R pursuant to 17 CFR 229.402(m)(2)(ii) (Item 402(m) of Regulation S-K), and Employees N and O pursuant to 17 CFR 229.402(m)(2)(iii) (Item 402(m) of Regulation S-K).

(2) *Conclusion.* The result is the same as in paragraph (c)(2)(vii)(L) of this section (Example

2). For purposes of identifying a corporation's covered employees, it is irrelevant whether the reporting obligation under the Exchange Act for smaller reporting companies and emerging growth companies apply to the corporation, and it is irrelevant whether the specific executive officers' compensation must be disclosed pursuant to the disclosure rules under the Exchange Act applicable to the corporation.

(D) *Example 4 (Covered employees of a publicly held corporation that is not required to file a Form 10-K)—(1) Facts.* The facts are the same as in paragraph (c)(2)(vii)(B) of this section (Example 2), except that on February 4, 2021, Corporation J files Form 15, Certification and Notice of Termination of Registration under Section 12(g) of the Securities Exchange Act of 1934 or Suspension of Duty to File Reports under Sections 13 and 15(d) of the Securities Exchange Act of 1934, (or its successor) to terminate the registration of its securities. Corporation J's duty to file reports under Section 13(a) of the Exchange Act is suspended upon the filing of the Form 15 and, as a result, Corporation J is not required to file a Form 10-K and disclose the compensation of its executive officers for 2020.

(2) *Conclusion.* The result is the same as in paragraph (c)(2)(vii)(B) of this section (Example 2). Covered employees include executive officers of a publicly held corporation even if the corporation is not required to disclose the compensation of its executive officers under the Exchange Act. Therefore, Employees K, L, M, N, O, and P are covered employees for 2020. The result would be different if Corporation J filed Form 15 to terminate the registration of its securities prior to December 31, 2020. In that case, Corporation J would not be a publicly held corporation for its 2020 taxable year, and, therefore, Employees K, L, M, N, O, and P would not be covered employees for Corporation J's 2020 taxable year.

(E) *Example 5 (Covered employees of two publicly held corporations after a corporate transaction)—(1) Facts.* Corporation T is a publicly held corporation for its 2019 taxable year. Corporation U is a privately held corporation for its 2019 and 2020 taxable years. On July 31, 2020, Corporation U acquires for cash 80% of the only class of outstanding stock of Corporation T. The affiliated group (comprised of Corporations U and T) elects to file a consolidated Federal income tax return. As a result of this election, Corporation T has a short taxable year ending on July 31, 2020. Corporation T does not change its fiscal year for reporting purposes under the Exchange Act to correspond to the short taxable year. Corporation T remains a publicly held corporation for its short taxable year ending on July 31, 2020, and its subsequent taxable year ending on December 31, 2020, for which it files a consolidated Federal income tax return with Corporation U. For Corporation T's taxable year ending July 31, 2020, Employee V serves as the only PEO, and Employee W serves as the only PFO. Employees X, Y, and Z are the three most highly compensated executive officers of Corporation T for the taxable year ending July 31, 2020, other than the PEO and PFO. As a result of the acquisition, effective July 31, 2020, Employee V ceases to serve as the PEO of Corporation

T. Instead, Employee AA starts serving as the PEO of Corporation T on August 1, 2020. Employee V continues to provide services for Corporation T but never serves as PEO again (or as an individual acting in such capacity). For Corporation T's taxable year ending December 31, 2020, Employee AA serves as the only PEO, and Employee W serves as the only PFO. Employees X, Y, and Z continue to serve as executive officers of Corporation T during the taxable year ending December 31, 2020. Employees BB, CC, and DD are the three most highly compensated executive officers of Corporation T, other than the PEO and PFO, for the taxable year ending December 31, 2020.

(2) *Conclusion (Employee V)*. Because Employee V served as the PEO during Corporation T's short taxable year ending July 31, 2020, Employee V is a covered employee for Corporation T's short taxable year ending July 31, 2020, even though Employee V's compensation is required to be disclosed pursuant to the executive compensation disclosure rules under the Exchange Act only for the fiscal year ending December 31, 2020. Because Employee V was a covered employee for Corporation T's short taxable year ending July 31, 2020, Employee V is also a covered employee for Corporation T's short taxable year ending December 31, 2020.

(3) *Conclusion (Employee W)*. Because Employee W served as the PFO during Corporation T's short taxable years ending July 31, 2020, and December 31, 2020, Employee W is a covered employee for both taxable years, even though Employee W's compensation is required to be disclosed pursuant to the executive compensation disclosure rules under the Exchange Act only for the fiscal year ending December 31, 2020. Because Employee W was a covered employee for Corporation T's short taxable year ending July 31, 2020, Employee W would be a covered employee for Corporation T's short taxable year ending December 31, 2020, even if Employee W did not serve as the PFO during this taxable year.

(4) *Conclusion (Employee AA)*. Because Employee AA served as the PEO during Corporation T's short taxable year ending December 31, 2020, Employee AA is a covered employee for that short taxable year.

(5) *Conclusion (Employees X, Y, and Z)*. Employees X, Y, and Z are covered employees for Corporation T's short taxable years ending July 31, 2020, and December 31, 2020. Employees X, Y, and Z are covered employees for Corporation T's short taxable year ending July 31, 2020, because those employees are the three highest compensated executive officers for that short taxable year. Because they were covered employees for Corporation T's short taxable year ending July 31, 2020, Employees X, Y, and Z are covered employees for Corporation T's short taxable year ending December 31, 2020 and would be covered employees for that later short taxable year even if their compensation would not be required to be disclosed pursuant to the executive compensation disclosure rules under the Exchange Act.

(6) *Conclusion (Employees BB, CC, and DD)*. Employees BB, CC, and DD are covered employees for Corporation T's short taxable year ending December 31, 2020, because those employees are the three highest compensated executive officers for that short taxable year.

(F) *Example 6 (Predecessor of a publicly held corporation)*—(1) *Facts*. Corporation EE is a publicly held corporation for its 2021 taxable year. Corporation EE is a privately held corporation for its 2022 and 2023 taxable years. For its 2024 taxable year, Corporation EE is a publicly held corporation.

(2) *Conclusion*. For its 2024 taxable year, Corporation EE is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(A) of this section because, after ceasing to be a publicly held corporation, it again became a publicly held corporation for a taxable year ending prior to April 15, 2025. Therefore, for Corporation EE's 2024 taxable year, the covered employees of Corporation EE include the covered employees of Corporation EE for its 2021 taxable year and any additional covered employees determined pursuant to this paragraph (c)(2).

(G) *Example 7 (Predecessor of a publicly held corporation)*—(1) *Facts*. The facts are the same as in paragraph (c)(2)(vii)(F) of this section (*Example 6*), except that Corporation EE remains a privately held corporation until it becomes a publicly held corporation for its 2027 taxable year.

(2) *Conclusion*. Corporation EE is not a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(A) of this section because it became a publicly held corporation for a taxable year ending after April 15, 2025. Therefore, any covered employee of Corporation EE for its 2021 taxable year is not a covered employee of Corporation EE for its 2027 taxable year due to that individual's status as a covered employee of Corporation EE for a preceding taxable year (beginning after December 31, 2016) but may be a covered employee due to that individual's status during the 2027 taxable year.

(H) *Example 8 (Predecessor of a publicly held corporation that is party to a merger)*—(1) *Facts*. On June 30, 2021, Corporation FF (a publicly held corporation) merged into Corporation GG (a publicly held corporation) in a transaction that qualifies as a reorganization under section 368(a)(1)(A), with Corporation GG as the surviving corporation. As a result of the merger, Corporation FF has a short taxable year ending June 30, 2021. Corporation FF is a publicly held corporation for this short taxable year. Corporation GG does not have a short taxable year and is a publicly held corporation for its 2021 taxable year.

(2) *Conclusion*. Corporation FF is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(B) of this section. Therefore, any covered employee of Corporation FF for its short taxable year ending June 30, 2021, is a covered employee of Corporation GG for its 2021 taxable year. For Corporation GG's 2021 and subsequent taxable years, the covered employees of Corporation GG include the covered employees of Corporation FF (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(I) *Example 9 (Predecessor of a publicly held corporation that is party to a merger)*—(1) *Facts*. The facts are the same as in paragraph (c)(2)(vii)(H) of this section (*Example 8*), except that, after the merger, Corporation GG is a privately held corporation for its 2021 taxable year.

(2) *Conclusion*. Because Corporation GG is a privately held corporation for its 2021 taxable year, it is not subject to section 162(m)(1) for this taxable year.

(J) *Example 10 (Predecessor of a publicly held corporation that is party to a merger)*—(1) *Facts*. The facts are the same as in paragraph (c)(2)(vii)(I) of this section (*Example 9*), except that Corporation GG, becomes a publicly held corporation (as defined in paragraph (c)(1)(i) of this section) on June 30, 2023, and is a publicly held corporation for its 2023 taxable year.

(2) *Conclusion*. Because Corporation GG became a publicly held corporation for a taxable year ending prior to April 15, 2025, Corporation FF is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section. For Corporation GG's 2023 and subsequent taxable years, the covered employees of Corporation GG include the covered employees of Corporation FF (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(K) *Example 11 (Predecessor of a publicly held corporation that is party to a merger)*—(1) *Facts*. The facts are the same as in paragraph (c)(2)(vii)(J) of this section (*Example 10*), except that Corporation FF is a privately held corporation for its taxable year ending June 30, 2021, but was a publicly held corporation for its 2020 taxable year.

(2) *Conclusion*. Even though Corporation FF was a privately held corporation when it merged with Corporation GG on June 30, 2021, Corporation FF will be a predecessor corporation if Corporation GG becomes a publicly held corporation within a taxable year ending prior to April 15, 2024. Because Corporation GG became a publicly held corporation for its taxable year ending December 31, 2023, Corporation FF is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section. For Corporation GG's 2023 and subsequent taxable years, the covered employees of Corporation GG include the covered employees of Corporation FF (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(L) *Example 12 (Predecessor of a publicly held corporation that is party to a merger and subsequently becomes member of an affiliated group)*—(1) *Facts*. The facts are the same as in paragraph (c)(2)(vii)(J) of this section (*Example 10*), except that, on June 30, 2022, Corporation GG becomes a publicly held corporation by becoming a member of an affiliated group (as defined in paragraph (c)(1)(ii) of this section). Corporation II is the parent corporation of the group and is a publicly held corporation. Employee HH was a covered employee of Corporation FF for its taxable year ending June 30, 2021. On July 1, 2022, Employee HH becomes an employee of Corporation II.

(2) *Conclusion*. By becoming a member of an affiliated group (as defined in paragraph (c)(1)(ii) of this section) on June 30, 2022, Corporation GG became a publicly held corporation for a taxable year ending prior to April 15, 2025. Therefore, Corporation FF is a predecessor of a publicly held cor-

poration (Corporation GG) within the meaning of paragraph (c)(2)(ii)(G) of this section. Furthermore, Corporation FF is also a predecessor of Corporation II, a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section. For Corporation II's 2022 and subsequent taxable years, Employee HH is a covered employee of the affiliated group that includes Corporation II because Employee HH was a covered employee of Corporation FF for its taxable year ending June 30, 2021.

(M) *Example 13 (Predecessor of a publicly held corporation that is party to a merger and subsequently becomes member of an affiliated group)*—(1) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(L) of this section (*Example 12*), except that Corporation FF was a privately held corporation for its taxable year ending June 30, 2021, and Employee HH was a covered employee of Corporation FF for its taxable year ending December 31, 2020.

(2) *Conclusion.* Even though Corporation FF was a privately held corporation when it merged with Corporation GG on June 30, 2021, Corporation FF will be a predecessor corporation if Corporation GG becomes a publicly held corporation for a taxable year ending prior to April 15, 2024. Because Corporation GG became a publicly held corporation for its 2022 taxable year by becoming a member of an affiliated group (as defined in paragraph (c)(1)(ii) of this section), Corporation FF is a predecessor of a publicly held corporation (Corporation GG) within the meaning of paragraph (c)(2)(ii)(G) of this section. Furthermore, Corporation FF is also a predecessor of Corporation II, a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section. Therefore, any covered employee of Corporation FF for its 2020 taxable year is a covered employee of the affiliated group that includes Corporation II for its 2022 and subsequent taxable years. For Corporation II's 2022 taxable year, Employee HH is a covered employee of the affiliated group that includes Corporation II because Employee HH was a covered employee of Corporation FF for its 2020 taxable year.

(N) *Example 14 (Predecessor of a publicly held corporation that is a party to a merger)*—(1) *Facts.* Corporation JJ is a publicly held corporation for its 2019 taxable year and is incorporated in State KK. On June 1, 2019, Corporation JJ formed a wholly-owned subsidiary, Corporation LL. Corporation LL is a publicly held corporation incorporated in State MM. On June 30, 2021, Corporation JJ merged into Corporation LL under State MM law in a transaction that qualifies as a reorganization under section 368(a)(1)(A), with Corporation LL as the surviving corporation. As a result of the merger, Corporation JJ has a short taxable year ending June 30, 2021. Corporation JJ is a publicly held corporation for this short taxable year.

(2) *Conclusion.* Corporation JJ is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(B) of this section. For Corporation LL's taxable years ending after June 30, 2021, the covered employees of Corporation LL include the covered employees of Corporation JJ for its short taxable year ending June 30, 2021 (as well as preceding taxable years beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(O) *Example 15 (Predecessor of a publicly held corporation becomes member of an affiliated group)*—(1) *Facts.* On June 30, 2021, Corporation OO acquires for cash 100% of the only class of outstanding stock of Corporation NN. The affiliated group (comprised of Corporations NN and OO) elects to file a consolidated Federal income tax return. As a result of this election, Corporation NN has a short taxable year ending on June 30, 2021. Corporation NN is a publicly held corporation for its taxable year ending June 30, 2021, and a privately held corporation for subsequent taxable years. On June 30, 2022, Corporation OO completely liquidates Corporation NN. Corporation OO is a publicly held corporation for its 2021 and 2022 taxable years.

(2) *Conclusion.* After Corporation OO acquired Corporation NN, Corporations NN and OO comprise an affiliated group as defined in paragraph (c)(1)(ii) of this section. Thus, Corporation NN is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(D) of this section. For Corporation OO's taxable years ending after June 30, 2021, the covered employees of Corporation OO include the covered employees of Corporation NN for its short taxable year ending June 30, 2021 (as well as preceding taxable years beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(P) *Example 16 (Predecessor of a publicly held corporation becomes member of an affiliated group)*—(1) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(O) of this section (*Example 15*), except that Corporation OO is a privately held corporation on June 30, 2021, and for its 2021 and 2022 taxable years.

(2) *Conclusion.* Because Corporation OO is a privately held corporation for its 2021 and 2022 taxable years, it is not subject to section 162(m)(1) for these taxable years.

(Q) *Example 17 (Predecessor of a publicly held corporation becomes member of an affiliated group)*—(1) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(P) of this section (*Example 16*), except that, on October 1, 2022, the SEC declares effective Corporation OO's Securities Act registration statement in connection with its initial public offering, and Corporation OO is a publicly held corporation for its 2022 taxable year.

(2) *Conclusion (Taxable Year Ending December 31, 2021).* Because Corporation OO is a privately held corporation for its 2021 taxable year, it is not subject to section 162(m)(1) for this taxable year.

(3) *Conclusion (Taxable Year Ending December 31, 2022).* For the 2022 taxable year, Corporations NN and OO comprise an affiliated group as defined in paragraph (c)(1)(ii) of this section. Corporation NN is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(D) and (G) of this section because Corporation OO became a publicly held corporation for a taxable year ending prior to April 15, 2025. For Corporation OO's 2022 and subsequent taxable years, the covered employees of Corporation OO include the covered employees of Corporation NN for its short taxable year ending June 30, 2021 (as well as preceding taxable years beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(R) *Example 18 (Predecessor of a publicly held corporation and asset acquisition)*—(1) *Facts.* Corporations VV, WW, and XX are publicly held corporations for their 2020 and 2021 taxable years. Corporations VV and WW are members of an affiliated group. Corporation WW is a direct subsidiary of Corporation VV. On June 30, 2021, Corporation VV acquires for cash 40% of the gross operating assets (determined by fair market value as of January 31, 2022) of Corporation XX. On January 31, 2022, Corporation WW acquires an additional 40% of the gross operating assets (determined by fair market value as of January 31, 2022) of Corporation XX. Employees EB, EC, and EA are covered employees for Corporation XX's 2020 taxable year. Employees ED and EF are also covered employees for Corporation XX's 2021 taxable year. On January 15, 2021, Employee EA started performing services as an employee of Corporation WW. On July 1, 2021, Employee EB started performing services as an employee of Corporation WW. On February 1, 2022, Employees EC and ED started performing services as employees of Corporation WW. On June 30, 2023, Employee EF started performing services as an employee of Corporation WW.

(2) *Conclusion.* Because an affiliated group, comprised of Corporations VV and WW, acquired 80% of Corporation XX's gross operating assets (determined by fair market value) within a twelve-month period, Corporation XX is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(E) of this section. Therefore, any covered employee of Corporation XX for its 2020 and 2021 taxable years (who started performing services as an employee of Corporation WW within the period beginning 12 months before and ending 12 months after the date of the January 31, 2022, acquisition (determined under paragraph (c)(2)(ii)(I) of this section) is a covered employee of Corporation WW for its 2021, 2022, and subsequent taxable years. For Corporation WW's 2021 and subsequent taxable years, the covered employees of Corporation WW include Employee EB and any additional covered employees determined pursuant to paragraph (c)(2)(i) of this section. For Corporation WW's 2022 and subsequent taxable years, the covered employees of Corporation WW include Employees EB, EC, and ED, and any additional covered employees determined pursuant to this paragraph (c)(2). Because Employee EA started performing services as an employee of Corporation WW before January 31, 2021, Employee EA is not a covered employee of Corporation WW for its 2021 taxable year and subsequent taxable years by reason of paragraph (c)(2)(ii)(E) of this section, but may be a covered employee of Corporation WW by application of other rules in this paragraph (c)(2). Because Employee EF started performing services as an employee of Corporation WW after January 31, 2023, Employee EF is not a covered employee of Corporation WW for its 2023 taxable year by reason of paragraph (c)(2)(ii)(E) of this section, but may be a covered employee of Corporation WW by application of other rules in this paragraph (c)(2).

(S) *Example 19 (Predecessor of a publicly held corporation and asset acquisition)*—(1) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(R) of this section (*Example 18*), except that Corporations

VV and WW are not publicly held corporations on June 30, 2021, or for their 2021 taxable years.

(2) *Conclusion.* Because Corporations VV and WW are not publicly held corporations for their 2021 taxable years, they are not subject to section 162(m)(1) for their 2021 taxable years.

(T) *Example 20 (Predecessor of a publicly held corporation and asset acquisition)—(1) Facts.* The facts are the same as in paragraph (c)(2)(vii)(R) of this section (*Example 18*), except that, on October 1, 2022, the SEC declares effective Corporation VV's Securities Act registration statement in connection with its initial public offering, and Corporation VV is a publicly held corporation for its 2022 taxable year.

(2) *Conclusion (2021 taxable year).* Because Corporations VV and WW are not publicly held corporations for their 2021 taxable years, they are not subject to section 162(m)(1) for their 2021 taxable years.

(3) *Conclusion (2022 taxable year).* Corporation XX is a predecessor of a publicly held corporation within the meaning of paragraphs (c)(2)(ii)(E) and (G) of this section because a member of the affiliated group comprised of Corporations VV and WW acquired 80% of Corporation XX's gross operating assets (determined by fair market value) within a twelve-month period ending on January 31, 2022, and the parent of the affiliated group, Corporation VV, subsequently became a publicly held corporation for a taxable year ending prior to April 15, 2024. Therefore, any covered employee of Corporation XX for its 2020 and 2021 taxable years (who started performing services as an employee of Corporation WW within the period beginning 12 months before and ending 12 months after the acquisition) is a covered employee of the affiliated group comprised of Corporations VV and WW for its 2022 and subsequent taxable years. For Corporation WW's 2022 and subsequent taxable years, the covered employees of Corporation WW include Employees EB, EC, and ED, and any additional covered employees determined pursuant to this paragraph (c)(2).

(U) *Example 21 (Predecessor of a publicly held corporation and a division)—(1) Facts.* Corporation CA is a publicly held corporation for its 2021 and 2022 taxable years. On March 2, 2021, Corporation DDD forms a wholly-owned subsidiary, Corporation CB, and transfers assets to it. On April 1, 2022, Corporation CA distributes all shares of Corporation CB to its shareholders in a transaction described in section 355(a)(1). On April 1, 2022, the SEC declares effective Corporation CB's Securities Act registration statement in connection with its initial public offering. Corporation CB is a publicly held corporation for its 2022 taxable year. Employee EG serves as the PFO of Corporation CA from January 1, 2022, to March 31, 2022. On April 2, 2022, Employee EG starts performing services as an employee of Corporation CB advising the PFO of Corporation CB. After March 31, 2022, Employee EG ceases to provide services for Corporation CA.

(2) *Conclusion.* Because the distribution of the stock of Corporation CB is a transaction described under section 355(a)(1), Corporation CA is a predecessor of Corporation CB within the meaning of paragraph (c)(2)(ii)(C) of this section. Because Employee EG was a covered employee of Corpo-

ration CA for its 2022 taxable year, Employee ED is a covered employee of Corporation CB for its 2022 taxable year. The result is the same whether Employee EG performs services as an advisor for Corporation CB as an employee or an independent contractor.

(V) *Example 22 (Predecessor of a publicly held corporation and a division)—(1) Facts.* The facts are the same as in paragraph (c)(2)(vii)(U) of this section (*Example 21*), except that Corporation CA distributes 100% of the shares of Corporation CB to Corporation CD in exchange for all of Corporation CD's stock in Corporation CA in a transaction described in section 355(a)(1) and Corporation CB does not register any class of securities with the SEC. Also, Employee EG performs services as an employee of Corporation CD instead of as an employee of Corporation CB. Corporation CD is a privately held corporation for its 2022 taxable year. On October 1, 2023, the SEC declares effective Corporation CD's Securities Act registration statement in connection with its initial public offering. Corporation CD is a publicly held corporation for its 2023 taxable year. On January 1, 2028, Employee EG starts performing services as an employee of Corporation CA. Corporation CA is a publicly held corporation for its 2028 taxable year.

(2) *Conclusion (2022 taxable year).* Because Corporation CD is a privately held corporation for its 2022 taxable year, it is not subject to section 162(m)(1) for this taxable year.

(3) *Conclusion (2023 taxable year).* Because the exchange of the stock of Corporation CB for the stock of Corporation CA is a transaction described in section 355(a)(1), Corporations CB and CD are an affiliated group, and Corporation CD became a publicly held corporation for a taxable year ending prior to April 15, 2026, Corporation CA is a predecessor of Corporation CD within the meaning of paragraphs (c)(2)(ii)(D) and (G) of this section. Employee EG was a covered employee of Corporation CA for its 2022 taxable year, and started performing services as an employee of Corporation CD following April 1, 2021, and before April 1, 2023. Therefore, Employee ED is a covered employee of Corporation CD for its 2023 taxable year.

(4) *Conclusion (2028 taxable year).* Because Employee EG served as the PFO of Corporation CA from January 1, 2022, to March 31, 2022, Employee EG was a covered employee of Corporation CA for its 2022 taxable year. Because an individual who is a covered employee for a taxable year remains a covered employee for all subsequent taxable years (even after the individual has separated from service), Employee EG is a covered employee of Corporation CA for its 2028 taxable year.

(W) *Example 23 (Predecessor of a publicly held corporation and a division)—(1) Facts.* The facts are the same as in paragraph (c)(2)(vii)(V) of this section (*Example 22*), except that Employee EG starts performing services as an employee of Corporation CD on June 30, 2023, instead of on April 2, 2022, and never performs services for Corporation CA after June 30, 2023. Furthermore, on June 30, 2023, Employee EH, a covered employee of Corporation CB for all of its taxable years, starts performing services for Corporation EF as an independent contractor advising its PEO but not serving as a PEO.

(2) *Conclusion (2023 taxable year).* Because the exchange of the stock of Corporation CB for the stock of Corporation CA is a transaction described in section 355(a)(1) and Corporation CD became a publicly held corporation for a taxable year ending before April 15, 2026, Corporation CA is a predecessor of Corporation CD within the meaning of paragraphs (c)(2)(ii)(D) and (G) of this section. Even though Employee EG was a covered employee of Corporation CA for its 2022 taxable year, because Employee EG started performing services as an employee of Corporation CD after April 1, 2023, Employee EG is not a covered employee of Corporation CD for its 2023 taxable year under paragraph (c)(2)(ii)(C) of this section. However, Employee EG may be a covered employee of Corporation CD by application of other rules in this paragraph (c)(2). Because Employee EH was a covered employee of Corporation CB for its 2022 taxable year, Employee EH is a covered employee of Corporation CD for its 2023 taxable year.

(X) *Example 24 (Predecessor of a publicly held corporation and election under section 338(h)(10))—(1) Facts.* Corporation CE is the common parent of a group of corporations filing consolidated returns that includes Corporation CF as a member. Corporation CE wholly-owns Corporation CF, a publicly held corporation within the meaning of paragraph (c)(1)(i) of this section. On June 30, 2021, Corporation CG purchases Corporation CF from Corporation CE. Corporation CE and Corporation CG make a timely election under section 338(h)(10) with respect to the purchase of Corporation CF stock. For its taxable year ending December 31, 2021, Corporation CF continues to be a publicly held corporation within the meaning of paragraph (c)(1)(i) of this section.

(2) *Conclusion.* As provided in paragraph (c)(2)(ii)(H) of this section, Corporation CF is treated as the same corporation after the section 338(h)(10) transaction as before the transaction for purposes for purposes of this paragraph (c)(2). Any covered employee of Corporation CF for its short taxable year ending June 30, 2021, is a covered employee of Corporation CF for its short taxable year ending on December 31, 2021, and subsequent taxable years.

(Y) *Example 25 (Disregarded entity)—(1) Facts.* Corporation CH is a privately held corporation for its 2020 taxable year. Entity CI is a wholly-owned limited liability company and is disregarded as an entity separate from its owner, Corporation CH, under §301.7701-2(c)(2)(i) of this chapter. As of December 31, 2020, Entity CI is required to file reports under section 15(d) of the Exchange Act. For the 2020 taxable year, Employee EI is the PEO and Employee EJ is the PFO of Corporation CH. Employees EK, EL, and EM, are the three most highly compensated executive officers of Corporation CH (other than Employees EI and EJ). Employee EN is the PFO of Entity CI and does not perform any policy making functions for Corporation CH. Entity CI has no other executive officers.

(2) *Conclusion.* Because Entity CI is disregarded as an entity separate from its owner, Corporation CH, and is required to file reports under section 15(d) of the Exchange Act, Corporation CH is a publicly held corporation under paragraph (c)(1)(iii) of this section for its 2020 taxable year. Even

though Employee EN is a PFO of Entity CI, Employee EN is not considered a PFO of Corporation CH under paragraph (c)(2)(iii) of this section. As PEO and PFO, Employees EI and EJ are covered employees of Corporation CH under paragraph (c)(2)(i) of this section. Additionally, as the three most highly compensated executive officers of Corporation CH (other than Employees EI and EJ), Employees EK, EL, and EM also are covered employees of Corporation CH under paragraph (c)(2)(i) of this section for Corporation CH's 2020 taxable year. The result would be the same if Entity CI was not required to file reports under section 15(d) of the Exchange Act and Corporation CH was a publicly held corporation pursuant to paragraph (c)(1)(i) instead of paragraph (c)(1)(iii) of this section.

(Z) Example 26 (Disregarded entity)—(1) Facts. The facts are the same as in paragraph (c)(2)(vii)(Y) of this section (Example 25), except that Employee EN performs a policy making function for Corporation CH. If Corporation CH were subject to the SEC executive compensation disclosure rules, then Employee EN would be treated as an executive officer of Corporation CH pursuant to 17 CFR 240.3b-7 for purposes of determining the three highest compensated executive officers for Corporation CH's 2020 taxable year. Employee EN is compensated more than Employee EK, but less than Employees EL and EM.

(2) Conclusion. Because Entity CI is disregarded as an entity separate from its owner, Corporation CH, and is required to file reports under section 15(d) of the Exchange Act, Corporation CH is a publicly held corporation under paragraph (c)(1)(iii) of this section for its 2020 taxable year. As PEO and PFO, Employees EI and EJ are covered employees of Corporation CH under paragraph (c)(2)(i) of this section. Employee EN is one of the three highest compensated executive officers for Corporation CH's taxable year. Because Employees EN, EL, and EM are the three most highly compensated executive officers of Corporation CH (other than Employees EI and EJ), they are covered employees of Corporation CH under paragraph (c)(2)(i) of this section for Corporation CH's 2020 taxable year. The result would be the same if Entity CI was not required to file reports under section 15(d) of the Exchange Act and Corporation CH was a publicly held corporation pursuant to paragraph (c)(1)(i) instead of paragraph (c)(1)(iii) of this section.

(AA) Example 27 (Individual as covered employee of a publicly held corporation that includes the affiliated group)—(1) Facts. Corporations CJ and CK are publicly held corporations for their 2020, 2021, and 2022 taxable years. Corporation CK is a direct subsidiary of Corporation CJ. Employee EO is an employee, but not a covered employee (as defined in paragraph (c)(2)(i) of this section), of Corporation CJ for its 2020, 2021, and 2022 taxable years. From April 1, 2020, to September 30, 2020, Employee EO serves as the PFO of Corporation CK. Employee EO does not perform any services for Corporation CK for its 2021 and 2022 taxable years, however, employee EO is a covered employee (as defined in paragraph (c)(2)(i) of this section) of Corporation CK for its 2020, 2021, and 2022 taxable years. For the 2020 taxable year, Employee EO receives compensation of \$1,500,000 for services provided to Corporations

CJ and CK. Employee EO receives \$2,000,000 from Corporation CJ for performing services for Corporation CJ during each of its 2021 and 2022 taxable years. On June 30, 2022, Corporation CK pays \$500,000 to Employee EO from a nonqualified deferred compensation plan that complies with section 409A.

(2) Conclusion (2020 taxable year). Because Employee EO is a covered employee of Corporation CK and because the affiliated group (comprised of Corporations CJ and CK) is a publicly held corporation, Employee EO is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(vi) of this section. Compensation paid by Corporations CJ and CK is aggregated for purposes of section 162(m)(1) and, as a result, \$500,000 of the aggregate compensation paid is nondeductible. The result would be the same if Corporation CJ was a privately held corporation for its 2020 taxable year.

(3) Conclusion (2021 taxable year). Because Employee EO is a covered employee of Corporation CK pursuant to paragraph (c)(2)(i)(C) of this section and because the affiliated group (comprised of Corporations CJ and CK) is a publicly held corporation, Employee EO is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(vi) of this section. Compensation paid by Corporations CJ and CK is aggregated for purposes of section 162(m)(1) and, as a result, \$1,000,000 of the aggregate compensation paid is nondeductible. The result would be the same if Corporation CJ was a privately held corporation for its 2021 taxable year.

(4) Conclusion (2022 taxable year). Because Employee EO is a covered employee of Corporation CK pursuant to paragraph (c)(2)(i)(C) of this section and because the affiliated group (comprised of Corporations CJ and CK) is a publicly held corporation, Employee EO is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(vi) of this section. Compensation paid by Corporations CJ and CK is aggregated for purposes of section 162(m)(1) and, as a result, \$1,500,000 of the aggregate compensation paid is nondeductible. The result would be the same if Corporation CJ was a privately held corporation for its 2022 taxable year.

(BB) Example 28 (Individual as covered employee of a publicly held corporation that includes the affiliated group)—(1) Facts. Corporation CL is a publicly held corporation for its 2020 through 2023 taxable years. Corporations CM and CN are direct subsidiaries of Corporation CL and are privately held corporations for their 2020 through 2022 taxable years. Employee EP serves as the PFO of Corporation CL from January 1, 2020 to December 31, 2020, when Employee EP terminates employment from Corporation CL. On January 1, 2021, Employee EP starts performing services as an employee of Corporation CM. In 2021, Employee EP receives compensation from Corporation CM in excess of \$1,000,000. On April 1, 2022, Employee EP starts performing services as an employee of Corporation CN. On September 30, 2022, Employee EP terminates employment from Corporations CM and CN. In 2022, Employee EP receives compensation from Corporations CM and CN in excess

of \$1,000,000. For the 2021 and 2022 taxable years, Employee EP does not serve as either the PEO or PFO of Corporations CM and CN, and is not one of the three highest compensated executive officers (other than the PEO or PFO) of Corporations CM and CN. On April 1, 2023, Corporation CL distributes all the shares of Corporation CM to its shareholders in a transaction described in section 355(a)(1). On April 1, 2023, the SEC declares effective Corporation CM's Securities Act registration statement in connection with its initial public offering. Corporation CM is a publicly held corporation for its 2023 taxable year. On April 2, 2023, Employee EP starts performing services as an employee of Corporation CM but is not an executive officer of Corporation CM.

(2) Conclusion (2021 taxable year). Employee EP is a covered employee of Corporation CL for the 2020 and subsequent taxable years. Because Employee EP is a covered employee of Corporation CL and because the affiliated group (comprised of Corporations CL, CM, and CN) is a publicly held corporation, Employee EP is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(vi) of this section for the 2020 and subsequent taxable years. Therefore, Corporation CM's deduction for compensation paid to Employee EP for the 2021 taxable year is subject to section 162(m)(1). The result would be the same if Corporation CM was a publicly held corporation as defined in paragraph (c)(1)(i) of this section.

(3) Conclusion (2022 taxable year). Because Employee EP is a covered employee of Corporation CL and because the affiliated group (comprised of Corporations CL, CM, and CN) is a publicly held corporation, Employee EP is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(vi) of this section. Therefore, Corporation CM's and CN's deduction for compensation paid to Employee EP for the 2022 taxable year is subject to section 162(m)(1). Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m)(1), \$1,000,000 of the aggregate compensation paid is nondeductible. Corporations CM and CN are each treated as paying a ratable portion of the nondeductible compensation. The result would be the same if either Corporation CM or CN (or both) was a publicly held corporation as defined in paragraph (c)(1)(i) of this section.

(4) Conclusion (2023 taxable year). Because the distribution of the stock of Corporation CM is a transaction described in section 355(a)(1), Corporation CL is a predecessor of Corporation CM within the meaning of paragraph (c)(2)(ii)(C) of this section. However, because Employee EP started performing services as an employee of Corporation CM on January 1, 2021, and the distribution of stock of Corporation CM did not occur until April 1, 2023, Employee EP is not a covered employee of Corporation CM for its 2023 taxable year.

(3) Compensation—(i) In general. For purposes of the deduction limitation described in paragraph (b) of this section, compensation means the aggregate amount allowable as a deduction to the publicly held corporation under chapter I

of the Internal Revenue Code for the taxable year (determined without regard to section 162(m)(1)) for remuneration for services performed by a covered employee in any capacity, whether or not the services were performed during the taxable year. Compensation includes an amount that is includible in the income of, or paid to, a person other than the covered employee (including a beneficiary after the death of the covered employee) for services performed by the covered employee.

(ii) *Compensation paid by a partnership.* For purposes of paragraph (c)(3)(i) of this section, compensation includes an amount equal to a publicly held corporation's distributive share of a partnership's deduction for compensation expense attributable to the remuneration paid by the partnership to a covered employee of the publicly held corporation for services performed by the covered employee, including a payment for services under section 707(a) or under section 707(c).

(iii) *Exceptions.* Compensation does not include—

(A) Remuneration covered in section 3121(a)(5)(A) through (D) (concerning remuneration that is not treated as wages for purposes of the Federal Insurance Contributions Act);

(B) Remuneration consisting of any benefit provided to or on behalf of an employee if, at the time the benefit is provided, it is reasonable to believe that the employee will be able to exclude it from gross income; or

(C) Salary reduction contributions described in section 3121(v)(1).

(iv) *Examples.* The following examples illustrate the provisions of this paragraph (c)(3). For each example, assume that the corporation is a calendar year taxpayer.

(A) *Example 1—(1) Facts.* Corporation Z is a publicly held corporation for its 2020 taxable year, during which Employee A serves as the PEO of Corporation Z and also serves on the board of directors of Corporation Z. In 2020, Corporation Z paid \$1,200,000 to Employee A plus a \$50,000 fee for serving as a director of Corporation Z. These amounts are otherwise deductible for Corporation Z's 2020 taxable year.

(2) *Conclusion.* The \$1,200,000 paid to Employee A in 2020 plus the \$50,000 director's fee paid to Employee A in 2020 are compensation within the meaning of this paragraph (c)(3). Therefore, Corporation Z's \$1,250,000 deduction for the 2020 taxable year is subject to the section 162(m)(1) limit.

(B) *Example 2—(1) Facts.* Corporation X is a publicly held corporation for its 2020 and all subsequent taxable years. Employee B serves as the PEO of Corporation X for its 2020 taxable year and is a participant in the Corporation X nonqualified retirement plan that meets the requirements of section 409A. The plan provides for the distribution of benefits over a three-year period beginning after a participant separates from service. Employee B terminates employment in 2021. In 2022, Employee B receives a \$75,000 fee for services as a director and \$1,500,000 as the first payment under the retirement plan. Employee B continues to serve on the board of directors until 2023 when Employee B dies before receiving the retirement benefit for 2023 and before becoming entitled to any director's fees for 2023. In 2023 and 2024, Corporation X pays the \$1,500,000 annual retirement benefits to Person C, a beneficiary of Employee B.

(2) *Conclusion (2022 Taxable Year).* In 2022, Corporation X paid Employee B \$1,575,000, including \$1,500,000 under the retirement plan and \$75,000 in director's fees. The retirement benefit and the director's fees are compensation within the meaning of this paragraph (c)(3). Therefore, Corporation X's \$1,575,000 deduction for the 2022 taxable year is subject to the section 162(m)(1) limit.

(3) *Conclusion (2023 and 2024 Taxable Years).* In 2023 and 2024, Corporation X made payments to Person C of \$1,500,000 under the retirement plan. The retirement benefits are compensation within the meaning of this paragraph (c)(3). Therefore, Corporation X's deduction for each annual payment of \$1,500,000 for the 2023 and 2024 taxable years is subject to the section 162(m)(1) limit.

(C) *Example 3—(1) Facts.* Corporation T is a publicly held corporation for its 2021 taxable year. Corporation S is a privately held corporation for its 2021 taxable year. On January 2, 2021, Corporations S and T form a general partnership. Under the partnership agreement, Corporations S and T each have a 50% distributive share of the partnership's income, gain, loss, and deductions. For the taxable year ending December 31, 2021, Employee D, a covered employee of Corporation T, performs services for the partnership, and the partnership pays \$800,000 to Employee D for these services, the deduction of \$400,000 of which is allocated to Corporation T. Corporation T's \$400,000 distributive share of the partnership's deduction is reported separately to Corporation T pursuant to §1.702-1(a)(8)(iii).

(2) *Conclusion.* Because Corporation T's \$400,000 distributive share of the partnership's deduction is attributable to the compensation paid by the partnership for services performed by Employee D, a covered employee of Corporation T, the \$400,000 is compensation within the meaning of this paragraph (c)(3) and Corporation T's deduction for this expense for its 2021 taxable year is subject to the section 162(m)(1) limit. Corporation T's \$400,000 allocation of the partnership's deduction is aggregated with Corporation T's deduction for compensation paid to Employee D, if any, in determining the amount allowable as a deduction to Corporation T for compensation paid to Employee D for Corporation T's 2021 taxable year. The result is the same whether Employee D performs services for the partnership as a common law employee, an independent

contractor, or a partner, and whether the payment to Employee D is a payment under section 707(a) or section 707(c).

(4) *Securities Act.* The Securities Act means the Securities Act of 1933.

(5) *Exchange Act.* The Exchange Act means the Securities Exchange Act of 1934.

(6) *SEC.* The SEC means the United States Securities and Exchange Commission.

(7) *Foreign Private Issuer.* A foreign private issuer means an issuer as defined in 17 CFR 240.3b-4(c).

(8) *American Depositary Receipt (ADR).* An American Depositary Receipt or ADR means a negotiable certificate that evidences ownership of a specified number (or fraction) of a foreign private issuer's securities held by a depositary (typically, a U.S. bank).

(9) *Privately held corporation.* A privately held corporation is a corporation that is not a publicly held corporation as defined in paragraph (c)(1) of this section (without regard to paragraph (c)(1)(ii) of this section).

(d) *Corporations that become publicly held—(1) In general.* In the case of a corporation that was a privately held corporation and then becomes a publicly held corporation, the deduction limitation of paragraph (b) of this section applies to any compensation that is otherwise deductible for the taxable year ending on or after the date that the corporation becomes a publicly held corporation. A corporation is considered to become publicly held on the date that its registration statement becomes effective either under the Securities Act or the Exchange Act. The rules in this section apply to a partnership that becomes a publicly traded partnership that is a publicly held corporation within the meaning of paragraph (c)(1)(i) of this section.

(2) *Example.* The following example illustrates the provision of this paragraph (d).

(i) *Facts.* In 2021, Corporation E plans to issue debt securities in a public offering registered under the Securities Act. Corporation E is not required to file reports under section 15(d) of the Exchange Act with respect to any other class of securities and does not have another class of securities required to be registered under section 12 of the Exchange Act. On December 18, 2021, the SEC declares effective the Securities Act registration statement for Corporation E's debt securities.

(ii) *Conclusion.* Corporation E becomes a publicly held corporation on December 18, 2021 because it is then required to file reports under section 15(d) of the Exchange Act. The deduction limitation of paragraph (b) of this section applies to any compensation that is otherwise deductible for Corporation E's taxable year ending on or after December 18, 2021.

(e) *Coordination with disallowed excess parachute payments under section 280G.* The \$1,000,000 limitation in paragraph (b) of this section is reduced (but not below zero) by the amount (if any) that would have been included in the compensation of the covered employee for the taxable year but for being disallowed by reason of section 280G. For example, assume that during a taxable year a corporation pays \$1,500,000 to a covered employee, of which \$600,000 is an excess parachute payment, as defined in section 280G(b)(1), and a deduction for that excess parachute payment is disallowed by reason of section 280G(a). Because the \$1,000,000 limitation in paragraph (b) of this section is reduced by the amount of the excess parachute payment, the corporation may deduct \$400,000 (\$1,000,000 - \$600,000), and \$500,000 of the otherwise deductible amount is nondeductible by reason of section 162(m)(1). Thus \$1,100,000 (of the total \$1,500,000 payment) is non-deductible, reflecting the disallowance related to the excess parachute payment under section 280G and the application of section 162(m)(1).

(f) *Coordination with excise tax on specified stock compensation.* The \$1,000,000 limitation in paragraph (b) of this section is reduced (but not below zero) by the amount (if any) of any payment (with respect to such employee) of the tax imposed by section 4985 directly or indirectly by the expatriated corporation (as defined in section 4985(e)(2)) or by any member of the expanded affiliated group (as defined in section 4985(e)(4)) that includes such corporation.

(g) *Transition rules—(1) Amount of compensation payable under a written binding contract that was in effect on November 2, 2017—(i) General rule.* This section does not apply to the deduction for compensation payable under a written binding contract that was in effect on November 2, 2017, and that is not modified in any material respect on or after that date (a grandfathered amount). Instead, section 162(m), as in effect prior to its amendment

by Public Law 115-97, applies to limit the deduction for that compensation. Because §1.162-27 implemented section 162(m) as in effect prior to its amendment by Public Law 115-97, the rules of §1.162-27 determine the applicability of the deduction limitation under section 162(m) with respect to the payment of a grandfathered amount (including the potential application of the separate grandfathering rules contained in §1.162-27(h)). Compensation is a grandfathered amount only to the extent that as of November 2, 2017, the corporation was and remains obligated under applicable law (for example, state contract law) to pay the compensation under the contract if the employee performs services or satisfies the applicable vesting conditions. This section applies to the deduction for any amount of compensation that exceeds the grandfathered amount. If a grandfathered amount and non-grandfathered amount are otherwise deductible for the same taxable year and, under the rules of §1.162-27, the deduction of some or all of the grandfathered amount may be limited (for example, the grandfathered amount does not satisfy the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation), then the grandfathered amount is aggregated with the non-grandfathered amount to determine the deduction disallowance for the taxable year under section 162(m)(1) (so that the deduction limit applies to the excess of the aggregated amount over \$1 million).

(ii) *Contracts that are terminable or cancelable.* If a written binding contract is renewed after November 2, 2017, this section (and not §1.162-27) applies to any payments made after the renewal. A written binding contract that is terminable or cancelable by the corporation without the employee's consent after November 2, 2017, is treated as renewed as of the earliest date that any such termination or cancellation, if made, would be effective. Thus, for example, if the terms of a contract provide that it will be automatically renewed or extended as of a certain date unless either the corporation or the employee provides notice of termination of the contract at least 30 days before that date, the contract is treated as renewed as of the date that termination would be effective if that notice were given. Similar-

ly, for example, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date (unless the contract is renewed before that date, in which case, it is treated as renewed on the earlier date). Alternatively, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as renewed as of that date if the employee exercises the discretion to keep the corporation bound to the contract. A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment relationship of the employee. A contract is not treated as renewed if upon termination or cancellation of the contract the employment relationship continues but would no longer be covered by the contract. However, if the employment continues after the termination or cancellation, payments with respect to the post-termination or post-cancellation employment are not made pursuant to the contract (and, therefore, are not grandfathered amounts).

(iii) *Compensation payable under a plan or arrangement.* If a compensation plan or arrangement is a written binding contract in effect on November 2, 2017, the deduction for the amount that the corporation is obligated to pay to an employee pursuant to the plan or arrangement is not subject to this section solely because the employee was not eligible to participate in the plan or arrangement as of November 2, 2017, provided the employee was employed on November 2, 2017, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

(iv) *Compensation subject to recovery by corporation.* If the corporation is obligated or has discretion to recover compensation paid in a taxable year only upon the future occurrence of a condition that is objectively outside of the corporation's control, then the corporation's right to recovery is disregarded for purposes of determining the grandfathered amount

for the taxable year. Whether or not the corporation exercises its discretion to recover any compensation does not affect the amount of compensation that the corporation remains obligated to pay under applicable law.

(v) *Compensation payable from an account balance plan—(A) In general.* Except as otherwise provided in this paragraph (g), the grandfathered amount of payments from an account balance plan (as defined in §1.409A-1(c)(2)(i)(A)) that is a written binding contract in effect as of November 2, 2017, is the amount that the corporation is obligated to pay pursuant to the terms of the account balance plan in effect as of that date, as determined under applicable law. If under the terms of the plan, the corporation is obligated to pay the employee the account balance that is credited with earnings and losses and has no right to terminate or materially amend the plan, then the grandfathered amount would be the account balance as of November 2, 2017, plus any additional contributions and earnings and losses that the corporation is obligated to credit to the account balance in accordance with the terms of the plan as of November 2, 2017, through the date of payment.

(B) *Account balance plan providing right to terminate.* If under the terms of the account balance plan in effect as of November 2, 2017, the corporation may terminate the contract and distribute the account balance to the employee, then the grandfathered amount would be the account balance determined as if the corporation had terminated the plan on November 2, 2017 or, if later, the earliest possible date the plan could be terminated in accordance with the terms of the plan (termination date). Whether additional contributions and earnings and losses credited to the account balance after the termination date, through the earliest possible date the account balance could have been distributed to the employee in accordance with the terms of the plan, are grandfathered depends on whether the terms of the plan require the corporation to make those contributions or credit those earnings and losses through that distribution date. Notwithstanding the foregoing, the corporation may treat the account balance as of the termination date as the grandfathered amount regardless of when the amount is

paid and regardless of whether it has been credited with additional contributions or earnings or losses prior to payment.

(C) *Account balance plan providing right to discontinue future contributions.* If under the terms of the account balance plan in effect as of November 2, 2017, the corporation has no right to terminate the plan, but may discontinue future contributions and distribute the account balance in accordance with the terms of the plan, then the grandfathered amount would be the account balance determined as if the corporation had exercised the right to discontinue contributions on November 2, 2017, or, if later, the earliest permissible date the corporation could exercise that right in accordance with the terms of the plan (the freeze date). If, after the freeze date, the plan requires the crediting of earnings and losses on the account balance through the payment date, then the earnings and losses credited to the grandfathered account balance would also be grandfathered. Notwithstanding the foregoing, the corporation may treat the account balance as of the freeze date as the grandfathered amount regardless of when the amount is paid and regardless of whether it has been credited with earnings or losses prior to payment.

(vi) *Compensation payable from a nonaccount balance plan—(A) In general.* Except as otherwise provided in this paragraph (g), the grandfathered amount of payments from a nonaccount balance plan (as defined in §1.409A-1(c)(2)(i)(C)) that is a written binding contract in effect as of November 2, 2017, is the amount that the corporation is obligated to pay pursuant to the terms of the nonaccount balance plan in effect as of that date, as determined under applicable law. If under the terms of the plan, the corporation is obligated to pay the employee the benefit under the plan and has no right to terminate or materially amend the plan, then the grandfathered amount would be the benefit under the plan as of November 2, 2017, plus any additional accrued benefits that the corporation is obligated to pay in accordance with the terms of the plan as of November 2, 2017, through the date of payment.

(B) *Nonaccount balance plan providing right to terminate.* If under the terms of the nonaccount balance plan in effect as of November 2, 2017, the corporation may

terminate the plan and distribute the total benefit to the employee, then the grandfathered amount would be the present value of the total benefit (lump sum value) determined as if the corporation had terminated the plan on November 2, 2017 or, if later, the earliest possible date the plan could be terminated in accordance with the terms of the plan (termination date). Whether an increase or decrease in the lump sum value after the termination date, through the earliest possible date the lump sum value could have been distributed to the employee, is grandfathered depends on whether the terms of the plan require the corporation to increase or decrease the lump sum value through the distribution date. For example, if the plan did not require the corporation to make further service or compensation credits, then any increase in the lump sum value for these credits after the termination date is not grandfathered. Notwithstanding the foregoing, the corporation may treat the lump sum value as of the termination date as the grandfathered amount regardless of when the amount is paid and regardless of whether it has increased or decreased prior to payment. For purposes of this paragraph (g)(1)(vi) (B), the lump sum value is determined based on the actuarial methods and assumptions provided in the plan in effect on November 2, 2017, if the assumptions are reasonable, or any reasonable actuarial assumptions if the plan does not provide for applicable actuarial methods and assumptions or the terms of the plan were not reasonable. The determination of the lump sum value may not take into account the likelihood that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies. If the benefit provided under the plan in effect on November 2, 2017, is paid as a life annuity or other form of benefit that is not a single lump sum payment, the application of the grandfathered amount to the payments of the benefit is determined in accordance with the ordering rule of paragraph (g)(1) (viii) of this section.

(C) *Nonaccount balance plan providing right to discontinue future accrual of*

benefits. If under the terms of the nonaccrual balance plan in effect as of November 2, 2017, the corporation has no right to terminate the plan, but may discontinue future accruals of benefits and distribute the benefit in accordance with the terms of the plan, then the grandfathered amount would be the lump sum value of the total benefit (lump sum value) determined as if the corporation had exercised the right to discontinue the future accrual of benefits on November 2, 2017, or, if later, the earliest permissible date the corporation could exercise such right in accordance with the terms of the plan (the freeze date). If, after the freeze date, the plan required the corporation to increase or decrease the lump sum value through the payment date, then any increase to the grandfathered lump sum would also be grandfathered. Notwithstanding the foregoing, the corporation may treat the lump sum value determined as of the freeze date as the grandfathered amount regardless of when the amount is paid and regardless of whether it has been increased or decreased prior to payment. For purposes of this paragraph (g)(1)(vi)(C), the lump sum value is determined based on the actuarial methods and assumptions provided in the plan in effect on November 2, 2017, if the assumptions are reasonable, or any reasonable actuarial assumptions if the plan does not provide for applicable actuarial methods and assumptions or the terms of the plan were not reasonable. The determination of the lump sum value may not take into account the likelihood that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies. If the benefit paid under the plan in effect on November 2, 2017, is paid as a life annuity or other form of benefit that is not a single lump sum payment, the application of the grandfathered amount to the payments of the benefit is determined in accordance with the ordering rule of paragraph (g)(1)(viii) of this section.

(vii) *Grandfathered amount limited to a particular plan or arrangement.* The grandfathered amount under a plan or ar-

angement applies solely to the amounts paid under that plan or arrangement, so that regardless of whether all of the grandfathered amount is paid to the participant (for example, regardless of whether some or all of the grandfathered amount under the plan is forfeited under the terms of the plan), no portion of that grandfathered amount may be treated as a grandfathered amount under any other separate plan or arrangement in which the employee is a participant.

(viii) *Ordering rule.* If a portion of the amount payable under a plan or arrangement is a grandfathered amount and a portion is subject to this section, and payment under the plan or arrangement is made in a series of payments (including payments as a life annuity), the grandfathered amount is allocated to the first payment of an amount under the plan or arrangement that is otherwise deductible. If the grandfathered amount exceeds the initial payment, the excess is allocated to the next payment of an amount under the plan or arrangement that is otherwise deductible, and this process is repeated until the entire grandfathered amount has been paid. Notwithstanding the foregoing, for amounts otherwise deductible for taxable years ending before December 20, 2019, the grandfathered amount may be allocated to each payment on a pro rata basis or to the last otherwise deductible payment. If one of these two methods was used for taxable years ending before December 20, 2019, then, for taxable years ending on or after December 20, 2019, the method must be changed to allocate any remaining grandfathered amount to the first payment for the remaining payments (treating as the first payment the first otherwise deductible amount for taxable years ending on or after December 20, 2019).

(2) *Material modifications.* (i) If a written binding contract is modified on or after November 2, 2017, this section (and not §1.162-27) applies to any payments made after the modification. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a written binding contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received by an employee under the contract before a material mod-

ification are not affected, but amounts received subsequent to the material modification are treated as paid pursuant to a new contract, rather than as paid pursuant to a written binding contract in effect on November 2, 2017.

(ii) A modification of the contract that accelerates the payment of compensation is a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable to the employee under the contract will not be treated as resulting in a material modification if the additional amount is based on applying to the amount originally payable either a reasonable rate of interest or the rate of return on a predetermined actual investment as defined in §31.3121(v)(2)-1(d)(2)(i)(B) of this chapter (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the reasonable rate of interest or the actual rate of return on the predetermined actual investment (including any decrease, as well as any increase, in the value of the investment). For an arrangement under which the grandfathered amounts are subject to increase or decrease based on the performance of a predetermined actual investment, the addition or substitution of a predetermined actual investment or reasonable interest rate as an investment alternative for amounts deferred is not treated as a material modification. However, a modification of a contract to defer payment of a grandfathered amount that results in payment of additional amounts (such as additional earnings) does not necessarily mean that the additional amounts are grandfathered amounts; for rules concerning the determination of grandfathered amounts see paragraph (g) of this section. Notwithstanding the foregoing, if compensation attributable to an option to purchase stock (other than an incentive stock option described in section 422 or a stock option granted under an employee stock purchase plan described in section 423) or a stock appreciation right is grandfathered, an extension of the exer-

cise period that is extended in compliance with §1.409A-1(b)(5)(v)(C)(I) will not be treated as a material modification and the amount of compensation paid upon the exercise of the stock option or stock appreciation right will be grandfathered.

(iii) The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a written binding contract if the facts and circumstances demonstrate that the additional compensation to be paid is based on substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In addition, the failure, in whole or in part, to exercise negative discretion under a contract does not result in the material modification of that contract (although the existence of the negative discretion under the contract may impact the initial determination of whether amounts under the contract are grandfathered amounts).

(iv) If a grandfathered amount is subject to a substantial risk of forfeiture (as defined in §1.409A-1(d)), then a modification of the contract that results in a lapse of the substantial risk of forfeiture is not considered a material modification. Furthermore, for compensation received pursuant to the substantial vesting of restricted property, or the exercise of a stock option or stock appreciation right that does not provide for a deferral of compensation (as defined in §1.409A-1(b)(5)(i) and (ii)), a modification of a written binding contract in effect on November 2, 2017, that results in a lapse of the substantial risk of forfeiture (as defined in §1.83-3(c)) is not considered a material modification.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (g). For each example, assume for all relevant years that the corporation is a publicly held corporation within the meaning of paragraph (c)(1) of this section and is a calendar year taxpayer, and is not a “smaller reporting company” or “emerging growth company” for purposes

of reporting under the Exchange Act. Furthermore, assume that, for each example, if any arrangement is subject to section 409A, then the arrangement complies with section 409A, and that no arrangement is subject to section 457A.

(i) *Example 1 (Multi-year agreement for annual salary)*—(A) *Facts.* On October 2, 2017, Corporation X executed a three-year employment agreement with Employee A for an annual salary of \$2,000,000 beginning on January 1, 2018. Employee A serves as the PFO of Corporation X for the 2017 through 2020 taxable years. The agreement provides for automatic extensions after the three-year term for additional one-year periods, unless the corporation exercises its option to terminate the agreement within 30 days before the end of the three-year term or, thereafter, within 30 days before each anniversary date. Termination of the employment agreement does not require the termination of Employee A’s employment with Corporation X. Under applicable law, the agreement for annual salary constitutes a written binding contract in effect on November 2, 2017, to pay \$2,000,000 of annual salary to Employee A for three years through December 31, 2020.

(B) *Conclusion.* If this section applies, Employee A is a covered employee for Corporation X’s 2018 through 2020 taxable years. Because the October 2, 2017, employment agreement is a written binding contract to pay Employee A an annual salary of \$2,000,000, this section does not apply (and §1.162-27 does apply) to the deduction for Employee A’s annual salary. Pursuant to §1.162-27(c)(2), Employee A is not a covered employee for Corporation X’s 2018 through 2020 taxable years. The deduction for Employee A’s annual salary for the 2018 through 2020 taxable years is not subject to section 162(m)(1). However, the employment agreement is treated as renewed on January 1, 2021, unless it is previously terminated, and the deduction limit of this §1.162-33 (and not §1.162-27) will apply to the deduction for any payments made under the employment agreement on or after that date.

(ii) *Example 2 (Agreement for severance based on annual salary and discretionary bonus)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(i) of this section (*Example 1*), except that the employment agreement also requires Corporation X to pay Employee A severance if Corporation X terminates the employment relationship without cause during the term of the agreement. The amount of severance is equal to the sum of two times Employee A’s annual salary plus two times Employee A’s discretionary bonus (if any) paid within 24 months preceding termination. Under applicable law, the agreement for severance constitutes a written binding contract in effect on November 2, 2017, to pay \$4,000,000 (two times Employee A’s \$2,000,000 annual salary) if Corporation X terminates Employee A’s employment without cause during the term of the agreement.

(B) *Conclusion.* If this section applies, Employee A is a covered employee for Corporation X’s 2018 through 2020 taxable years. Because the October 2, 2017, employment agreement is a written binding contract to pay Employee A \$4,000,000 if Employee A is terminated without cause prior to December 31, 2020, this section does not apply (and §1.162-

27 does apply) to the deduction for \$4,000,000 of Employee A’s severance. Pursuant to §1.162-27(c)(2), Employee A is not a covered employee for Corporation X’s 2018 through 2020 taxable years. The deduction for \$4,000,000 of Employee A’s severance is not subject to section 162(m)(1). However, the employment agreement is treated as renewed on January 1, 2021, unless it is previously terminated, and this §1.162-33 (and not §1.162-27) will apply to the deduction for any payments made under the employment agreement, including for severance, on or after that date.

(iii) *Example 3 (Effect of discretionary bonus payment on agreement for severance based on annual salary and discretionary bonus)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(ii) of this section (*Example 2*), except that, on October 31, 2017, Corporation X paid Employee A a discretionary bonus of \$100,000, on May 14, 2018, Corporation X paid Employee A a discretionary bonus of \$600,000, and on April 30, 2019, terminated Employee A’s employment without cause. Pursuant to the terms of the employment agreement for severance, on May 1, 2019, Corporation X paid to Employee A a \$5,400,000 severance payment (the sum of two times the \$2,000,000 annual salary, two times the \$100,000 discretionary bonus, and two times the \$600,000 discretionary bonus).

(B) *Conclusion.* If this section applies, Employee A is a covered employee for Corporation X’s 2019 taxable year. Because the October 2, 2017, agreement is a written binding contract to pay Employee A \$4,000,000 if Employee A is terminated without cause prior to December 31, 2020, and \$200,000 if Corporation X terminates Employee A’s employment without cause prior to October 31, 2019, this section does not apply (and §1.162-27 does apply) to the deduction for \$4,200,000 of Employee A’s severance payment. The deduction for \$4,200,000 of Employee A’s severance payment is not subject to section 162(m)(1). Because the October 2, 2017, agreement is not a written binding contract to pay Employee A’s \$600,000 discretionary bonus (since, as of November 2, 2017, Corporation X was not obligated under applicable law to make the bonus payment), the deduction for \$1,200,000 of the \$5,400,000 payment is subject to this section (and not §1.162-27).

(iv) *Example 4 (Effect of adjustment to annual salary on severance)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(ii) of this section (*Example 2*), except that the employment agreement provides for discretionary increases in salary and, on January 1, 2019, Corporation X increased Employee A’s annual salary from \$2,000,000 to \$2,050,000, an increase that was less than a reasonable, cost-of-living adjustment.

(B) *Conclusion (Annual salary).* If this section applies, Employee A is a covered employee for Corporation X’s 2018 through 2020 taxable years. Because the October 2, 2017, agreement is a written binding contract to pay Employee A an annual salary of \$2,000,000, this section does not apply (and §1.162-27 does apply) to the deduction for Employee A’s annual salary unless the change in the salary is a material modification. Even though the \$50,000 increase is paid on the basis of substantially the same elements or conditions as the salary that is otherwise

paid under the contract, the \$50,000 increase does not constitute a material modification because it is less than or equal to a reasonable cost-of-living increase to the \$2,000,000 annual salary Corporation X is required to pay under applicable law as of November 2, 2017. However, the deduction for the \$50,000 increase is subject to this section (and not §1.162-27).

(C) *Conclusion (Severance payment)*. Because the October 2, 2017, agreement is a written binding contract to pay Employee A severance of \$4,000,000, this section would not apply (and §1.162-27 would apply) to the deduction for this amount of severance unless the change in the employment agreement is a material modification. Even though the \$100,000 increase in severance (two times the \$50,000 increase in salary) would be paid on the basis of substantially the same elements or conditions as the severance that would otherwise be paid pursuant to the written binding contract, the \$50,000 increase in salary on which it is based does not constitute a material modification of the written binding contract since it is less than or equal to a reasonable cost-of-living increase. However, the deduction for the \$100,000 increase in severance is subject to this section (and not §1.162-27).

(v) *Example 5 (Effect of adjustment to annual salary on severance)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(iv) of this section (*Example 4*), except that, on January 1, 2019, Corporation X increased Employee A's annual salary from \$2,000,000 to \$3,000,000, an increase that exceeds a reasonable, cost-of-living adjustment.

(B) *Conclusion (Annual salary)*. If this section applies, Employee A is a covered employee for Corporation X's 2018 through 2020 taxable years. Because the October 2, 2017, agreement is a written binding contract to pay Employee A an annual salary of \$2,000,000, this section does not apply (and §1.162-27 does apply) to the deduction for Employee A's annual salary unless the change in the employment agreement is a material modification. The \$1,000,000 increase is a material modification of the written binding contract because the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract, and it exceeds a reasonable, annual cost-of-living increase from the \$2,000,000 annual salary for 2018 that Corporation X is required to pay under applicable law as of November 2, 2017. Because the written binding contract is materially modified as of January 1, 2019, the deduction for all annual salary paid to Employee A in 2019 and thereafter is subject to this section (and not §1.162-27).

(C) *Conclusion (Severance payment)*. Because the October 2, 2017, agreement is a written binding contract to pay Employee A severance of \$4,000,000, this section would not apply (and §1.162-27 would apply) to the deduction for this amount of severance unless the change in the employment agreement is a material modification. The additional \$2,000,000 severance payment (two times the \$1,000,000 increase in annual salary) constitutes a material modification of the written binding contract because the \$1,000,000 increase in salary on which it is based

constitutes a material modification of the written binding contract since it exceeds a reasonable cost-of-living increase from the \$2,000,000 annual salary for 2018 that Corporation X is required to pay under applicable law as of November 2, 2017. Because the agreement is materially modified as of January 1, 2019, the deduction for any amount of severance paid to Employee A under the agreement is subject to this section (and not §1.162-27).

(vi) *Example 6 (Elective deferral of an amount that corporation was obligated to pay under applicable law)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(i) of this section (*Example 1*), except that, on December 15, 2018, Employee A makes a deferral election under a nonqualified deferred compensation (NQDC) plan to defer \$200,000 of annual salary earned and payable in 2019. Pursuant to the NQDC plan, the \$200,000, including earnings, is to be paid in a lump sum on the date six months following Employee A's separation from service. The earnings are based on the Standard & Poor's 500 Index. Under applicable law, pursuant to the written binding contract in effect on November 2, 2017, (and absent the deferral agreement) Corporation X would have been obligated to pay \$200,000 to Employee A in 2019, but is not obligated to pay any earnings on the \$200,000 deferred pursuant to the deferral election Employee A makes on December 15, 2018. Employee A separates from service on December 15, 2020. On June 15, 2021, Corporation X pays \$250,000 (the deferred \$200,000 of salary plus \$50,000 in earnings).

(B) *Conclusion*. If this section applies, Employee A is a covered employee for Corporation X's 2021 taxable year. Employee A's NQDC plan is not a material modification of the written binding contract in effect on November 2, 2017, because the earnings to be paid under the NQDC plan are based on a predetermined actual investment (as defined in §31.3121(v)(2)-1(d)(2)(i)(B) of this chapter). The deduction for the \$50,000 of earnings to be paid that exceed the amount originally payable to Employee A under the written binding contract (\$200,000 of salary) are subject to this section (and not §1.162-27). This section does not apply (and §1.162-27 does apply) to the deduction for the \$200,000 portion of the \$250,000 payment that Corporation X was obligated under applicable law to pay as of November 2, 2017. Pursuant to §1.162-27(c)(2), Employee A is not a covered employee for Corporation X's 2021 taxable year; thus, the deduction for the \$200,000 payment is not subject to section 162(m)(1).

(vii) *Example 7 (Compensation subject to discretionary recovery by corporation)*—(A) *Facts*. Employee B serves as the PFO of Corporation Z for its 2017 through 2019 taxable years. On October 2, 2017, Corporation Z executed a bonus agreement with Employee B that requires Corporation Z to pay Employee B a performance bonus of \$3,000,000 on May 1, 2019, if Corporation Z's net earnings increase by at least 10% for its 2018 taxable year based on the financial statements filed with the SEC. The agreement does not permit Corporation Z to reduce the amount of the bonus payment for any reason if the Corporation Z attains

the net earnings performance target. However, the agreement provides that, if the bonus is paid and subsequently the financial statements are restated to show that the net earnings did not increase by at least 10%, then Corporation Z may, in its discretion, recover the \$3,000,000 from Employee B within six months of the restatement. Under applicable law, the agreement for the performance bonus constitutes a written binding contract in effect on November 2, 2017, to pay \$3,000,000 to Employee B if Corporation Z's net earnings increase by at least 10% for its 2018 taxable year based on the financial statements filed with the SEC. On May 1, 2019, Corporation Z pays \$3,000,000 to Employee B because its net earnings increased by at least 10% of its 2018 taxable year.

(B) *Conclusion*. If this section applies, Employee B is a covered employee for Corporation Z's 2019 taxable year. Because the October 2, 2017, agreement is a written binding contract to pay Employee B \$3,000,000 if the applicable conditions are met, this section does not apply (and §1.162-27 does apply) to the deduction for the \$3,000,000 regardless of whether Corporation Z's financial statements are restated to show that its net earnings did not increase by at least 10%, and regardless of whether Corporation Z exercises its discretion to recover the bonus if Corporation Z's financial statements are restated to show that its net earnings did not increase by at least 10%.

(viii) *Example 8 (Performance bonus plan with negative discretion)*—(A) *Facts*. Employee E serves as the PEO of Corporation V for the 2017 and 2018 taxable years. On February 1, 2017, Corporation V establishes a bonus plan, under which Employee E will receive a cash bonus of \$1,500,000 if a specified performance goal is satisfied. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to no less than \$400,000 if, in its judgment, other subjective factors warrant a reduction. On November 2, 2017, under applicable law, which takes into account the employer's ability to exercise negative discretion, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay \$400,000. On March 1, 2018, the compensation committee certifies that the performance goal was satisfied, but exercises its discretion to reduce the award to \$500,000. On April 1, 2018, Corporation V pays \$500,000 to Employee E. The payment satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation.

(B) *Conclusion*. If this section applies, Employee E is a covered employee for Corporation V's 2018 taxable year. Because the February 1, 2017, plan is a written binding contract to pay Employee E \$400,000 if the performance goal is satisfied, this section does not apply (and §1.162-27 does apply) to the deduction for the \$400,000 portion of the \$500,000 payment. Furthermore, pursuant to paragraph (g)(2)(iii) of this section, the failure of the compensation committee to exercise its discretion to reduce the award further to \$400,000, instead of \$500,000, does not result in a material modification of the contract. Pursuant to §1.162-27(e)(1), the deduction for the \$400,000 payment is not subject to section 162(m)(1) because the payment satis-

fies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation. The deduction for the remaining \$100,000 of the \$500,000 payment is subject to this section (and not §1.162-27) and therefore the status as qualified performance-based compensation is irrelevant to the application of section 162(m)(1) to this remaining amount.

(ix) *Example 9 (Equity-based compensation with underlying grants made prior to November 2, 2017)*—(A) *Facts*. On January 2, 2017, Corporation T executed a 4-year employment agreement with Employee G to serve as its PEO, and Employee G serves as the PEO for the four-year term. Pursuant to the employment agreement, on January 2, 2017, Corporation T executed a grant agreement and granted to Employee G nonqualified stock options to purchase 1,000 shares of Corporation T stock, stock appreciation rights (SARs) on 1,000 shares, and 1,000 shares of Corporation T restricted stock. On the date of grant, the stock options had no readily ascertainable fair market value as defined in §1.83-7(b), and neither the stock options nor the SARs provided for a deferral of compensation under § 1.409A-1(b)(5)(i) (A) and (B). The stock options, SARs, and shares of restricted stock are subject to a substantial risk of forfeiture and all substantially vest on January 2, 2020. Employee G may exercise the stock options and the SARs at any time from January 2, 2020, through January 2, 2027. On January 2, 2020, Employee G exercises the stock options and the SARs, and the 1,000 shares of restricted stock become substantially vested (as defined in §1.83-3(b)). The grant agreement pursuant to which grants of the stock options, SARs, and shares of restricted stock are made constitutes a written binding contract under applicable law. The compensation attributable to the stock options and the SARs satisfy the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation.

(B) *Conclusion*. If this section applies, Employee G is a covered employee for Corporation T's 2020 taxable year. Because the January 2, 2017, grant agreement constitutes a written binding contract, this section does not apply (and §1.162-27 does apply) to the deduction for compensation received pursuant to the exercise of the stock options and the SARs, or the restricted stock becoming substantially vested (as defined in §1.83-3(b)). Pursuant to §1.162-27(e)(1), the deduction attributable to the stock options and the SARs is not subject to section 162(m)(1) because the compensation satisfies the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation. However, the deduction attributable to the restricted stock is subject to section 162(m)(1) because the compensation does not satisfy the requirements of §1.162-27(e)(2) through (5) as qualified performance-based compensation.

(x) *Example 10 (Plan in which an employee is not a participant on November 2, 2017)*—(A) *Facts*. On October 2, 2017, Employee H executes an employment agreement with Corporation Y to serve as its PFO, and begins employment with Corporation Y. The employment agreement, which is a written binding contract under applicable law, provides that if Employee H continues in his position through April 1, 2018, Employee H will become a

participant in the NQDC plan of Corporation Y and that Employee H's benefit accumulated on that date will be \$3,000,000. On April 1, 2021, Employee H receives a payment of \$4,500,000 (the increase from \$3,000,000 to \$4,500,000 is not a result of a material modification as defined in paragraph (g)(2) of this section), which is the entire benefit accumulated under the plan through the date of payment.

(B) *Conclusion*. If this section applies, Employee H is a covered employee for Corporation Y's 2021 taxable year. Even though Employee H was not eligible to participate in the NQDC plan on November 2, 2017, Employee H had the right to participate in the plan under a written binding contract as of that date. Because the amount required to be paid pursuant to the written binding contract is \$3,000,000, this section does not apply (and §1.162-27 does apply) to the deduction for the \$3,000,000 portion of the \$4,500,000. Pursuant to §1.162-27(c)(2), Employee H is not a covered employee of Corporation Y for the 2021 taxable year. The deduction for the \$3,000,000 portion of the \$4,500,000 is not subject to section 162(m)(1). The deduction for the remaining \$1,500,000 portion of the payment is subject to this section (and not §1.162-27).

(xi) *Example 11 (Material modification of annual salary)*—(A) *Facts*. On January 2, 2017, Corporation R executed a 5-year employment agreement with Employee I to serve as Corporation R's PFO, providing for an annual salary of \$1,800,000. The agreement constitutes a written binding contract under applicable law. In 2017 and 2018, Employee I receives the salary of \$1,800,000 per year. In 2019, Corporation R increases Employee I's salary by \$40,000, which is less than a reasonable cost-of-living increase from \$1,800,000. On January 1, 2020, Corporation R increases Employee I's salary to \$2,400,000. The \$560,000 increase exceeds a reasonable, annual cost-of-living increase from \$1,840,000.

(B) *Conclusion (\$1,840,000 Payment in 2019)*. If this section applies, Employee I is a covered employee for Corporation R's 2018 through 2020 taxable years. Because the January 1, 2017, agreement is a written binding contract to pay Employee I an annual salary of \$1,800,000, this section does not apply (and §1.162-27 does apply) to the deduction for Employee I's annual salary unless the change in the employment agreement is a material modification. Pursuant to §1.162-27(c)(2), Employee I is not a covered employee of Corporation R for the 2019 taxable year, so the deduction for the \$1,800,000 salary is not subject to section 162(m)(1). Even though the \$40,000 increase is made on the basis of substantially the same elements or conditions as the salary, the \$40,000 increase does not constitute a material modification of the written binding contract because the \$40,000 is less than or equal to a reasonable cost-of-living increase. However, the deduction for the \$40,000 increase is subject to this section (and not §1.162-27).

(C) *Conclusion (Salary increase to \$2,400,000 in 2020)*. The \$560,000 increase in salary in 2020 is a material modification of the written binding contract because the additional compensation is paid on the basis of substantially the same elements or conditions as the salary, and it exceeds a reasonable,

annual cost-of-living increase from \$1,840,000. Because the written binding contract is materially modified as of January 1, 2020, the deduction for all salary paid to Employee I on and after January 1, 2020, is subject to this section (and not §1.162-27).

(xii) *Example 12 (Additional payment not considered a material modification)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(xi) of this section (*Example 11*), except that instead of an increase in salary, in 2020 Employee I receives a restricted stock grant subject to Employee I's continued employment for the balance of the contract.

(B) *Conclusion*. The restricted stock grant is not a material modification of the written binding contract because any additional compensation paid to Employee I under the grant is not paid on the basis of substantially the same elements and conditions as Employee I's salary. However, the deduction attributable to the restricted stock grant is subject to this section (and not §1.162-27).

(h) *Effective/Applicability dates*—(1) *Effective date*. This section is effective on **December 30, 2020**.

(2) *Applicability dates*—(i) *General applicability date*. Except as otherwise provided in paragraph (h)(2)(ii) of this section, this section applies to taxable years beginning on or after **December 30, 2020**. Taxpayers may choose to apply this section for taxable years beginning after December 31, 2017, and before **December 30, 2020** provided the taxpayer applies this section in its entirety and in a consistent manner.

(ii) *Special applicability dates*—(A) *Definition of covered employee*. The definition of covered employee in paragraph (c)(2)(i) of this section applies to taxable years ending on or after September 10, 2018. However, for a corporation whose fiscal year and taxable year do not end on the same date, the rule in paragraph (c)(2)(i)(B) of this section requiring the determination of the three most highly compensated executive officers to be made pursuant to the rules under the Exchange Act applies to taxable years ending on or after December 20, 2019.

(B) *Definition of predecessor of a publicly held corporation*—(1) *Publicly held corporations that become privately held*. The definition of predecessor of a publicly held corporation in paragraph (c)(2)(ii)(A) of this section applies to any publicly held corporation that becomes a privately held corporation for a taxable year beginning after December 31, 2017, and, subsequently, again becomes a publicly held corporation on or

after **December 30, 2020**. The definition of predecessor of a publicly held corporation in paragraph (c)(2)(ii)(A) of this section does not apply to any publicly held corporation that became a privately held corporation for a taxable year beginning before January 1, 2018, with respect to the earlier period as a publicly held corporation; or a publicly held corporation that becomes a privately held corporation for a taxable year beginning after December 31, 2017, and, subsequently, again becomes a publicly held corporation before **December 30, 2020**.

(2) *Corporate transactions*. The definition of predecessor of a publicly held corporation in paragraphs (c)(2)(ii)(B) through (H) of this section applies to corporate transactions that occur (as provided in the transaction timing rule of paragraph (c)(2)(ii)(I) of this section) on or after **December 30, 2020**. With respect to any of the following corporate transactions occurring after December 20, 2019, and before **December 30, 2020**, excluding target corporations from the definition of the term “predecessor” is not a reasonable good faith interpretation of the statute:

(i) A publicly held target corporation the stock or assets of which are acquired by another publicly held corporation in a transaction to which section 381(a) applies.

(ii) A publicly held target corporation, at least 80% of the total voting power of the stock of which, and at least 80% of the total value of the stock of which, are acquired by a publicly held acquiring corporation (including an affiliated group).

(C) *Definition of compensation*. The definition of compensation provided in paragraph (c)(3)(ii) of this section (relating to distributive share of partnership deductions for compensation paid) applies to any deduction for compensation that is paid after December 18, 2020. The definition of compensation in paragraph (c)(3)(ii) does not apply to compensation paid pursuant to a written binding contract that is in effect on December 20, 2019, and that is not materially modified after that date. For purposes of this paragraph (h)(3), written binding contract and material modification have the same meanings as provided in paragraphs (g)(1) and (2) of this section.

(D) *Corporations that become publicly held*. The rule in paragraph (d) of this section (providing that the deduction limitation of paragraph (b) of this section applies to a deduction for any compensation that is otherwise deductible for the taxable year ending on or after the date that a privately held corporation becomes a publicly held corporation) applies to corporations that become publicly held after December 20, 2019. A privately held corporation that becomes a publicly held corporation on or before December 20, 2019, may rely on the transition rules provided in §1.162-27(f)(1) until the earliest of the events provided in §1.162-27(f)(2). A subsidiary that is a member of an affiliated group (as defined in §1.162-27(c)(1)(ii)) may rely on transition relief provided in §1.162-27(f)(4) if it becomes a separate publicly held corporation (whether in a spin-off transaction or otherwise) on or before December 20, 2019.

(E) *Transition rules*. Except for the transition rules in paragraphs (g)(1)(v) through (vii) of this section, the transition rules in paragraphs (g)(1) and (2) of this section (providing that this section does not apply to compensation payable under a written binding contract which was in effect on November 2, 2017, and which is not modified in any material respect on or after such date) apply to taxable years ending on or after September 10, 2018.

Par. 4. Section 1.338-1 is amended by revising paragraph (b)(2)(i) to read as follows:

§ 1.338-1 *General principles; status of old target and new target.*

* * * * *

(b) * * *

(2) * * *

(i) The rules applicable to employee benefit plans (including those plans described in sections 79, 104, 105, 106, 125, 127, 129, 132, 137, and 220), qualified pension, profit-sharing, stock bonus and annuity plans (sections 401(a) and 403(a)), simplified employee pensions (section 408(k)), tax qualified stock option plans (sections 422 and 423), welfare benefit funds (sections 419, 419A, 512(a)(3), and 4976), voluntary employee benefit associations (section 501(c)(9) and the regulations thereunder (§§ 1.501(c)(9)-1

through 1.501(c)(9)-8)) and certain excessive employee remuneration (section 162(m) and the regulations thereunder (§§ 1.162-27, 1.162-31, and 1.162-33));

* * * * *

Sunita Lough,
*Deputy Commissioner for Services
and Enforcement.*

Approved: December 11, 2020.

David J. Kautter,
*Assistant Secretary of the Treasury
(Tax Policy).*

(Filed by the Office of the Federal Register on December 18, 2020, 8:45 a.m., and published in the issue of the Federal Register for December 30, 2020, 85 F.R. 86481)

26 CFR 1.274-13 *Disallowance of deductions for certain qualified transportation fringe expenditures;*
26 CFR 1.274-14 *Disallowance of deductions for certain transportation and commuting benefit expenditures*

T.D. 9939

**DEPARTMENT OF
TREASURY
Internal Revenue Service
26 CFR Part 1**

**Qualified Transportation
Fringe, Transportation
and Commuting Expenses
under Section 274**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations to implement legislative changes to section 274 of the Internal Revenue Code (Code) effective for taxable years beginning after December 31, 2017. Specifically, the final regulations address the elimination of the deduction under section 274 for expenses related to certain transportation and commuting benefits provided by employers to their employees. The final regulations pro-

vide guidance to determine the amount of such expenses that is nondeductible and apply certain exceptions under section 274(e) that may allow such expenses to be deductible. These final regulations affect taxpayers who pay or incur such expenses.

DATES: *Effective Date:* These regulations are effective on December 16, 2020.

Applicability Date: These regulations apply to taxable years beginning on or after December 16, 2020. Notwithstanding the preceding sentence, taxpayers may choose to apply §1.274-13(b)(14)(ii) to taxable years ending after December 31, 2019.

FOR FURTHER INFORMATION CONTACT: Patrick Clinton of the Office of Associate Chief Counsel (Income Tax and Accounting), (202) 317-7005 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations under section 274 of the Code that amend the Income Tax Regulations (26 CFR part 1). In general, section 274 limits or disallows deductions for certain expenditures that otherwise would be allowable under chapter 1 of the Code (chapter 1), primarily under section 162(a), which allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

On December 22, 2017, section 274 was amended by section 13304 of Public Law 115-97 (131 Stat. 2054), commonly referred to as the Tax Cuts and Jobs Act (TCJA), to disallow a deduction for the expense of any qualified transportation fringe (QTF) as defined in section 132(f) provided to an employee of the taxpayer, effective for amounts paid or incurred after December 31, 2017.

The TCJA also added section 274(l), which provides that no deduction is allowed under chapter 1 for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection

with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee, effective for transportation and commuting expenses paid or incurred after December 31, 2017.

On December 24, 2018, the Department of the Treasury (Treasury Department) and the IRS published Notice 2018-99, 2018-52 I.R.B. 1067, "Parking Expenses for Qualified Transportation Fringes under § 274(a)(4) and § 512(a)(7) of the Internal Revenue Code." Notice 2018-99, in part, provided interim guidance for taxpayers to determine the amount of parking expenses for QTFs that is nondeductible under section 274(a)(4).

On June 23, 2020, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-119307-19) in the **Federal Register** (85 FR 37599) containing proposed regulations under section 274 (proposed regulations) to implement the TCJA's amendments to section 274. The proposed regulations would add a new section at §1.274-13 to address parking and other QTF expenses under section 274(a)(4), including the application of certain exceptions in section 274(e) to QTF expenses. The proposed regulations also would add a new section at §1.274-14 to address transportation and commuting expenses under section 274(l).

Pending the issuance of these final regulations, taxpayers were allowed to rely on the proposed regulations or the guidance provided in Notice 2018-99 for parking expenses, other QTF expenses, and transportation and commuting expenses, as applicable, paid or incurred in taxable years beginning after December 31, 2017.

The Treasury Department and the IRS received one request to speak at a public hearing that was later withdrawn. Therefore, no public hearing was held. The Treasury Department and the IRS received 12 written and electronic comments responding to the proposed regulations. All comments were considered and are available at <https://www.regulations.gov> or upon request. The comments addressing the proposed regulations are summarized in the Summary of Comments and Explanation of Revisions section. However, comments recommending statutory revisions or addressing issues outside the scope of

these final regulations are not discussed in this preamble.

After full consideration of the comments received on the proposed regulations, this Treasury decision adopts the proposed regulations with modifications in response to certain comments, as described in the Summary of Comments and Explanation of Revisions section.

Summary of Comments and Explanation of Revisions

1. Qualified Transportation Fringes

A. In General

Section 274(a)(4), as added by the TCJA, provides that no deduction is allowed under chapter 1 for the expense of any QTF (as defined in section 132(f)) provided by taxpayers to their employees for expenses paid or incurred after December 31, 2017. Section 132 generally excludes from employees' gross income the value of certain fringe benefits. Section 132(a)(5) generally provides that gross income does not include any fringe benefit that qualifies as a QTF under section 132(f). QTFs are defined in section 132(f)(1) to mean any of the following provided by an employer to an employee: (1) transportation in a commuter highway vehicle between the employee's residence and place of employment, (2) any transit pass, (3) qualified parking, and (4) any qualified bicycle commuting reimbursement. Section 132(f)(5)(A), (B), (C), and (F)(i) define transit pass, commuter highway vehicle, qualified parking, and qualified bicycle commuting reimbursement, respectively. Section 132(f)(2) provides that the amount of QTFs provided by an employer to any employee that can be excluded from gross income under section 132(a)(5) cannot exceed a maximum monthly dollar amount, adjusted for inflation. The adjusted maximum monthly excludable amount for 2020 is \$270.

The proposed regulations restated the statutory rules under section 274(a)(4), defined relevant terms, and provided a general rule and three simplified methodologies to determine the amount of nondeductible parking expenses when a parking facility is owned or leased by the taxpayer. Additionally, the proposed

regulations included rules addressing the deduction disallowance for expenses related to providing employees transportation in a commuter highway vehicle and transit pass QTFs. Finally, the proposed regulations applied the applicable exceptions in section 274(e) to all QTF expenses.

Specifically, the proposed regulations provided that if the taxpayer pays a third party for its employee's QTF, the section 274(a)(4) disallowance is generally calculated as the taxpayer's total annual cost of the QTF paid to the third party. With regard to QTF parking expenses, the proposed regulations provided that if the taxpayer owns or leases all or a portion of one or more parking facilities, the section 274(a)(4) disallowance may be calculated using a general rule or any one of three simplified methodologies. The proposed regulations provided taxpayers the option to apply the general rule or a simplified methodology for each taxable year and for each parking facility. The proposed regulations included special rules and definitions for allocating certain mixed parking expenses, aggregating parking spaces by geographic location, removing inventory/unusable spaces from available parking spaces, defining general public for multi-tenant building parking facilities, disregarding five or fewer reserved parking spaces if the reserved spaces are 5 percent or less of total parking spaces, and determining employee use of parking on a typical business day. The preamble to the proposed regulations provided that taxpayers may use statistical sampling with the general rule or simplified methodologies if they follow the procedures in Rev. Proc. 2011-42, 2011-37 I.R.B. 318, as corrected by Ann. 2013-46, 2013-48 I.R.B. 593.

The general rule in the proposed regulations allowed taxpayers to calculate the disallowance based on a reasonable interpretation of section 274(a)(4). However, the proposed regulations required taxpayers to use the expense paid or incurred in providing a QTF and not its value to an employee, allocate parking expenses to reserved employee spaces, and properly apply the exception for parking made available to the general public. The

proposed regulations allowed a special rule for aggregating parking spaces by geographic location to be used with the general rule.

The proposed regulations also included three simplified methodologies as alternatives to the general rule. Under the first simplified methodology, the "qualified parking limit methodology," taxpayers calculate the disallowance by multiplying the total number of spaces used by employees during the peak demand period, or, alternatively, the total number of the taxpayer's employees, by the section 132(f)(2) monthly per employee limitation on exclusion for qualified parking (\$270 for 2020), for each month in the taxable year.

The second simplified methodology, the "primary use methodology," is largely based on the method deemed reasonable in Notice 2018-99, modified in response to comments received on the Notice. The proposed regulations permitted the use of special rules for allocating certain mixed parking expenses and aggregating parking spaces by geographic location. The proposed regulations also provided definitions for employee, general public, parking facility, total parking spaces, reserved employee spaces, reserved nonemployee spaces, primary use, and total parking expenses, geographic location, inventory/unusable spaces, available parking spaces, peak demand period, and mixed parking expense.

The third simplified methodology provided in the proposed regulations is the "cost per space methodology," which allows taxpayers to calculate the disallowance by multiplying the cost per parking space by the number of available parking spaces used by employees during the peak demand period. The proposed regulations provided that cost per space is calculated by dividing total parking expenses (including expenses for inventory/unusable spaces) by total parking spaces (including inventory/unusable spaces). The proposed regulations also permitted special rules for allocating certain mixed parking expenses and aggregating parking spaces by geographic location to be used with the cost per space methodology.

Finally, the proposed regulations provided that the deduction disallowance

under section 274(a)(4) does not apply to expenditures for QTFs that meet the requirements of section 274(e)(2), (7), or (8), the three exceptions in section 274(e) that are relevant for QTFs. Pursuant to section 274(e)(2), the proposed regulations provided that the disallowance under section 274(a) does not apply to expenditures for QTFs to the extent the taxpayer properly treats the expenses as compensation to the employee on the taxpayer's Federal income tax return as originally filed, and as wages to the employee for purposes of withholding under chapter 24 of the Code (chapter 24) relating to collection of Federal income tax at source on wages. The proposed regulations also provided, in accordance with section 274(e)(7), that any taxpayer expense for transportation in a commuter highway vehicle, a transit pass, or parking that otherwise qualifies as a QTF under section 132(f)(1) is not subject to the deduction disallowance under section 274(a) to the extent such transportation, transit pass, or parking is made available to the general public. Finally, consistent with section 274(e)(8), the proposed regulations provided that any taxpayer expense for transportation in a commuter highway vehicle, a transit pass, or parking that otherwise qualifies as a QTF under section 132(f)(1) that is sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth is not subject to the deduction disallowance under section 274(a).

The final regulations substantially adopt the proposed regulations, with certain modifications and clarifications, as discussed in this Summary of Comments and Explanation of Revisions. In applying the final regulations, taxpayers may continue to use statistical sampling with the general rule or simplified methodologies if they follow the procedures in Rev. Proc. 2011-42, 2011-37 I.R.B. 318, as corrected by Ann. 2013-46, 2013-48 I.R.B. 593.

B. Definitions

As described in this part I.B., the final regulations generally include the definitions from the proposed regulations, modified and clarified in response to comments.

i. Qualified Transportation Fringe

The final regulations adopt the proposed regulations' definition for the term "qualified transportation fringe." The definition is based on section 132(f)(1), except that it does not include qualified bicycle commuting reimbursements. Although section 132(f)(1) includes qualified bicycle commuting reimbursements as a QTF, section 132(f)(8) provides that the inclusion of qualified bicycle commuting reimbursements in the definition of a QTF is suspended for taxable years beginning after December 31, 2017, and before January 1, 2026. Accordingly, for such taxable years, qualified bicycle commuting reimbursements are not excluded from an employee's income as a QTF. Because qualified bicycle commuting reimbursements are not QTFs, deductions for qualified bicycle commuting reimbursements are not disallowed under section 274(a)(4) for taxable years beginning after December 31, 2017 and before January 1, 2026. Thus, the final regulations provide that the term "qualified transportation fringe" means any of the following provided by an employer to an employee: (1) transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee's residence and place of employment (as described in section 132(f)(1)(A) and (f)(5)(B)), (2) any transit pass (as described in section 132(f)(1)(B) and (f)(5)(A)), or (3) qualified parking (as described in section 132(f)(1)(C) and (f)(5)(C)).

Under section 132(f)(1)(C) and (f)(5)(C), the term "qualified parking" includes parking provided by an employer to an employee on or near the business premises of the employer. A commenter requested that the final regulations define "parking provided to an employee" to include only parking spaces that are reserved or otherwise set aside exclusively for employee use. The Treasury Department and the IRS decline to adopt this suggestion. Section 1.132-9, Q/A-4(d) provides that parking is provided by an employer to an employee if the parking is on property that the employer owns or leases, the employer pays for the parking, or the employer reimburses the employee for parking expense. Thus, the definition

of qualified parking as a QTF under section 132(f) is not limited to parking that is reserved or otherwise set aside exclusively for employee use.

Another commenter suggested that parking with no objective value to an employee, such as parking in industrial, remote, or rural areas (that is, areas where the general public would not pay to park) is not a QTF and therefore, that section 274(a)(4) should not disallow the deduction of the expenses. The Treasury Department and the IRS note that there is nothing in section 132 or §1.132-9 that supports the proposition that the value of parking to an employee is relevant in determining whether the parking itself constitutes qualified parking and a QTF. Thus, the Treasury Department and the IRS do not agree with the commenter that qualified parking with no objective value to an employee is not a QTF. However, see part I.E.iii. of this Summary of Comments and Explanation of Revisions section for a discussion of the applicability of the section 274(e)(8) exception to parking with no objective value to an employee.

ii. Employee

The proposed regulations defined the term "employee" based on definitions in §§1.132-1(b)(2)(i) and 1.132-9(b), Q/A-5 and Q/A-24. The term "employee" for Federal tax purposes generally is understood to refer to a common-law employee. Whether a service provider is a common-law employee generally turns on whether the service recipient has the right to direct and control the service provider, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. *See, e.g.*, §31.3121(d)-1(c)(2) of the Employment Taxes and Collection of Income Tax at Source Regulations. The determination does not depend on whether or how the individual is compensated, or by which person. The regulations under section 132 also include certain statutory employees such as officers of corporations in the definition of employee for purposes of QTFs. No comments were received on the proposed definition of "employee". Thus, the final regulations adopt this definition without modification.

iii. General Public

Commenters on Notice 2018-99 raised concerns that, for taxpayers that lease space in a multi-tenant building, the Notice did not include employees, partners, 2-percent shareholders of S corporations (as defined in section 1372(b)), independent contractors, clients, or customers of unrelated tenants in the building as members of the general public. In response to these comments, the proposed regulations provided that "general public" includes employees, partners, 2-percent shareholders of S corporations (as defined in section 1372(b)), sole proprietors, independent contractors, clients, or customers of unrelated tenants in multi-tenant buildings, as well as customers, clients, or visitors of the taxpayer, individuals delivering goods or services to the taxpayer, students of an educational institution, and patients of a health care facility.

A commenter on the proposed regulations raised concerns that the definition of the term "general public" in the proposed regulations gives tenants of multi-tenant buildings an unfair advantage in comparison to tenants in buildings with only one tenant and suggested all tenants be treated the same. The Treasury Department and the IRS decline to adopt this suggestion because any alternative would likely impose an undue administrative burden on taxpayers in a multi-tenant building to determine the use of the parking facility by numerous other tenants.

A commenter also asked why taxpayers that own or lease space in a multi-tenant building may include independent contractors in the definition of general public. The Treasury Department and the IRS note that the proposed regulations defined general public to include independent contractors of unrelated taxpayers in a multi-tenant building because unlike independent contractors of the taxpayer, independent contractors of unrelated tenants do not have a relationship with the taxpayer. The final regulations continue to provide that independent contractors of unrelated tenants in multi-tenant buildings are included in the general public. However, independent contractors of the taxpayer continue to be excluded from the general public regardless of whether the taxpayer owns or leases space in a multi-tenant building.

A commenter requested that a car dealership's parking spaces occupied by customers' vehicles being repaired or serviced be excluded from the definition of inventory/unusable spaces and instead be included in the definition of spaces available to the general public because the parking spaces are used by customers and are not available for employee parking. The Treasury Department and the IRS agree with the commenter and have revised the definition of general public in the final regulations accordingly. Thus, the final regulations follow the definition of the term general public as provided in the proposed regulations with the clarification that parking spaces that are used to park vehicles owned by members of the general public while the vehicles await repair or service by the taxpayer also are treated as provided to the general public.

iv. Parking Facility

The final regulations include a definition of the term "parking facility" that follows the definition of qualified parking in section 132(f)(5)(C) and includes one or more indoor or outdoor garages and other structures, as well as parking lots and other areas where employees may park. Commenters on Notice 2018-99 suggested that because qualified parking as defined in section 132(f)(5)(C) and §1.132-9(b), Q/A-4(c) does not include any parking on or near property used by the employee for residential purposes, including parking for resident employees of residential rental buildings, the definition of "total parking spaces" in the proposed regulations should exclude such spaces. In response to these comments, the proposed regulations specifically excluded parking spaces on or near property used by the employee for residential purposes from the definition of parking facility. The final regulations adopt this definition, without modification.

v. Geographic Location

Consistent with the proposed regulations, the final regulations allow the taxpayer to aggregate the number of parking spaces in a single geographic location to determine the section 274(a)(4) disallowance using the general rule, primary use

methodology, or cost per space methodology.

The proposed regulations defined the term "geographic location" as contiguous tracts or parcels of land owned or leased by the taxpayer. Two or more tracts or parcels of land are contiguous if they share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream, or similar property. Tracts or parcels of land which touch only at a common corner are not contiguous.

A commenter suggested that the definition of geographic location be expanded to allow parking lots located within reasonable distance (1/4 mile) of a principal parking lot to be aggregated as part of a single geographic location. The commenter explained that automotive dealers often have overflow parking lots not designated for any purpose available relatively close to the business location in the event the inventory levels exceed the spaces available at the principal location.

The Treasury Department and the IRS considered this comment and decline to adopt it because the term "reasonable distance" is difficult to define and, as the commenter explained, overflow parking facilities are typically utilized for excess inventory vehicles, instead of parking for the general public. The Treasury Department and the IRS believe that expanding the definition of geographic location to include noncontiguous tracts or parcels of land would introduce unnecessary complexity without providing a meaningful benefit to taxpayers. Thus, the final regulations adopt the proposed regulations' definition of geographic location, without modification.

vi. Total Parking Spaces

The proposed regulations defined the term "total parking spaces" as the total number of parking spaces, or the taxpayer's portion thereof, in the parking facility. No comments were received on this definition, and the final regulations adopt it without modification.

vii. Reserved Employee Spaces

A commenter on Notice 2018-99 recommended that the definition of the term

"reserved employee spaces" be limited to parking spaces actually used by employees on a typical business day. Because section 274(a)(4) disallows the deduction for the expense of providing a QTF to an individual employee, the commenter reasoned that the taxpayer should identify the expense for each QTF provided to each individual employee when determining the amount that is disallowed.

After considering the comment, the Treasury Department and the IRS, in the proposed regulations, provided that costs allocated to reserved employee spaces would be disallowed regardless of actual use of the reserved spaces. However, the proposed regulations also included a special rule in step 1 of the primary use methodology providing that there is no disallowance for reserved employee spaces if the primary use of the available parking spaces is to provide parking to the general public, there are five or fewer reserved employee spaces, and the number of reserved employee spaces is 5 percent or less of the total parking spaces in the parking facility. The final regulations adopt the disallowance of costs allocated to reserved employee spaces and the special rule in step 1 of the primary use methodology provided in the proposed regulations, without modification.

viii. Reserved Nonemployee Spaces

A commenter on Notice 2018-99 suggested that parking spaces reserved for drivers with disabilities be treated as "reserved nonemployee spaces" and thus, any related expenses not be disallowed under section 274(a)(4). After considering the comment, the Treasury Department and the IRS declined to include parking spaces reserved for drivers with disabilities from the definition of reserved nonemployee spaces in the proposed regulations. The Treasury Department and the IRS reasoned that unlike parking spaces reserved for customers or visitors, parking spaces reserved for drivers with disabilities may be used by employees (with disabilities), and section 274(a)(4) would then apply to disallow the expense. The proposed regulations also did not include parking spaces reserved for drivers with disabilities in "reserved employee spaces" because they may or

may not be exclusively reserved for employees. The final regulations adopt the proposed regulations' definitions of reserved nonemployee spaces and reserved employee spaces, without modification.

ix. Inventory/Unusable Spaces

The Treasury Department and the IRS received questions and comments in response to Notice 2018-99 on how parking spaces reserved for, or used by, inventoried vehicles are to be treated for purposes of determining the disallowance. For example, taxpayers asked whether parking spaces reserved exclusively for, or used by, vehicles to be sold or leased to customers at a car dealership or car rental agency are treated as spaces available to the general public.

In response to the comments and questions received, the proposed regulations added a new definition for the term "inventory/unusable spaces" that includes parking spaces used exclusively for inventoried vehicles, qualified nonpersonal use vehicles (as described in §1.274-5(k)), other fleet vehicles used in a taxpayer's trade or business, or otherwise not usable for parking by employees.

A commenter on the proposed regulations suggested that inventory spaces should be included in the definition of spaces available to the general public in cases where inventory spaces may at times be used by customers and are not available for employee parking. The Treasury Department and the IRS note that spaces used by customers should not be included in inventory/unusable spaces. Therefore, the final regulations adopt the definition of "inventory/unusable spaces" included in the proposed regulations, with the clarification that inventory/unusable spaces are otherwise not usable for parking by the general public.

Inventory/unusable spaces are specifically excluded from the definitions of "available parking spaces," discussed later, and "reserved nonemployee spaces," discussed earlier, under the primary use methodology and primary use test in the final regulations. The final regulations exclude inventory/unusable spaces because those spaces are not available to employees or the general public but are instead used exclusively for other

purposes. Inventory/unusable spaces are included in total parking spaces under the cost per space methodology because taxpayers do incur costs in maintaining the spaces.

A commenter on the proposed regulations requested that a safe harbor be added to the final regulations to determine the number of inventory spaces at a car dealership because of extreme fluctuations of inventory over a car dealer's tax year. The commenter suggested that the safe harbor should be based on an annualization of the number of spaces occupied by inventory vehicles at the end of the month during the tax year with lowest inventory, or alternatively, based on the average number of spaces occupied by inventory vehicles at the end of each month. The commenter further suggested that inventory per month should be determined based on inventory levels a car dealer reports to the vehicle manufacturer on monthly financial reporting.

The Treasury Department and the IRS note that the proposed regulations did not specifically describe how taxpayers should determine the number of inventory/unusable spaces in the parking facility. Thus, the Treasury Department and the IRS have added a rule in these final regulations providing that taxpayers may use any reasonable methodology to determine the number of inventory/unusable spaces in the parking facility. In addition, in response to the commenter's alternative suggestion, the final regulations provide that a reasonable methodology may include using the average of monthly inventory counts.

x. Available Parking Spaces

The proposed regulations included a definition of "available parking spaces" to clarify that reserved employee spaces and inventory/unusable spaces are not included in determining primary use under the primary use methodology. No comments were received on this definition, and the final regulations adopt it without modification.

xi. Primary Use

The proposed regulations provided that for purposes of the primary use test

of the primary use methodology, "primary use" means greater than 50 percent of actual or estimated usage of the parking spaces in the parking facility by the general public. A commenter on the proposed regulations suggested that the final regulations provide that primary use should mean 30 percent or greater for healthcare facilities, including skilled nursing and assisted living healthcare facilities, because the employees at these types of healthcare businesses provide essential and life-saving care services to the public, especially during the ongoing Coronavirus Disease (COVID-19) pandemic.

After considering this comment, the Treasury Department and the IRS have decided to retain the primary use test as described in the proposed regulations. The Treasury Department and the IRS continue to believe that this primary use test is a reasonable interpretation of the exception in section 274(e)(7) for parking made available to the general public. Further, this interpretation is consistent with recent final regulations addressing the application of the section 274(e)(7) exception to the limitation on the deduction for meals and entertainment expenses, which apply the section 274(e)(7) exception to food and beverages "primarily consumed" by the general public, meaning greater than 50 percent of actual or reasonably estimated consumption. *See* TD 9925, 85 FR 64026 (October 9, 2020).

The Treasury Department and the IRS understand that the primary use of a parking facility could be affected by a federally declared disaster such as the COVID-19 pandemic. Thus, as discussed in part I.B.xiv. of this Summary of Comments and Explanation of Revisions section, the final regulations modify the definition of "peak demand period" to provide flexibility for taxpayers affected by a federally declared disaster to determine the primary use of parking spaces used by employees during the peak demand period.

xii. Total Parking Expenses

Commenters on Notice 2018-99 suggested that safety-related expenses, such as lighting, snow and ice removal, leaf removal, trash removal, cleaning, and security, should be excluded from the definition

of “total parking expenses.” Commenters reasoned that including the expenses may encourage unsafe parking conditions and neglect of care in maintaining the parking facilities. Commenters on the Notice also requested the removal of indirect costs, such as utility costs, insurance, property taxes, snow and ice removal, leaf removal, trash removal, cleaning, parking lot attendant expenses, and security. Multiple commenters on the Notice also suggested adding depreciation to total parking expenses, reasoning that these are costs of parking facilities.

After considering the comments received, the Treasury Department and the IRS determined that the proposed regulations should include the definition of the term “total parking expenses” from Notice 2018-99, and the final regulations adopt this definition without modification. Section 274(a)(4) disallows a deduction for the expense of providing a QTF, without regard to whether the expense is required for safety reasons. Further, QTF parking expenses include indirect costs such as allocable salaries for security and maintenance personnel, property taxes, repairs and maintenance, etc. *See* Joint Committee on Taxation, *General Explanation of Public Law 115-97* (JCS-1-18), at 190, December 2018. However, a deduction for an allowance for depreciation is not included in total parking expenses because it is an allowance for the exhaustion, wear and tear, and obsolescence of property, and not a parking expense.

xiii. Mixed Parking Expense

Numerous commenters on Notice 2018-99 expressed concerns and asked questions about how to determine the amount of expenses allocable to a parking facility if the invoice does not separate parking facility expenses from nonparking facility expenses. Commenters explained that determining and allocating expenses may impose excessive and unduly burdensome recordkeeping requirements on taxpayers and may be difficult for taxpayers and the IRS to administer. Commenters noted that such expenses for parking and nonparking property may include rent or lease payments, repairs, maintenance, utility costs, insurance,

property taxes, interest, snow or ice removal, and security. In response to the comments, the Treasury Department and the IRS included in the proposed regulations a definition for the term “mixed parking expense” and a special rule for allocating certain mixed parking expenses. The proposed regulations defined “mixed parking expense” as an amount paid or incurred by a taxpayer for both a parking facility and nonparking facility property that a taxpayer owns or leases. The proposed regulations provided that mixed parking expenses may be allocated using any reasonable methodology but provided a special rule for allocating certain mixed costs that taxpayers could choose to apply in conjunction with certain of the methodologies for determining disallowed parking expenses.

The final regulations adopt the definition of “mixed parking expenses” included in the proposed regulations, as well as the rule allowing the use of any reasonable methodology to allocate mixed parking expenses. However, the final regulations make certain modifications to the allowance of the special rule in the proposed regulations for allocating certain mixed parking expenses. The special rule for allocating certain mixed parking expenses to a parking facility and the modifications made in the final regulations is explained in part 1.C of this Summary of Comments and Explanation of Revisions section.

A commenter on the proposed regulations suggested using property tax assessments and/or acreage to determine the amount of mixed parking expenses allocable to a parking facility. The Treasury Department and the IRS note that taxpayers may use any reasonable methodology to allocate mixed parking expenses. However, the Treasury Department and the IRS decline to adopt a specific methodology as reasonable for this purpose. The Treasury Department and the IRS further note that the methodology must be reasonable for the expense being allocated. Thus, one methodology for multiple expenses may be used only if the methodology is reasonable for all such expenses.

xiv. Peak Demand Period

In the proposed regulations, several of the methodologies for determining the

section 274(a)(4) disallowance for parking facilities require the taxpayer to determine the total number of parking spaces used by employees during the peak demand period for employee parking on a typical business day. The proposed regulations provided that for purposes of §1.274-13, the term “peak demand period” means the period of time on a typical business day when the greatest number of the taxpayer’s employees are utilizing parking spaces in the taxpayer’s parking facility. If a taxpayer’s employees work in shifts, the peak demand period would take into account the shift during which the largest number of employees park in the taxpayer’s parking facility. However, a brief transition period during which two shifts overlap in their use of parking spaces, as one shift of employees is getting ready to leave and the next shift is reporting to work, may be disregarded.

A commenter on the proposed regulations explained that it is overly burdensome for taxpayers at healthcare facilities to determine how many employees are at each location 24 hours a day, 7 days a week and instead suggested using an average based on the primary location of each employee and the amount of time each employee typically works each week. The Treasury Department and the IRS considered the comment and have determined that the proposed rules regarding “peak demand period” should be adopted in the final regulations, subject to an optional rule for parking facilities located in a federally declared disaster area as discussed later in this part 1.B.xiv. of this Summary of Comments and Explanation of Revisions section. However, the Treasury Department and the IRS note that the definition of peak demand period allows for flexibility based on taxpayer facts and circumstances by allowing taxpayers to choose a typical business day during the taxable year and to use any reasonable methodology to determine the total number of spaces used by employees. For example, a taxpayer may determine the total number of spaces used by employees based on periodic inspections or employee surveys.

The ongoing COVID-19 pandemic highlights that taxpayers may experience significant variations in employee parking during the taxable year due to a national

emergency or other type of disaster. In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on what additional rules, if any, are needed to address significant variations in employee parking during the taxable year due to the COVID-19 pandemic. One commenter suggested that the final regulations allow for a COVID-19 exception for employees not working at the workplace location and thus not using employee parking during the period of the COVID-19 pandemic. Specifically, the commenter requested that taxpayers be permitted to calculate their disallowance under one of the simplified methodologies in §1.274-13(d)(2), and then reduce their disallowance by a certain amount based on the taxpayer's "COVID relief period" and the reduction in their workforce during that period.

Although the commenter's example would not be permitted under any of the simplified methodologies in the proposed or final regulations because taxpayers must use one methodology for the entire year, taxpayers may achieve a similar result using any reasonable method under the general rule. Taxpayers also may achieve a similar result by using a monthly computation method such as the qualified parking limit methodology or the cost per space methodology. A taxpayer using the cost per space methodology generally computes the cost per space and multiplies it by the number of spaces used by employees during the peak demand period. Although the proposed regulations did not specify whether the cost per space must be based on one peak demand period in the taxable year, these final regulations clarify that the cost per space calculation may be performed on a monthly basis.

A taxpayer using the primary use methodology would be allowed a full deduction for parking expenses (except for expenses related to reserved employee spaces) if the primary use of the parking facility during the peak demand period is for the general public. The proposed regulations defined "peak demand period" as the period of time on a typical business day when the greatest number of the taxpayer's employees are utilizing parking spaces in the taxpayer's parking facility. As discussed previously in this part I.B.iv. of this Summary of Comments and Explanation

of Revisions section, the final regulations retain this general definition. However, to provide relief to taxpayers affected by the COVID-19 pandemic or other federally declared disasters, the final regulations add an optional rule in the definition of "peak demand period" for taxpayers who own or lease a parking facility that is located in a federally declared disaster area, as defined in section 165(i)(5). A taxpayer that uses this rule may identify a typical business day for the taxable year in which the disaster occurred by reference to a typical business day in that taxable year prior to the date that the taxpayer's operations were impacted by the federally declared disaster. For example, a restaurant that transitioned from a dine-in restaurant to take-out service due to the COVID-19 pandemic could determine its parking disallowance under the primary use test based on the usage of parking on a typical business day prior to its transition to take-out service. Alternatively, under this rule, a taxpayer may choose to identify a typical business day for the month(s) of the taxable year in which the disaster occurred by reference to a typical business day in the same month(s) of the taxable year immediately preceding the taxable year in which the disaster first occurred. For purposes of this rule, the taxable year in which the disaster occurred is determined without regard to whether the taxpayer makes an election under section 165(i). In order to allow taxpayers affected by the COVID-19 pandemic to benefit from this rule, the final regulations allow a taxpayer to apply this rule to taxable years ending after December 31, 2019. This rule is intended to provide relief to both calendar and fiscal year taxpayers, as well as taxpayers with a seasonal business, that are affected by a federally declared disaster.

C. Optional Rules for QTF Parking Expenses

The proposed regulations included a special rule for allocating certain mixed parking expenses to reduce administrative burdens for taxpayers and simplify calculations in complying with section 274(a)(4). Specifically, the proposed regulations provided that a taxpayer may choose to allocate 5 percent of certain mixed parking expenses to the park-

ing facility. This special rule applies to mixed parking expenses related to payments under a lease or rental agreement, and payments for utilities, insurance, interest and property taxes. However, the proposed regulations provided that the special rule for allocating certain mixed parking expenses may only be used in applying the primary use methodology and cost per space methodology and may not be used in applying the general rule or the qualified parking limit methodology. The proposed regulations did not require taxpayers to use the special rule for allocating certain mixed parking expenses and provided that taxpayers may instead use any reasonable methodology for mixed parking expenses.

A commenter on the proposed regulations requested that the final regulations allow taxpayers to use this special rule for applicable mixed parking expenses when using the general rule to calculate the disallowance of deductions for QTFs based on a reasonable interpretation of section 274(a)(4). In response to the commenter's request, these final regulations have extended the 5 percent optional rule for allocating certain mixed parking expenses to the general rule as a further attempt to reduce administrative burdens for taxpayers and to simplify calculations in complying with section 274(a)(4). The optional rule for allocating certain mixed parking expenses in these final regulations may therefore be used in applying the general rule, the primary use methodology, and the cost per space methodology. In addition, this optional rule may be used by taxpayers using the qualified parking methodology, but solely for the purpose of determining total parking expenses. As revised, this optional rule may be used to determine total parking expenses under any of the parking methodologies permitted in the proposed and final regulations. Thus, the final regulations relocate this rule from §1.274-13(c) to the definition of total parking expenses in §1.274-13(b)(12).

A commenter suggested that the 5 percent special rule for allocating mixed parking expenses be expanded to include any parking expense that is not allocated by a service provider to a parking facility or is not accounted for separately on the taxpayer's books, in-

cluding expenses for maintenance, snow and ice removal, landscape costs, security, cleaning. The Treasury Department and the IRS continue to believe that this optional rule should apply only to mixed parking expenses related to payments under a lease or rental agreement, and payments for utilities, insurance, interest and property taxes, and therefore, decline to adopt this comment. However, the final regulations clarify that a taxpayer who chooses to apply the 5 percent optional rule is not required to apply the rule to allocate all eligible mixed parking expenses. Thus, a taxpayer may choose to apply the 5 percent optional rule to allocate one or more of the eligible mixed parking expenses, while using a reasonable methodology to allocate remaining eligible mixed parking expenses. Certain types of expenses, such as parking facility maintenance, snow and ice removal, landscape costs, security, and parking facility cleaning are more likely to be separately billed and/or primarily allocable to the parking facility. Taxpayers may, however, continue to use any reasonable methodology to allocate these mixed parking expenses.

Consistent with the proposed regulations, the final regulations permit taxpayers using certain methodologies to aggregate the number of parking spaces in a single geographic location if they so choose. The final regulations adopt the proposed definition of the term “geographic location,” which is based on tracts or parcels of land that are contiguous. The optional rule for aggregation of parking spaces in a single geographic location may be used in applying the general rule, primary use methodology, and cost per space methodology, but may not be used with the qualified parking limit methodology. The final regulations clarify that a taxpayer that chooses to apply this optional aggregation rule must treat the aggregated parking spaces as one parking facility for purposes of determining total parking expenses.

D. Calculation of Disallowance of QTF Parking Expenses

Like the proposed regulations, the final regulations provide that if a taxpayer pays one or more third parties an amount for

its employees’ QTFs, the section 274(a)(4) disallowance is equal to the taxpayer’s total annual cost for the QTFs paid or incurred to third parties. The Treasury Department and the IRS determined that amounts paid to a third party for qualified parking should be disallowed regardless of actual employee use of the spaces because the taxpayer paid or incurred the expense for its employees’ QTFs regardless of employee use.

If instead, the taxpayer owns or leases a parking facility, the final regulations continue to provide that a taxpayer may use the general rule or choose any of the following three simplified methodologies for each parking facility to determine the section 274(a)(4) disallowance for each taxable year. The general rule and three simplified methodologies are substantially the same as those provided in the proposed regulations, with the following modifications based on comments received.

i. General Rule

Consistent with the proposed regulations, under the general rule provided in the final regulations taxpayers may calculate the disallowance based on a reasonable interpretation of section 274(a)(4), as long as the taxpayer’s methodology does not use the value of a QTF instead of its expense, fail to allocate parking expense to reserved employee spaces, or improperly apply the exception for qualified parking made available to the public (for example, by treating a parking facility regularly used by employees as available to the public merely because the public has access to the parking facility).

In response to the proposed regulations, a commenter recommended that taxpayers be permitted to elect to use historic information to calculate the current year disallowance to reduce the compliance burden of annually calculating the disallowance under section 274(a)(4). For example, the commenter suggested that the average disallowed amount for the prior two years may be used as the disallowance for the next five years or, alternatively, if the primary use of the available parking spaces is to provide parking to the general public for two out of three years, then the taxpayer may treat the primary use of

the available parking spaces as providing parking to the general public for the next five years. The Treasury Department and the IRS considered this comment and do not believe that section 274(a)(4) permits taxpayers to compute the amount of a permanently disallowed deduction for a taxable year based on the amount of the disallowance in one or more different taxable years.

ii. Qualified Parking Limit Methodology

Consistent with the proposed regulations, the final regulations provide that the maximum monthly dollar amount under section 132(f)(2), adjusted for inflation, may be used as a simple estimate of the taxpayer’s monthly total cost per parking space. The adjusted maximum monthly excludable amount for 2020 is \$270 per employee. Taxpayers using the qualified parking limit methodology may determine the disallowance simply by multiplying the section 132(f)(2) monthly per employee limitation on the exclusion by the total number of spaces used by employees during the peak demand period. Alternatively, taxpayers using this methodology may instead multiply the section 132(f)(2) monthly per employee limitation on the exclusion by the total number of the taxpayer’s employees.

A commenter recommended the adoption of an alternative monthly rate of \$25 per parking space, instead of the maximum monthly dollar amount under section 132(f)(2), to estimate a taxpayer’s monthly total cost per parking space for parking facilities located outside the city limits of the 20 most populous cities in the United States. The commenter explained that this will encourage the use of the qualified parking limit methodology by manufacturers and employers with parking spaces in less populous areas. The Treasury Department and the IRS decline to adopt this comment because the commenter provided no evidence that the monthly rate of \$25 per parking space is the appropriate cost for all parking spaces located outside the city limits of the 20 most populous cities in the United States.

Section 274(e)(2) provides that the section 274(a)(4) disallowance for QTFs does not apply to the extent that a QTF is treated as compensation to an employee on

the taxpayer's return and as wages to the employee. Under §1.274-13(e)(2)(i) of the proposed regulations, a taxpayer using this qualified parking limit methodology who has monthly expenses per parking space exceeding the section 132(f)(2) monthly per employee limitation on the exclusion could deduct those excess expenses without regard to how much (if any) of the value of the parking space to the employee exceeds the section 132(f)(2) monthly per employee limitation on exclusion. However, the proposed regulations provided that the qualified parking limit methodology could be used only if the value of the QTF, to the extent it exceeds the sum of the amount paid (if any) by the employee for the QTF and the applicable statutory monthly limit in section 132(f)(2), is included on the taxpayer's Federal income tax return as originally filed as compensation paid to the employee and as wages to the employee for purposes of withholding under chapter 24 (relating to collection of Federal income tax at source on wages). The final regulations adopt this rule from the proposed regulations without change.

iii. Primary Use Methodology

The Treasury Department and the IRS received numerous comments on Notice 2018-99 related to the four-step method provided in the Notice. The proposed regulations adopted the four-step method provided in the Notice, with revisions in response to comments, and renamed it the "primary use methodology." No comments were received on the primary use methodology included in the proposed regulations, and the final regulations adopt the primary use methodology without modification.

iv. Cost Per Space Methodology

The proposed regulations also provided a cost per space methodology, which allows taxpayers to calculate the disallowance by multiplying the cost per space by the number of available parking spaces used by employees. Taxpayers must identify the number of total parking spaces used by employees during the peak demand period. Cost per space is calculated by dividing total parking expenses (including expenses related to inventory/

unusable spaces) by total parking spaces (including inventory/unusable spaces).

In response to the proposed regulations, a commenter pointed out that a taxpayer using the cost per space methodology calculates the disallowance of deductions for QTF parking expenses by multiplying the cost per space by the total number of "available parking spaces" used by employees during the peak demand period rather than the "total parking spaces" used by employees. The commenter suggested that "total parking spaces" should be used instead of "available parking spaces" because reserved spaces are excluded from the definition of "available parking spaces." The Treasury Department and the IRS agree with this suggestion and modify the cost per space methodology provided in the proposed regulations by specifying that "total parking spaces" is used to calculate the disallowance under the final regulations. In addition, as discussed in part I.B.xiv. of this Summary of Comments and Explanation of Revisions section, the final regulations clarify that the cost per space calculation may be performed on a monthly basis.

v. Expenses for Transportation in a Commuter Highway Vehicle and Transit Pass QTFs

Consistent with the proposed regulations, the final regulations include rules addressing the disallowance of deductions for expenses for transportation in a commuter highway vehicle and transit pass QTFs, as well as the applicability of certain exceptions under section 274(e). The general rules are unchanged from those in the proposed regulations.

E. Specific Exceptions to Section 274(a) for QTF Expenses

Section 274(e) provides that the deduction disallowance under section 274(a) does not apply to any expense described in section 274(e). Consistent with the proposed regulations, the final regulations provide that the deduction disallowance does not apply to expenditures for QTFs that meet the requirements of section 274(e)(2), (7), or (8), which are the three exceptions in section 274(e) that are relevant for QTFs.

A commenter suggested that the IRS implement a moratorium on enforcement of the deduction disallowance for the expense of QTFs during the ongoing COVID-19 pandemic. In addition, a commenter requested that healthcare facilities, including skilled nursing and assisted living healthcare facilities, be excepted from the section 274(a)(4) disallowance because the employees at these types of healthcare businesses provide essential and life-saving care services to the public.

The Treasury Department and the IRS note that exceptions for QTFs during the COVID-19 pandemic or for healthcare facility taxpayers are not provided for in any of the exceptions under section 274(e) and therefore are not exceptions to the section 274(a)(4) disallowance that the Treasury Department and the IRS may allow. However, as discussed in part I.B.xiv. of this Summary of Comments and Explanation of Revisions section, the Treasury Department and the IRS are modifying the definition of "peak demand period" to provide additional flexibility for taxpayers affected by the COVID-19 pandemic or other federally declared disaster in applying the methodologies for determining the section 274(a)(4) disallowance for parking facilities.

i. Certain QTF Expenses Treated as Compensation under Section 274(e)(2)

Section 274(e)(2) provides an exception to section 274(a) for expenses for goods, services, and facilities, to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation to its employees under chapter 1 and as wages to its employees under chapter 24. Pursuant to section 274(e)(2), the proposed regulations provided that the disallowance under section 274(a) does not apply to expenditures for QTFs to the extent the taxpayer properly treats the expenses as compensation to the employee on the taxpayer's Federal income tax return as originally filed, and as wages to the employee for purposes of withholding under chapter 24 relating to collection of Federal income tax at source on wages. Because section 132(a)(5) excludes the value of QTFs from an employee's

gross income up to the limitations on exclusion provided by section 132(f)(2), the proposed regulations provided that the exception in section 274(e)(2) does not apply to expenses paid or incurred for QTFs the value of which (including a purported value of zero) is excluded from an employee's gross income under section 132(a)(5). The proposed regulations further provided that section 274(e)(2) applies to expenses paid or incurred for QTFs, the value of which exceeds the sum of the amount, if any, paid by the employee for the fringe benefits and any amount excluded from gross income under section 132(a)(5), if treated as compensation on the taxpayer's Federal income tax return as originally filed and as wages to the employee for purposes of withholding under chapter 24.

Section 1.61-21(b)(1) provides rules for the valuation of fringe benefits and requires that an employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of the amount paid for the benefit by or on behalf of the recipient and the amount, if any, specifically excluded from gross income under the Code. Thus, in the case of reimbursements by a recipient, the amount of the reimbursement is taken into account in determining the amount properly includible in the recipient's income and does not affect the taxpayer's ability to use the exception in section 274(e)(2).

To prevent taxpayers from inappropriately claiming a full deduction under section 274(e)(2) by including a value that is less than the amount required to be included under §1.61-21, the proposed regulations provided that the exception in section 274(e)(2) does not apply to expenses for QTFs for which the taxpayer calculates a value that is less than the amount required to be included in gross income under §1.61-21.

Commenters on the proposed regulations under section 274 limiting deductions for meals and entertainment expenses (proposed §§1.274-11 and 1.274-12 (REG-100814-19)) asserted that a rule disallowing the application of section 274(e)(2) to expenses for which an improper amount is included in compensation and wages or in gross income, as applicable, is unduly harsh given the

difficulty in determining the value of a fringe benefit under §1.61-21 and the possibility of good faith errors. *See* TD 9925, 85 FR 64026, 64031 (October 9, 2020). In addition, a commenter noted that the "to the extent that" language in section 274(e)(2)(A) does not support applying an "all or nothing" rule against the taxpayer.

The Treasury Department and the IRS agree that the "all or nothing" rule in proposed §§ 1.274-13 and 1.274-14 may lead to unduly harsh results. Therefore, in response to these comments, the Treasury Department and the IRS have revised the rules in proposed §1.274-13(e)(2)(i) to allow a taxpayer to apply section 274(e)(2) even if the taxpayer includes less than the proper amount in compensation and wages as required under §1.61-21. In such a case, however, the amount of a taxpayer's deduction is limited to the amount included in compensation and wages, taking into account the amount, if any, reimbursed to the taxpayer by the employee (referred to as the "dollar-for-dollar" methodology in this preamble). This is consistent with the rule provided in section 274(e)(2)(B) for QTFs provided to specified individuals.

The final regulations also provide that if the value of a QTF exceeds the monthly per employee limitations on exclusion provided by section 132(f)(2) (\$270 per employee for 2020), so that only a portion of the value is included in the employees' wages, the taxpayer may apply section 274(e)(2). However, in this case, the taxpayer must use the dollar-for-dollar methodology.

ii. Expenses for Transportation in a Commuter Highway Vehicle, Transit Pass, or Parking Made Available to the Public

Section 274(e)(7) provides an exception to section 274(a) for expenses for goods, services, and facilities made available by the taxpayer to the general public. Pursuant to section 274(e)(7), the proposed regulations provided that any taxpayer expense for transportation in a commuter highway vehicle, a transit pass, or parking that otherwise qualifies as a QTF under section 132(f)(1) is not subject to the deduction disallowance under section

274(a) to the extent such transportation, transit pass, or parking is made available to the general public. No comments were received on this provision, and the final regulations adopt it without modification. As described further in part I.B.iii. of this Summary of Comments and Explanation of Revisions section, "general public" includes, but is not limited to, customers, clients, visitors, individuals delivering goods or services to the taxpayer, and patients of a health care facility. The general public does not include employees, partners, 2-percent shareholders of S corporations (as defined in section 1372(b)), sole proprietors, or independent contractors of the taxpayer. If a taxpayer owns or leases space in a multi-tenant building, employees, partners, 2-percent shareholders of S corporations (as defined in section 1372(b)), sole proprietors, independent contractors or customers of unrelated tenants in the building are included in the definition of general public.

iii. Expenses for Transportation in a Commuter Highway Vehicle, Transit Pass, or Parking Sold to Customers

Section 274(e)(8) provides an exception to section 274(a) for expenses for goods or services (including the use of facilities) which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth. Pursuant to section 274(e)(8), the proposed regulations provided that any taxpayer expense for transportation in a commuter highway vehicle, a transit pass, or parking that otherwise qualifies as a QTF under section 132(f)(1) that is sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth is not subject to the deduction disallowance under section 274(a). The proposed regulations also provided that for purposes of this section, the term "customer" includes an employee of the taxpayer who purchases the transportation in a commuter highway vehicle, transit pass, or parking in a bona fide transaction for an adequate and full consideration in money or money's worth. The final regulations adopt these provisions.

A commenter requested guidance in the final regulations for a situation in

which employees are charged for parking at a parking facility. If a taxpayer charges its employees for parking at its parking facilities in a bona fide transaction for adequate and full consideration in money or money's worth, the employees are the taxpayer's customers for this purpose and the exception in section 274(e)(8) and §1.274-13(e)(2)(iii) would apply. On the other hand, if an employee pays less than adequate and full consideration, this exception would not apply because the parking was not sold to the employee for full consideration. In this case, however, the taxpayer may apply the exception in section 274(e)(2) and §1.274-13(e)(2)(i) to the extent of the reimbursement.

Another commenter suggested that the deduction disallowance for the expense of any QTF should not apply to expenses for parking that has no objective value to the taxpayer's employees, such as parking in industrial, remote, or rural areas (that is, areas where the general public would not pay to park). In response to this comment, the Treasury Department and the IRS have determined that the exception in section 274(e)(8) and the final regulations at §1.274-13(e)(2)(iii) should apply if in a bona fide transaction, the adequate and full consideration for qualified parking is zero. The final regulations provide that to apply the exception in such a case, the taxpayer bears the burden of proving that the fair market value of the qualified parking is zero. However, a taxpayer will be treated as satisfying this burden if the qualified parking is provided in a rural, industrial, or remote area in which no commercial parking is available and an individual other than an employee ordinarily would not pay to park. The final regulations also provide an example illustrating the application of this rule.

2. Transportation and Commuting Expenses

Section 274(l)(1), as added by the TCJA, provides that no deduction is allowed under chapter 1 for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the em-

ployee. The provision applies to expenses paid or incurred after December 31, 2017. Section 274(l)(2) provides that the disallowance of a deduction for commuting and transportation expenses under section 274(l) is suspended for any qualified bicycle commuting reimbursement (described in section 132(f)(5)(F)) paid or incurred after December 31, 2017, and before January 1, 2026. Thus, for such period, deductions for qualified bicycle commuting reimbursements, which, also for such period, are not excluded from an employee's income under section 132(f)(8), are not disallowed under section 274(l).

Section 1.274-14 addresses the disallowance of deductions under section 274(l). Section 1.274-14 of the proposed regulations provided that travel between the employee's residence and place of employment includes travel that originates at a transportation hub near the employee's residence or place of employment. For example, an employee who commutes to work by airplane from an airport near the employee's residence to an airport near the employee's place of employment is traveling between the residence and place of employment.

A commenter suggested that the final regulations clarify that section 274(l) applies to commuting expenses only and does not apply to business travel. The commenter further requested that the concept of transportation originating at a hub near the employee's residence or place of employment be removed from the proposed regulations because it may disallow business travel between two places of employment. In addition, the commenter noted that it is incorrect to describe a commute as originating at a transportation hub because an individual's commute will always begin at the residence, even if the individual first travels from the residence to the transportation hub. Thus, the commenter suggested that instead of the hub reference, the final regulations provide that the application of section 274(l) to travel between a residence and place of employment is not affected by the use of different modes of transportation on the trip.

The Treasury Department and the IRS agree with these suggestions. The final regulations do not include a reference to a transportation hub and instead explain that

travel between the employee's residence and place of employment is not affected by the use of different modes of transportation, or by whether the employer pays for all modes of transportation during the commute. The final regulations also state that the disallowance under section 274(l) does not apply to business expenses under section 162(a)(2) paid or incurred while traveling away from home.

A commenter suggested that only the marginal cost of commuting should be disallowed, similar to spouse and dependent travel in section 274(m)(3). The Treasury Department and the IRS decline to adopt this suggestion because the language of section 274(l) broadly refers to "any expense" incurred for the provision of commuting to an employee. Further, the Treasury Department and the IRS are not aware of any evidence that Congress intended to disallow only the marginal cost of commuting.

A commenter requested that the final regulations include a definition of "employee" for purposes of section 274(l). In response to this comment, the Treasury Department and the IRS include a definition of employee in the final regulations. Under the final regulations, the term "employee" means an employee of the taxpayer as defined in section 3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules).

The proposed regulations provided a definition for an employee's "residence," referencing the definition of the term "residence" in §1.121-1(b)(1). Under §1.121-1(b)(1), whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation.

A commenter requested that the final regulations limit the definition of "residence" to the residence to or from which the employee regularly commutes, which generally is the employee's principal residence. The Treasury Department and the IRS decline to adopt this comment because nothing in the language of section 274(l) indicates that commuting is limit-

ed to transportation from a principal residence. An employee could, for example, regularly commute from a vacation home to the workplace. Thus, the final regulations continue to define “residence” by referencing the definition of the term “residence” in §1.121-1(b)(1), and specifically provide that this definition may include a residence that is not a principal residence.

The proposed regulations also defined the term “safety of the employee,” referencing the description of a bona fide business-oriented security concern in §1.132-5(m). Several commenters suggested that the proposed rules for determining when transportation provided by an employer is necessary for the safety of the employee were too narrow and should be expanded to apply beyond a bona fide business-oriented security concern in §1.132-5(m). These commenters generally suggested that the final regulations should instead define “safety of the employee” by reference to §1.61-21(k)(5). Section 1.61-21(k)(5) provides that unsafe conditions exist if a reasonable person would, under the facts and circumstances, consider it unsafe for the employee to walk to or from home, or to walk to or use public transportation at the time of day the employee must commute. One of the factors indicating whether it is unsafe is the history of crime in the geographic area surrounding the employee’s workplace or residence at the time of day the employee must commute.

The Treasury Department and the IRS agree with this suggestion. Accordingly, the final regulations clarify that a transportation or commuting expense is necessary for ensuring the safety of the employee if unsafe conditions, as described in §1.61-21(k)(5), exist for the employee.

To further clarify the exception, a commenter also suggested that examples be included illustrating situations in which transportation provided by an employer is necessary for the safety of the employee. The Treasury Department and the IRS believe that further clarification is unnecessary in light of the final regulations’ reference to unsafe conditions as described in §1.61-21(k)(5).

A commenter suggested that temporary or occasional places of employment should not be considered an employee’s

place of employment for purpose of section 274(l). The commenter pointed to prior guidance issued by the IRS as well as to case law that provides that travel to a temporary place of employment is not treated as commuting. The Treasury Department and the IRS agree with this comment and have modified the final regulations to explain that temporary or occasional places of employment are not an employee’s place of employment under section 274(l). However, the final regulations provide that an employee must have at least one regular or principal place of business.

The Treasury Department and the IRS have determined that the exceptions in section 274(e) do not apply to deductions disallowed by section 274(l), because the statutory language in section 274 applies the exceptions in 274(e) only to expenses that are otherwise disallowed or limited by section 274(a), (k), and (n). A commenter pointed out that although the exceptions in section 274(e) are applicable only to expenses disallowed or limited by section 274(a), (k), and (n), the Treasury Department and the IRS have previously extended the exceptions in 274(e)(2) to expenses otherwise disallowed by other subsections of section 274. Specifically, the commenter noted that the exception in section 274(e)(2) was extended to the spouse travel disallowance in §274(m)(3), pursuant to §1.274-2(f)(2)(iii).

The Treasury Department and the IRS considered this comment but do not believe that the exception in section 274(e)(2) should be extended to commuting expenses disallowed by section 274(l). The Joint Committee on Taxation’s “Bluebook” describing the TCJA confirms that the exception in section 274(e)(2) does not apply to section 274(l) expenses:

The provision is intended to include qualified transportation fringe expenses in the exception to the deduction disallowance for expenses that are treated as compensation. Any expenses incurred for providing any form of transportation which are not qualified transportation fringes (or any payment or reimbursement) for commuting between the employee’s residence and place of employment, even if included in compensation, are not eligible for this exception.

Joint Committee on Taxation, *General Explanation of Public Law 115-97* (JCS-1-18), at 190 (December 20, 2018). Thus, the final regulations do not apply the section 274(e) exceptions, including section 274(e)(2), to commuting expenses disallowed by section 274(l).

Applicability Date

These regulations apply to taxable years beginning on or after December 16, 2020. Notwithstanding the preceding sentence, taxpayers may choose to apply §1.274-13(b)(14)(ii) of these final regulations to taxable years ending after December 31, 2019.

Taxpayers may continue to rely on proposed §§ 1.274-13 through 1.274-14, which were issued in a notice of proposed rulemaking (REG-119307-19) and published on June 23, 2020, in the Federal Register (85 FR 37599) or the guidance provided in Notice 2018-99 for parking expenses, other QTF expenses, and transportation and commuting expenses, as applicable, paid or incurred in taxable years beginning after December 31, 2017 and before December 16, 2020.

Special Analyses

These final regulations are not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this final rule will not have a significant economic impact on a substantial number of small entities. Although the rule may affect a substantial number of small entities, the economic impact of the regulations is not likely to be significant. Data are not readily available about the number of taxpayers affected, but the number is likely to be substantial for both large and small entities because the rule may affect entities that incur QTF or commuting expenses. The economic impact of these regulations is not likely to be significant, however, because these final regulations substantially incorporate prior guidance

and otherwise clarify the application of the TCJA changes to section 274 related to QTF and commuting expenses. These final regulations will assist taxpayers in understanding the changes to section 274 and make it easier for taxpayers to comply with those changes. Accordingly, the Secretary of the Treasury's delegate certifies that the rule will not have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS welcome comments on the impact of these regulations on small entities.

Pursuant to section 7805(f), these final regulations have been submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on their impact on small business. No comments on the proposed regulations were received from the Chief Counsel for the Office of Advocacy of the Small Business Administration.

Effect on Other Documents

The following publications are obsolete as of December 16, 2020.

Notice 2018-99 (2018-52 I.R.B. 1067).

Statement of Availability of IRS Documents

Notices 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 web site at <http://www.irs.gov>.

Drafting Information

The principal author of this final regulation is Patrick Clinton, Office of the Associate Chief Counsel (Income Tax & Accounting). 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 record-keeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

Part 1—INCOME TAX

Paragraph 1. The authority citation for part 1 is amended by adding entries in for §§1.274-13 and 1.274-14 in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805.

* * * * *

Section 1.274-13 also issued under 26 U.S.C. 274.

Section 1.274-14 also issued under 26 U.S.C. 274.

* * * * *

Par. 2. Section 1.274-13 is added to read as follows:

§1.274-13 Disallowance of deductions for certain qualified transportation fringe expenditures.

(a) *In general.* Except as provided in this section, no deduction otherwise allowable under chapter 1 of the Internal Revenue Code (Code) is allowed for any expense of any qualified transportation fringe as defined in paragraph (b)(1) of this section.

(b) *Definitions.* The following definitions apply for purposes of this section:

(1) *Qualified transportation fringe.* The term *qualified transportation fringe* means any of the following provided by an employer to an employee:

(i) Transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee's residence and place of employment (as described in sections 132(f)(1)(A) and 132(f)(5)(B));

(ii) Any transit pass (as described in sections 132(f)(1)(B) and 132(f)(5)(A)); or

(iii) Qualified parking (as described in sections 132(f)(1)(C) and 132(f)(5)(C)).

(2) *Employee.* The term *employee* means a common law employee or other statutory employee, such as an officer of a corporation, who is currently employed by the taxpayer. See §1.132-9 Q/A-5. Partners, 2-percent shareholders of S corporations (as defined in section 1372(b)),

sole proprietors, and independent contractors are not employees of the taxpayer for purposes of this section. See §1.132-9 Q/A-24.

(3) *General public.* (i) *In general.* The term *general public* includes, but is not limited to, customers, clients, visitors, individuals delivering goods or services to the taxpayer, students of an educational institution, and patients of a health care facility. The term *general public* does not include individuals that are employees, partners, 2-percent shareholders of S corporations (as defined in section 1372(b)), sole proprietors, or independent contractors of the taxpayer. Also, an exclusive list of guests of a taxpayer is not the general public. Parking spaces that are available to the general public but empty are treated as provided to the general public. Parking spaces that are used to park vehicles owned by the general public while the vehicles await repair or service by the taxpayer are also treated as provided to the general public.

(ii) *Multi-tenant building.* If a taxpayer owns or leases space in a multi-tenant building, the term *general public* includes employees, partners, 2-percent shareholders of S corporations (as defined in section 1372(b)), sole proprietors, independent contractors, clients, or customers of unrelated tenants in the building.

(4) *Parking facility.* The term *parking facility* includes indoor and outdoor garages and other structures, as well as parking lots and other areas, where a taxpayer provides qualified parking (as defined in section 132(f)(5)(C)) to one or more of its employees. The term *parking facility* may include one or more parking facilities but does not include parking spaces on or near property used by an employee for residential purposes.

(5) *Geographic location.* The term *geographic location* means contiguous tracts or parcels of land owned or leased by the taxpayer. Two or more tracts or parcels of land are contiguous if they share common boundaries or would share common boundaries but for the interposition of a road, street, railroad, stream, or similar property. Tracts or parcels of land which touch only at a common corner are not contiguous.

(6) *Total parking spaces.* The term *total parking spaces* means the total number

of parking spaces, or the taxpayer's portion thereof, in the parking facility.

(7) *Reserved employee spaces.* The term *reserved employee spaces* means the spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for the taxpayer's employees. Employee spaces in the parking facility, or portion thereof, may be exclusively reserved for employees by a variety of methods, including, but not limited to, specific signage (for example, "Employee Parking Only") or a separate facility or portion of a facility segregated by a barrier to entry or limited by terms of access. Inventory/unusable spaces are not included in *reserved employee spaces*.

(8) *Reserved nonemployee spaces.* The term *reserved nonemployee spaces* means the spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for nonemployees. Such parking spaces may include, but are not limited to, spaces reserved exclusively for visitors, customers, partners, sole proprietors, 2-percent shareholders of S corporations (as defined in section 1372(b)), vendor deliveries, and passenger loading/unloading. Nonemployee spaces in the parking facility, or portion thereof, may be exclusively reserved for nonemployees by a variety of methods, including, but not limited to, specific signage (for example, "Customer Parking Only") or a separate facility, or portion of a facility, segregated by a barrier to entry or limited by terms of access. Inventory/unusable spaces are not included in *reserved non-employee spaces*.

(9) *Inventory/unusable spaces.* The term *inventory/unusable spaces* means the spaces in the parking facility, or the taxpayer's portion thereof, exclusively used or reserved for inventoried vehicles, qualified nonpersonal use vehicles described in §1.274-5(k), or other fleet vehicles used in the taxpayer's business, or that are otherwise not usable for parking by employees or the general public. Examples of such parking spaces include, but are not limited to, parking spaces for vehicles that are intended to be sold or leased at a car dealership or car rental agency, parking spaces for vehicles owned by an electric utility used exclusively to maintain electric power lines, or parking spaces occupied by trash dumpsters (or similar prop-

erty). Taxpayers may use any reasonable methodology to determine the number of inventory/unusable spaces in the parking facility. A reasonable methodology may include using the average of monthly inventory counts.

(10) *Available parking spaces.* The term *available parking spaces* means the total parking spaces, less reserved employee spaces and less inventory/unusable spaces, that are available to employees and the general public.

(11) *Primary use.* The term *primary use* means greater than 50 percent of actual or estimated usage of the available parking spaces in the parking facility.

(12) *Total parking expenses*—(i) *In general.* The term *total parking expenses* means all expenses of the taxpayer related to total parking spaces in a parking facility including, but not limited to, repairs, maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant expenses, security, and rent or lease payments or a portion of a rent or lease payment (if not broken out separately). A taxpayer may use any reasonable methodology to allocate mixed parking expenses to a parking facility. A deduction for an allowance for depreciation on a parking facility owned by a taxpayer and used for parking by the taxpayer's employees is an allowance for the exhaustion, wear and tear, and obsolescence of property, and not included in *total parking expenses* for purposes of this section. Expenses paid or incurred for nonparking facility property, including items related to property next to the parking facility, such as landscaping or lighting, also are not included in *total parking expenses*.

(ii) *Optional rule for allocating certain mixed parking expenses.* A taxpayer may choose to allocate 5 percent of any the following mixed parking expenses to a parking facility: lease or rental agreement expenses, property taxes, interest expense, and expenses for utilities and insurance.

(13) *Mixed parking expense.* The term *mixed parking expense* means a single expense amount paid or incurred by a taxpayer that includes both parking facility and nonparking facility expenses for a property that a taxpayer owns or leases.

(14) *Peak demand period*—(i) *In general.* The term *peak demand period* refers to the period of time on a typical business day during the taxable year when the greatest number of the taxpayer's employees are utilizing parking spaces in the taxpayer's parking facility. If a taxpayer's employees work in shifts, the *peak demand period* would take into account the shift during which the largest number of employees park in the taxpayer's parking facility. However, a brief transition period during which two shifts overlap in their use of parking spaces, as one shift of employees is getting ready to leave and the next shift is reporting to work, may be disregarded. Taxpayers may use any reasonable methodology to determine the total number of spaces used by employees during the *peak demand period* on a typical business day. A reasonable methodology may include periodic inspections or employee surveys.

(ii) *Optional rule for federally declared disasters.* If a taxpayer owns or leases a parking facility that is located in a federally declared disaster area, as defined in section 165(i)(5), the taxpayer may choose to identify a typical business day for the taxable year in which the disaster occurred by reference to a typical business day in that taxable year prior to the date that the taxpayer's operations were impacted by the federally declared disaster. Alternatively, a taxpayer may choose to identify a typical business day during the month(s) of the taxable year in which the disaster occurred by reference to a typical business day during the same month(s) of the taxable year immediately preceding the taxable year in which the disaster first occurred. For purposes of applying the optional rule for federally declared disasters, the taxable year in which the disaster occurs is determined without regard to whether an election under section 165(i) is made with respect to the disaster.

(c) *Optional aggregation rule for calculating total parking spaces; taxpayer owned or leased parking facilities.* For purposes of determining total parking spaces in calculating the disallowance of deductions for qualified transportation fringe parking expenses under the general rule in paragraph (d)(2)(i) of this section, the primary use methodology in paragraph (d)(2)(ii)(B) of this section, or the cost per

space methodology in paragraph (d)(2)(ii)(C) of this section, a taxpayer that owns or leases more than one parking facility in a single geographic location may aggregate the number of spaces in those parking facilities. For example, parking spaces at an office park or an industrial complex in the geographic location may be aggregated. However, a taxpayer may not aggregate parking spaces in parking facilities that are in different geographic locations. A taxpayer that chooses to aggregate its parking spaces under this paragraph (c) must determine its total parking expenses, including the allocation of mixed parking expenses, as if the aggregated parking spaces constitute one parking facility.

(d) *Calculation of disallowance of deductions for qualified transportation fringe expenses*—(1) *Taxpayer pays a third party for parking qualified transportation fringe.* If a taxpayer pays a third party an amount for its employees' parking qualified transportation fringe, the section 274(a)(4) disallowance generally is calculated as the taxpayer's total annual cost of employee parking qualified transportation fringes paid to the third party.

(2) *Taxpayer provides parking qualified transportation fringe at a parking facility it owns or leases.* If a taxpayer owns or leases all or a portion of one or more parking facilities where its employees park, the section 274(a)(4) disallowance may be calculated using the general rule in paragraph (d)(2)(i) of this section or any of the simplified methodologies in paragraph (d)(2)(ii) of this section. A taxpayer may choose to use the general rule or any of the following methodologies for each taxable year and for each parking facility.

(i) *General rule.* A taxpayer that uses the general rule in this paragraph (d)(2)(i) must calculate the disallowance of deductions for qualified transportation fringe parking expenses for each employee receiving the qualified transportation fringe based on a reasonable interpretation of section 274(a)(4). A taxpayer that uses the general rule in this paragraph (d)(2)(i) may use the aggregation rule in paragraph (c) of this section for determining total parking spaces. An interpretation of section 274(a)(4) is not reasonable unless the taxpayer applies the following rules when calculating the disallowance under this paragraph (d)(2)(i).

(A) *A taxpayer must not use value to determine expense.* A taxpayer may not use the value of employee parking to determine expenses allocable to employee parking that is either owned or leased by the taxpayer because section 274(a)(4) disallows a deduction for the expense of providing a qualified transportation fringe, regardless of its value.

(B) *A taxpayer must not deduct expenses related to reserved employee spaces.* A taxpayer must determine the allocable portion of total parking expenses that relate to any reserved employee spaces. No deduction is allowed for the parking expenses that relate to reserved employee spaces.

(C) *A taxpayer must not improperly apply the exception for qualified parking made available to the public.* A taxpayer must not improperly apply the exception in section 274(e)(7) or paragraph (e)(2)(ii) of this section to parking facilities, for example, by treating a parking facility regularly used by employees as available to the general public merely because the general public has access to the parking facility.

(ii) *Additional simplified methodologies.* Instead of using the general rule in paragraph (d)(2)(i) of this section for a taxpayer owned or leased parking facility, a taxpayer may use a simplified methodology under paragraph (d)(2)(ii)(A), (B), or (C) of this section.

(A) *Qualified parking limit methodology.* A taxpayer that uses the qualified parking limit methodology in this paragraph (d)(2)(ii)(A) must calculate the disallowance of deductions for qualified transportation fringe parking expenses by multiplying the total number of spaces used by employees during the peak demand period, or the total number of taxpayer's employees, by the section 132(f)(2) monthly per employee limitation on exclusion (adjusted for inflation), for each month in the taxable year. The result is the amount of the taxpayer's expenses that are disallowed under section 274(a)(4). In applying this methodology, a taxpayer calculates the disallowed amount as required under this paragraph (d)(2)(ii)(A), regardless of the actual amount of the taxpayer's total parking expenses. This methodology may be used only if the taxpayer includes the value of the qualified transportation fringe in excess of the sum of

the amount, if any, paid by the employee for the qualified transportation fringe and the applicable statutory monthly limit in section 132(f)(2) as compensation paid to the employee under chapter 1 of the Code (chapter 1) and as wages to the employee for purposes of withholding under chapter 24 of the Code (chapter 24), relating to collection of Federal income tax at source on wages. In addition, the exception to the disallowance for amounts treated as employee compensation provided for in section 274(e)(2) and in paragraph (e)(2)(i) of this section cannot be applied to reduce a section 274(a)(4) disallowance calculated using this method. A taxpayer using this methodology may not use the aggregation rule in paragraph (c) of this section.

(B) *Primary use methodology.* A taxpayer that uses the primary use methodology in this paragraph (d)(2)(ii)(B) must use the following four-step methodology to calculate the disallowance of deductions for qualified transportation fringe parking expenses for each parking facility for which the taxpayer uses the primary use methodology. A taxpayer using this methodology may use the aggregation rule in paragraph (c) of this section for determining total parking spaces.

(1) *Step 1 - Calculate the disallowance for reserved employee spaces.* A taxpayer must identify the total parking spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for the taxpayer's employees. The taxpayer must then determine the percentage of reserved employee spaces in relation to total parking spaces and multiply that percentage by the taxpayer's total parking expenses for the parking facility. The product is the amount of the deduction for total parking expenses that is disallowed under section 274(a)(4) for reserved employee spaces. There is no disallowance for reserved employee spaces if the following conditions are met:

(i) The primary use (as defined in paragraphs (b)(11) and (d)(2)(ii)(B)(2) of this section) of the available parking spaces is to provide parking to the general public;

(ii) There are five or fewer reserved employee spaces in the parking facility; and

(iii) The reserved employee spaces are 5 percent or less of the total parking spaces.

(2) *Step 2 - Determine the primary use of available parking spaces.* A taxpayer must identify the available parking spaces in the parking facility and determine whether their primary use is to provide parking to the general public. If the primary use of the available parking spaces in the parking facility is to provide parking to the general public, then total parking expenses allocable to available parking spaces at the parking facility are excepted from the section 274(a)(4) disallowance by the general public exception under section 274(e)(7) and paragraph (e)(2)(ii) of this section. Primary use of available parking spaces is based on the number of available parking spaces used by employees during the peak demand period.

(3) *Step 3 - Calculate the allowance for reserved nonemployee spaces.* If the primary use of a taxpayer's available parking spaces is not to provide parking to the general public, the taxpayer must identify the number of available parking spaces in the parking facility, or the taxpayer's portion thereof, exclusively reserved for nonemployees. A taxpayer that has no reserved nonemployee spaces may proceed to Step 4 in paragraph (d)(2)(ii)(B)(4) of this section. If the taxpayer has reserved nonemployee spaces, it may determine the percentage of reserved nonemployee spaces in relation to remaining total parking spaces and multiply that percentage by the taxpayer's remaining total parking expenses. The product is the amount of the deduction for remaining total parking expenses that is not disallowed because the spaces are not available for employee parking.

(4) *Step 4 - Determine remaining use of available parking spaces and allocable expenses.* If a taxpayer completes Steps 1 - 3 in paragraph (d)(2)(ii)(B) of this section and has any remaining total parking expenses not specifically categorized as deductible or nondeductible, the taxpayer must reasonably allocate such expenses by determining the total number of available parking spaces used by employees during the peak demand period.

(C) *Cost per space methodology.* A taxpayer using the cost per space methodology in this paragraph (d)(2)(ii)(C) must calculate the disallowance of deductions for qualified transportation fringe parking expenses by multiplying

the cost per space by the number of total parking spaces used by employees during the peak demand period. The product is the amount of the deduction for total parking expenses that is disallowed under section 274(a)(4). A taxpayer may calculate cost per space by dividing total parking expenses by total parking spaces. This calculation may be performed on a monthly basis. A taxpayer using this methodology may use the aggregation rule in paragraph (c) of this section for determining total parking spaces.

(3) *Expenses for transportation in a commuter highway vehicle or transit pass.* If a taxpayer pays a third party an amount for its employees' commuter highway vehicle or a transit pass qualified transportation fringe, the section 274(a)(4) disallowance generally is equal to the taxpayer's total annual cost of employee commuter highway vehicle or a transit pass qualified transportation fringes paid to the third party. If a taxpayer provides transportation in a commuter highway vehicle or transit pass qualified transportation fringes in kind directly to its employees, the taxpayer must calculate the disallowance of deductions for expenses for such fringes based on a reasonable interpretation of section 274(a)(4). However, a taxpayer may not use the value of the qualified commuter highway vehicle or transit pass fringe to the employee to determine expenses allocable to such fringe because section 274(a)(4) disallows a deduction for the expense of providing a qualified transportation fringe, regardless of its value to the employee.

(e) *Specific exceptions to disallowance of deduction for qualified transportation fringe expenses—*(1) *In general.* The provisions of section 274(a)(4) and paragraph (a) of this section (imposing limitations on deductions for qualified transportation fringe expenses) are not applicable in the case of expenditures set forth in paragraph (e)(2) of this section. Such expenditures are deductible to the extent allowable under chapter 1 of the Code. This paragraph (e) cannot be construed to affect whether a deduction under section 162 or 212 is allowed or allowable. The fact that an expenditure is not covered by a specific exception provided for in this paragraph (e) is not determinative of whether a deduction for the expenditure is disallowed

under section 274(a)(4) and paragraph (a) of this section.

(2) *Exceptions to disallowance.* The expenditures referred to in paragraph (e)(1) of this section are set forth in paragraphs (e)(2)(i) through (iii) of this section.

(i) *Certain qualified transportation fringe expenses treated as compensation—*(A) *Expenses includible in income of persons who are employees and are not specified individuals.* In accordance with section 274(e)(2)(A), and except as provided in paragraph (e)(2)(i)(C) of this section, an expense paid or incurred by a taxpayer for a qualified transportation fringe, if an employee who is not a specified individual is the recipient of the qualified transportation fringe, is not subject to the disallowance of deductions provided for in paragraph (a) of this section to the extent that the taxpayer—

(1) Properly treats the expense relating to the recipient of the qualified transportation fringe as compensation to an employee under chapter 1 and as wages to the employee for purposes of chapter 24; and

(2) Treats the proper amount as compensation to the employee under §1.61-21.

(B) *Specified Individuals.* In accordance with section 274(e)(2)(B), in the case of a specified individual (as defined in section 274(e)(2)(B)(ii)), the disallowance of deductions provided for in paragraph (a) of this section does not apply to an expense for a qualified transportation fringe of the specified individual to the extent that the amount of the expense does not exceed the sum of—

(1) the amount treated as compensation to the specified individual under chapter 1 and as wages to the specified individual for purposes of chapter 24; and

(2) any amount the specified individual reimburses the taxpayer.

(C) *Expenses for which an amount is excluded from income or is less than the proper amount.* Notwithstanding paragraph (e)(2)(i)(A) of this section, in the case of an expense paid or incurred by a taxpayer for a qualified transportation fringe for which an amount is wholly or partially excluded from a recipient's income under subtitle A of the Code (other than because the amount is reimbursed by the recipient), or for which an amount included in compensation and wages to an employee is less than the amount re-

quired to be included under §1.61-21, the disallowance of deductions provided for in paragraph (a) of this section does not apply to the extent that the amount of the expense does not exceed the sum of—

(1) the amount treated as compensation to the recipient under chapter 1 and as wages to the recipient for purposes of chapter 24; and

(2) any amount the recipient reimburses the taxpayer.

(ii) *Expenses for transportation in a commuter highway vehicle, transit pass, or parking made available to the public.* Under section 274(e)(7) and this paragraph (e)(2)(ii), any expense paid or incurred by a taxpayer for transportation in a commuter highway vehicle, a transit pass, or parking that otherwise qualifies as a qualified transportation fringe is not subject to the disallowance of deductions provided for in paragraph (a) of this section to the extent that such transportation, transit pass, or parking is made available to the general public. With respect to parking, this exception applies to the entire amount of the taxpayer's parking expense, less any expenses specifically attributable to employees (for example, expenses allocable to reserved employee spaces), if the primary use of the parking is by the general public. If the primary use of the parking is not by the general public, this exception applies only to the costs attributable to the parking used by the general public.

(iii) *Expenses for transportation in a commuter highway vehicle, transit pass, or parking sold to customers.* Under section 274(e)(8) and this paragraph (e)(2)(iii), any expense paid or incurred by a taxpayer for transportation in a commuter highway vehicle, a transit pass, or parking that otherwise qualifies as a qualified transportation fringe to the extent such transportation, transit pass, or parking is sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth, is not subject to the disallowance of deductions provided for in paragraph (a) of this section. For purposes of this paragraph (e)(2)(iii), the term *customer* includes an employee of the taxpayer who purchases transportation in a commuter highway vehicle, a transit pass, or parking in a bona fide transaction for an adequate and full consideration in money or money's worth. If in a bona fide

transaction, the adequate and full consideration for qualified parking is zero, the exception in this paragraph (e)(2)(iii) applies even though the taxpayer does not actually sell the parking to its employees. To apply the exception in this case, the taxpayer bears the burden of proving that the fair market value of the qualified parking is zero. However, solely for purposes of this paragraph (e)(2)(iii), a taxpayer will be treated as satisfying this burden if the qualified parking is provided in a rural, industrial, or remote area in which no commercial parking is available and an individual other than an employee ordinarily would not pay to park in the parking facility.

(f) *Examples.* The following examples illustrate the provisions of this section related to parking expenses for qualified transportation fringes. For each example, unless otherwise stated, assume the parking expenses are otherwise deductible expenses paid or incurred during the 2020 taxable year; all or some portion of the expenses relate to a qualified transportation fringe under section 132(f); the section 132(f)(2) monthly per employee limitation on an employee's exclusion is \$270; the fair market value of the qualified parking is not \$0; all taxpayers are calendar-year taxpayers; and the length of the 2020 taxable year is 12 months.

(1) *Example 1.* Taxpayer A pays B, a third party who owns a parking garage adjacent to A's place of business, \$100 per month per parking space for each of A's 10 employees to park in B's garage, or \$12,000 for parking in 2020 ($(\$100 \times 10) \times 12 = \$12,000$). The \$100 per month paid for each of A's 10 employees for parking is excludible from the employees' gross income under section 132(a)(5), and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable. Thus, the entire \$12,000 is subject to the section 274(a)(4) disallowance under paragraphs (a) and (d)(1) of this section.

(2) *Example 2.* (i) Assume the same facts as in paragraph (f)(1) of this section (*Example 1*), except A pays B \$300 per month for each parking space, or \$36,000 for parking for 2020 ($(\$300 \times 10) \times 12 = \$36,000$). Of the \$300 per month paid for parking for each of 10 employees, \$270 is excludible under section 132(a)(5) for 2020 and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount. A properly treats the excess amount of \$30 ($\$300 - \270) per employee per month as compensation and wages. Thus, \$32,400 ($(\$270 \times 10) \times 12 = \$32,400$) is subject to the section 274(a)(4) disallowance under paragraphs (a) and (d)(1) of this section.

(ii) The excess amount of \$30 per employee per month is not excludible under section 132(a)(5). As a result, the exceptions in section 274(e)(2) and para-

graph (e)(2)(i) of this section are applicable to this amount. Thus, \$3,600 ($\$36,000 - \$32,400 = \$3,600$) is not subject to the section 274(a)(4) disallowance and remains deductible.

(3) *Example 3.* (i) Taxpayer C leases from a third party a parking facility that includes 200 parking spaces at a rate of \$500 per space, per month in 2020. C's annual lease payment for the parking spaces is \$1,200,000 ($(200 \times \$500) \times 12 = \$1,200,000$). The number of available parking spaces used by C's employees during the peak demand period is 200.

(ii) C uses the qualified parking limit methodology described in paragraph (d)(2)(ii)(A) of this section to determine the disallowance under section 274(a)(4). Under this methodology, the section 274(a)(4) disallowance is calculated by multiplying the number of available parking spaces used by employees during the peak demand period, 200, the section 132(f)(2) monthly per employee limitation on exclusion, \$270, and 12, the number of months in the applicable taxable year. The amount subject to the section 274(a)(4) disallowance is \$648,000 ($200 \times \$270 \times 12 = \$648,000$). This amount is excludible from C's employees' gross incomes under section 132(a)(5) and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount. The excess \$552,000 ($\$1,200,000 - \$648,000$) for which C is not disallowed a deduction under 274(a)(4) is included in C's employees' gross incomes because it exceeds the section 132(f)(2) monthly per employee limitation on exclusion.

(4) *Example 4.* (i) *Facts.* Taxpayer D, a big box retailer, owns a surface parking facility adjacent to its store. D incurs \$10,000 of total parking expenses for its store in the 2020 taxable year. D's parking facility has 510 spaces that are used by its customers, employees, and its fleet vehicles. None of D's parking spaces are reserved. The number of available parking spaces used by D's employees during the peak demand period is 50. Approximately 30 nonreserved parking spaces are empty during D's peak demand period. D's fleet vehicles occupy 10 parking spaces.

(ii) *Methodology.* D uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

(iii) *Step 1.* Because none of D's parking spaces are exclusively reserved for employees, there is no amount to be specifically allocated to reserved employee spaces under paragraph (d)(2)(ii)(B)(1) of this section.

(iv) *Step 2.* D's number of available parking spaces is the total parking spaces reduced by the number of reserved employee spaces and inventory/unusable spaces or 500 ($510 - 0 - 10 = 500$). The number of available parking spaces used by D's employees during the peak demand period is 50. Of the 500 available parking spaces, 450 are used to provide parking to the general public, including the 30 empty nonreserved parking spaces that are treated as provided to the general public. The primary use of D's available parking spaces is to provide parking to the general public because 90% ($450 / 500 = 90\%$) of the available parking spaces are used by the general public under paragraph (d)(2)(ii)(B)(2) of this section. Because the primary use of the available parking spaces is to provide parking to the general public, the exception in section 274(e)(7) and paragraph (e)

(2)(ii) of this section applies and none of the \$10,000 of total parking expenses is subject to the section 274(a)(4) disallowance.

(5) *Example 5. (i) Facts.* Taxpayer E, a manufacturer, owns a surface parking facility adjacent to its plant. E incurs \$10,000 of total parking expenses in 2020. E's parking facility has 500 spaces that are used by its visitors and employees. E reserves 25 of these spaces for nonemployee visitors. The number of available parking spaces used by E's employees during the peak demand period is 400.

(ii) *Methodology.* E uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

(iii) *Step 1.* Because none of E's parking spaces are exclusively reserved for employees, there is no amount to be specifically allocated to reserved employee spaces under paragraph (d)(2)(ii)(B)(1) of this section.

(iv) *Step 2.* The primary use of E's parking facility is not to provide parking to the general public because 80% ($400 / 500 = 80\%$) of the available parking spaces are used by its employees. Thus, expenses allocable to those spaces are not excepted from the section 274(a) disallowance by section 274(e)(7) and paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(2) of this section.

(v) *Step 3.* Because 5% ($25 / 500 = 5\%$) of E's available parking spaces are reserved nonemployee spaces, up to \$9,500 ($\$10,000 \times 95\% = \$9,500$) of E's total parking expenses are subject to the section 274(a)(4) disallowance under this step as provided in paragraph (d)(2)(ii)(B)(3) of this section. The remaining \$500 ($\$10,000 \times 5\% = \500) of expenses allocable to reserved nonemployee spaces is excepted from the section 274(a) disallowance and continues to be deductible.

(vi) *Step 4.* E must reasonably determine the employee use of the remaining parking spaces by using the number of available parking spaces used by E's employees during the peak demand period and determine the expenses allocable to employee parking spaces under paragraph (d)(2)(ii)(B)(4) of this section.

(6) *Example 6. (i) Facts.* Taxpayer F, a manufacturer, owns a surface parking facility adjacent to its plant. F incurs \$10,000 of total parking expenses in 2020. F's parking facility has 500 spaces that are used by its visitors and employees. F reserves 50 spaces for management. All other employees park in nonreserved spaces in F's parking facility; the number of available parking spaces used by F's employees during the peak demand period is 400. Additionally, F reserves 10 spaces for nonemployee visitors.

(ii) *Methodology.* F uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

(iii) *Step 1.* Because F reserved 50 spaces for management, \$1,000 ($(50 / 500) \times \$10,000 = \$1,000$) is the amount of total parking expenses that is nondeductible for reserved employee spaces under section 274(a)(4) and paragraphs (a) and (d)(2)(ii)(B)(1) of this section. None of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount.

(iv) *Step 2.* The primary use of the remainder of F's parking facility is not to provide parking to the general public because 89% ($400 / 450 = 89\%$) of the available parking spaces in the facility are used by its employees. Thus, expenses allocable to these spaces are not excepted from the section 274(a)(4) disallowance by section 274(e)(7) and paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(2) of this section.

(v) *Step 3.* Because 2% ($10 / 450 = 2.22\%$) of F's available parking spaces are reserved nonemployee spaces, the \$180 allocable to those spaces ($(\$10,000 - \$1,000) \times 2\%$) is not subject to the section 274(a)(4) disallowance and continues to be deductible under paragraph (d)(2)(ii)(B)(3) of this section.

(vi) *Step 4.* F must reasonably determine the employee use of the remaining parking spaces by using the number of available parking spaces used by F's employees during the peak demand period and determine the expenses allocable to employee parking spaces under paragraph (d)(2)(ii)(B)(4) of this section.

(7) *Example 7. (i) Facts.* Taxpayer G, a financial services institution, owns a multi-level parking garage adjacent to its office building. G incurs \$10,000 of total parking expenses in 2020. G's parking garage has 1,000 spaces that are used by its visitors and employees. However, one floor of the parking garage is segregated by an electronic barrier that can only be accessed with a card provided by G to its employees. The segregated parking floor contains 100 spaces. The other floors of the parking garage are not used by employees for parking during the peak demand period.

(ii) *Methodology.* G uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

(iii) *Step 1.* Because G has 100 reserved spaces for employees, \$1,000 ($(100 / 1,000) \times \$10,000 = \$1,000$) is the amount of total parking expenses that is nondeductible for reserved employee spaces under section 274(a)(4) and paragraph (d)(2)(ii)(B)(1) of this section. None of the exceptions in section 274(e) or paragraph (e) of this section are applicable to this amount.

(iv) *Step 2.* The primary use of the available parking spaces in G's parking facility is to provide parking to the general public because 100% ($900 / 900 = 100\%$) of the available parking spaces are used by the public. Thus, expenses allocable to those spaces, \$9,000, are excepted from the section 274(a)(4) disallowance by section 274(e)(7) and paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(2).

(8) *Example 8. (i) Facts.* Taxpayer H, an accounting firm, leases a parking facility adjacent to its office building. H incurs \$10,000 of total parking expenses related to the lease payments in 2020. H's leased parking facility has 100 spaces that are used by its clients and employees. None of the parking spaces are reserved. The number of available parking spaces used by H's employees during the peak demand period is 60.

(ii) *Methodology.* H uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4).

(iii) *Step 1.* Because none of H's leased parking spaces are exclusively reserved for employees, there is no amount to be specifically allocated to reserved employee spaces under paragraph (d)(2)(ii)(B)(1) of this section.

(iv) *Step 2.* The primary use of H's leased parking facility under paragraph (d)(2)(ii)(B)(2) of this section is not to provide parking to the general public because 60% ($60 / 100 = 60\%$) of the lot is used by its employees. Thus, H may not utilize the general public exception from the section 274(a)(4) disallowance provided by section 274(e)(7) and paragraph (e)(2)(ii) of this section.

(v) *Step 3.* Because none of H's parking spaces are exclusively reserved for nonemployees, there is no amount to be specifically allocated to reserved nonemployee spaces under paragraph (d)(2)(ii)(B)(3) of this section.

(vi) *Step 4.* H must reasonably determine the use of the parking spaces and the related expenses allocable to employee parking. Because the number of available parking spaces used by H's employees during the peak demand period is 60, H reasonably determines that 60% ($60 / 100 = 60\%$) of H's total parking expenses or \$6,000 ($\$10,000 \times 60\% = \$6,000$) is subject to the section 274(a)(4) disallowance under paragraph (d)(2)(ii)(B)(4) of this section.

(9) *Example 9. (i) Facts.* Taxpayer I, a large manufacturer, owns multiple parking facilities adjacent to its manufacturing plant, warehouse, and office building at its complex in the city of X. All of I's tracts or parcels of land at its complex in city X are located in a single geographic location. I owns parking facilities in other cities. I incurs \$50,000 of total parking expenses related to the parking facilities at its complex in city X in 2020. I's parking facilities at its complex in city X have 10,000 total parking spaces that are used by its visitors and employees of which 500 are reserved for management. All other spaces at parking facilities in I's complex in city X are nonreserved. The number of nonreserved spaces used by I's employees other than management during the peak demand period at I's parking facilities in city X is 8,000.

(ii) *Methodology.* I uses the primary use methodology in paragraph (d)(2)(ii)(B) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4). I chooses to apply the aggregation rule in paragraph (c) of this section to aggregate all parking facilities in the geographic location that comprises its complex in city X. However, I may not aggregate parking facilities in other cities with its parking facilities in city X because they are in different geographic locations.

(iii) *Step 1.* Because 500 spaces are reserved for management, \$2,500 ($(500 / 10,000) \times \$50,000 = \$2,500$) is the amount of total parking expenses that is nondeductible for reserved employee spaces for I's parking facilities in city X under section 274(a)(4) and paragraphs (a) and (d)(2)(ii)(B)(1) of this section.

(iv) *Step 2.* The primary use of the remainder of I's parking facility is not to provide parking to the general public because 84% ($8,000 / 9,500 = 84\%$) of the available parking spaces in the facility are used by its employees. Thus, expenses allocable to these spaces are not excepted from the section 274(a)(4)

disallowance by section 274(e)(7) or paragraph (e)(2)(ii) of this section under the primary use test in paragraph (d)(2)(ii)(B)(2) of this section.

(v) *Step 3.* Because none of I's parking spaces in its parking facilities in city X are exclusively reserved for nonemployees, there is no amount to be specifically allocated to reserved nonemployee spaces under paragraph (d)(2)(ii)(B)(3) of this section.

(vi) *Step 4.* I must reasonably determine the use of the remaining parking spaces and the related expenses allocable to employee parking for its parking facilities in city X. Because the number of available parking spaces used by I's employees during the peak demand period in city X during an average workday is 8,000, I reasonably determines that 84.2% ($8,000 / 9,500 = 84.2\%$) of I's remaining parking expense or \$39,900 ($(\$50,000 - \$2,500) \times 84\% = \$39,900$) is subject to the section 274(a)(4) disallowance under paragraph (d)(2)(ii)(B)(4) of this section.

(10) *Example 10.* (i) Taxpayer J, a manufacturer, owns a parking facility and incurs the following mixed parking expenses (along with other parking expenses): property taxes, utilities, insurance, security expenses, and snow removal expenses. In accordance with paragraph (b)(12)(i) and (ii) of this section, J determines its total parking expenses by allocating 5% of its property tax, utilities, and insurance expenses to its parking facility. J uses a reasonable methodology to allocate to its parking facility an applicable portion of its security and snow removal expenses. J determines that it incurred \$100,000 of total parking expenses in 2020. J's parking facility has 500 spaces that are used by its visitors and employees. The number of total parking spaces used by J's employees during the peak demand period is 475.

(ii) J uses the cost per space methodology described in paragraph (d)(2)(ii)(C) of this section to determine the amount of parking expenses that are disallowed under section 274(a)(4). Under this methodology, J multiplies the cost per space by the number of total parking spaces used by J's employees during the peak demand period. J calculates the cost per space by dividing total parking expenses by the number of total parking spaces ($\$100,000 / 500 = \200). J determines that \$95,000 ($\$200 \times 475 = \$95,000$) of J's total parking expenses is subject to the section 274(a)(4) disallowance and none of the exceptions in section 274(e) or paragraph (e) of this section are applicable.

(11) *Example 11.* Taxpayer K operates an industrial plant with a parking facility in a rural area in which no commercial parking is available. K provides qualified parking at the plant to its employees free of charge. Further, an individual other than an employee ordinarily would not consider paying any amount to park in the plant's parking facility. Although K does not charge its employees for the qualified parking, the exception in section 274(e)(8) and this paragraph (e)(3)(iii) will apply to K's total parking expenses if in a bona fide transaction, the adequate and full consideration for the qualified parking is zero. In order to treat the adequate and full consideration as zero, K bears the burden of proving that the parking has no objective value. K is treated

as satisfying this burden because the parking is provided in a rural area in which no commercial parking is available and in which an individual other than an employee ordinarily would not consider paying any amount to park in the parking facility. Therefore, the exception in paragraph (e)(2)(iii) of this section applies to K's total parking expenses and a deduction for the expenses is not disallowed by reason of section 274(a)(4).

(g) *Applicability date.* This section applies to taxable years beginning on or after December 16, 2020. However, taxpayers may choose to apply §1.274-13(b)(14)(ii) to taxable years ending after December 31, 2019.

Par. 3. Section 1.274-14 is added to read as follows:

§1.274-14 Disallowance of deductions for certain transportation and commuting benefit expenditures.

(a) *General rule.* Except as provided in this section, no deduction is allowed for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment. The disallowance is not subject to the exceptions provided in section 274(e). The disallowance applies regardless of whether the travel between the employee's residence and place of employment includes more than one mode of transportation, and regardless of whether the taxpayer provides, or pays or reimburses the employee for, all modes of transportation used during the trip. For example, the disallowance applies if an employee drives a personal vehicle to a location where a different mode of transportation is used to complete the trip to the place of employment, even though the taxpayer may not incur any expense for the portion of travel in the employee's personal vehicle. The rules in section 274(l) and this section do not apply to business expenses under section 162(a)(2) paid or incurred while traveling away from home. The rules in section 274(l) and this section also do not apply to any expenditure for any qualified transportation fringe (as defined in section 132(f)) provided to an employee of the taxpayer. All qualified transportation

fringe expenses are required to be analyzed under section 274(a)(4) and §1.274-13

(b) *Exception.* The disallowance for the deduction for expenses incurred for providing any transportation or commuting in paragraph (a) of this section does not apply if the transportation or commuting expense is necessary for ensuring the safety of the employee. The transportation or commuting expense is necessary for ensuring the safety of the employee if unsafe conditions, as described in §1.61-21(k)(5), exist for the employee.

(c) *Definitions.* The following definitions apply for purposes of this section:

(1) *Employee.* The term *employee* means an employee of the taxpayer as defined in section 3121(d)(1) and (2) (that is, officers of a corporate taxpayer and employees of the taxpayer under the common law rules).

(2) *Residence.* The term *residence* means a residence as defined in §1.121-1(b)(1). An employee's residence is not limited to the employee's principal residence.

(3) *Place of employment.* The term *place of employment* means the employee's regular or principal (if more than one regular) place of business. An employee's place of employment does not include temporary or occasional places of employment. An employee must have at least one regular or principal place of business.

(d) *Applicability date.* This section applies to taxable years beginning on or after December 16, 2020.

Sunita Lough,
*Deputy Commissioner for Services
and Enforcement.*

Approved: December 4, 2020.

David J. Kautter,
*Assistant Secretary of the Treasury
(Tax Policy).*

(Filed by the Office of the Federal Register on December 15, 2020, 8:45 a.m. and published in the issue of the Federal Register for December 16, 2020, 85 F.R. 81391)

26 CFR 1.451-3 Timing of income inclusion for taxpayers with an applicable financial statement using an accrual method of accounting.; 26 CFR 1.451-8 Advance payments for goods, services, and certain other items.

T.D. 9941

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Taxable Year of Income Inclusion under an Accrual Method of Accounting and Advance Payments for Goods, Services, and Other Items

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding the timing of income inclusion under an accrual method of accounting, including the treatment of advance payments for goods, services, and certain other items. The regulations reflect changes made by the Tax Cuts and Jobs Act and affect taxpayers that use an accrual method of accounting and have an applicable financial statement. These final regulations also affect taxpayers that use an accrual method of accounting and receive advance payments.

DATES: Effective Date: The regulations are effective on December 30, 2020.

Applicability Dates: For dates of applicability, see §§1.451-3(m), 1.451-8(h), and 1.1275-2(l)(2).

FOR FURTHER INFORMATION CONTACT: Concerning any provisions in §1.451-3 within the jurisdiction of the Associate Chief Counsel (Income Tax & Accounting), Jo Lynn Ricks, (202) 317-4615, Sean Dwyer, (202) 317-4853, or Doug Kim, (202) 317-4794, and con-

cerning any provisions in §1.451-8 within the jurisdiction of the Associate Chief Counsel (Income Tax & Accounting), Jo Lynn Ricks, (202) 317-4615, or David Christensen, (202) 317-4861; concerning any provisions in §1.451-3 or § 1.451-8 within the jurisdiction of the Associate Chief Counsel (Financial Institutions & Products), Deepan Patel, (202) 317-3423, or Charles Culmer, (202) 317-4528 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 451(b) and (c) of the Internal Revenue Code (Code).

On December 22, 2017, section 451(b) and (c) were amended by section 13221 of Public Law 115-97 (131 Stat. 2054), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 451(b) was amended to provide that, for a taxpayer using an accrual method of accounting (accrual method taxpayer), the all events test for an item of gross income, or portion thereof, is met no later than when the item, or portion thereof, is included in revenue for financial accounting purposes on an applicable financial statement (AFS). Section 451(c) was amended to provide that an accrual method taxpayer may use the deferral method of accounting provided in section 451(c) for advance payments. Unless otherwise indicated, all references to section 451(b) and section 451(c) hereinafter are references to section 451(b) and section 451(c), as amended by the TCJA.

I. Section 451(b)

In general, section 451(a) 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(a), 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 in-

come and the amount of the income can be determined with reasonable accuracy (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 C.B. 288; Revenue Ruling 84-31, 1984-1 C.B. 127; Revenue Ruling 80-308, 1980-2 C.B. 162.

Section 451(b)(1)(A) provides that, for an accrual method taxpayer, the all events test for an item of gross income, or portion thereof, is met no later than when the item, or portion thereof, is included as revenue in an AFS (AFS Income Inclusion Rule).

Section 451(b)(1)(B) lists exceptions to the AFS Income Inclusion Rule. The AFS Income Inclusion Rule does not apply to taxpayers that do not have an AFS for a taxable year or to any item of gross income from a mortgage servicing contract.

Section 451(b)(1)(C) codifies the all events test, stating that the all events test is met for any item of gross income if all the events have occurred which fix the right to receive such income and the amount of such income can be determined with reasonable accuracy.

Section 451(b)(2) provides that the AFS Income Inclusion Rule does not apply for any item of gross income the recognition of which is determined using a special method of accounting, “other than any provision of part V of subchapter P (except as provided in clause (ii) of paragraph (1)(B)).”

Section 451(b)(3) defines an AFS, as referenced in section 451(b)(1)(A)(i), by providing a hierarchical list of financial statements.

Section 451(b)(4) provides that for purposes of section 451(b), in the case of a contract which contains multiple performance obligations, the allocation of the transaction price to each performance obligation is equal to the amount allocated to each performance obligation for purposes of including such item in revenue in the taxpayer’s AFS.

Section 451(b)(5) provides that, if the financial results of a taxpayer are reported on the AFS for a group of entities, the group’s financial statement shall be treated as the AFS of the taxpayer.

II. Section 451(c)

Section 451(c) provides special rules for the treatment of advance payments. Section 451(c)(1)(A) provides the general rule requiring an accrual method taxpayer to include an advance payment in gross income in the taxable year of receipt. However, section 451(c)(1)(B) permits a taxpayer to elect to include any portion of the advance payment in gross income in the taxable year following the year of receipt to the extent income is not included in revenue in the AFS in the year of receipt. Section 451(c)(1)(B) generally codifies Revenue Procedure 2004-34, 2004-22 I.R.B. 991, which provided for a similar deferral period.

Section 451(c)(2)(A) provides the Secretary of the Treasury or his delegate (Secretary) with the authority to provide the time, form and manner for making the election under section 451(c)(1)(B), and the categories of advance payments for which an election can be made. Under section 451(c)(2)(B), the election is effective for the taxable year that it is first made and for all subsequent taxable years, unless the taxpayer receives the consent of the Secretary to revoke the election. Section 451(c)(3) provides that the deferral election does not apply to advance payments received in the taxable year that the taxpayer ceases to exist.

Section 451(c)(4)(A) defines advance payment for purposes of section 451(c). Under section 451(c)(4)(A), the term advance payment means any payment that meets the following three requirements: (1) the full inclusion of the payment in gross income in the year of receipt is a permissible method of accounting; (2) any portion of the advance payment is included in revenue in an AFS for a subsequent tax year; and (3) the advance payment is for goods, services, or such other items that the Secretary has identified. Section 451(c)(4)(B) lists certain payments that are excluded from the definition of advance payment and gives the Secretary the authority to identify other payments to be excluded from the definition. Section 451(c)(4)(C) provides a special definition of the term “receipt” for purposes of the definition of advance payment, and section 451(c)(4)(D) states that rules similar to those for allocating the transaction

price among performance obligations in section 451(b)(4) also apply for purposes of section 451(c).

III. Prior Guidance

On April 12, 2018, the Department of the Treasury (Treasury Department) and the IRS issued Notice 2018-35, 2018-18 I.R.B. 520, providing interim guidance on the treatment of advance payments and requesting suggestions for future guidance under section 451(b) and section 451(c). On September 27, 2018, the Treasury Department and the IRS issued Notice 2018-80, 2018-42 I.R.B. 609, announcing that the Treasury Department and the IRS intend to issue proposed regulations providing that accrued market discount is not includible in income under section 451(b).

On September 9, 2019, the Treasury Department and the IRS published proposed regulations under section 451(b) (REG-104870-18, 84 FR 47191) (proposed section 451(b) regulations) and proposed regulations under section 451(c) (REG-104554-18, 84 FR 47175) (proposed section 451(c) regulations), referred to collectively hereinafter as the “proposed regulations.” The notices of proposed rulemaking for section 451(b) and (c) reflect consideration of the comments received in response to Notice 2018-35.

A public hearing on the proposed regulations was held on December 10, 2019, at which two speakers provided testimony. The Treasury Department and the IRS received approximately ten written comments responding to the proposed regulations.

After the comment period for the proposed regulations closed, the Treasury Department and the IRS received a comment letter regarding the allocation of transaction price for contracts that include both income subject to section 451 and income subject to a special method of accounting provision, specifically, section 460. In response to these comments, in the Explanation of Provisions of a notice of proposed rulemaking (REG-132766-18) that was published on August 5, 2020 (85 FR 47508), the Treasury Department and the IRS suggested allocation rules and requested comments regarding the application of section 451(b)(2) and (4) to contracts with income that is accounted for in

part under proposed §1.451-3 and in part under a special method of accounting. No formal comments were received regarding these suggested rules.

Comments received before these regulations were substantially developed, including all comments received on or before the deadline for comments on November 8, 2019, were carefully considered in developing these regulations. Copies of the comments received are available for public inspection at <http://www.regulations.gov> or upon request. After consideration of the comments received and the testimony at the public hearing, this Treasury decision adopts the proposed regulations as revised in response to such comments and testimony. The comments and the revisions are discussed in the Summary of Comments and Explanation of Revisions section of this preamble.

Summary of Comments and Explanation of Revisions

I. Overview

This Summary of Comments and Explanation of Revisions section summarizes the formal written comments and some of the informal commentary, both in writing and at public events, addressing the proposed regulations. Comments merely summarizing or interpreting the proposed regulations or recommending statutory revisions generally are not discussed in this preamble. Similarly, comments outside the scope of this rulemaking generally are not addressed in this Summary of Comments and Explanation of Revisions section.

II. Comments and Explanation of Revisions Regarding the Proposed Section 451(b) Regulations

A. Realization and recognition

As noted in the preamble to the proposed section 451(b) regulations, footnote 872 of the Conference Report to the TCJA states that section 451(b) was not intended to revise the rules associated with when an item is realized for Federal income tax purposes and does not require the recognition of income in situations where the Federal income tax realization event has

not taken place. See H.R. Rep. No. 115-466, at 428 fn. 872 (2017) (Conf. Rep.). As also noted in the preamble to the proposed section 451(b) regulations, footnote 874 of the Conference Report provides, by way of example, that the timing rules of section 451(b) apply to unbilled receivables for partially performed services. *Id.* at 428 fn. 874.

Commenters provided little commentary on footnote 874, except to state that it is contrary to footnote 872. Instead, the commenters presented two views. First, some commenters highlighted footnote 872 and cited case law to support the claim that a realization event is, and has always been, a prerequisite for income recognition. These commenters acknowledged, however, that the case law frames the issue not in terms of “realization” but rather in terms of whether a seller has a fixed right to income under the all events test.

Second, some commenters suggested definitions of realization. However, these recommended definitions differ, particularly as to whether realization applies to the provision of services. For example, some commenters described realization as applying to both contracts for the provision of services and contracts for the sale of goods, and stated that realization occurs when the taxpayer has a “fixed and unconditional right to payment” under the contract. One commenter reasoned that existing judicial precedents require realization without distinguishing between whether the income is for the performance of services or the sale of property. Another commenter asserted that realization means there has been a sale or disposition under section 1001(a), suggesting that realization applies only to the sale of property. In sum, these commenters suggested that the proposed section 451(b) regulations do not give effect to footnote 872 in the Conference Report and ask that the final regulations either explicitly define realization or clarify when realization occurs in certain circumstances, such as where a taxpayer produces goods for customers or where a taxpayer provides non-severable services to customers.

The Treasury Department and the IRS have considered these comments and decline to define the term realization in the final regulations. Congress did not explic-

itly define realization in the Conference Report. Some of the suggested definitions of realization, particularly the ones equating realization with the all events test, would nullify the AFS Income Inclusion Rule entirely, which is clearly contrary to Congress’ intent. Accordingly, it is reasonable to conclude that Congress intended a different concept of realization that would give full effect to the statute. Further, the final regulations do not clarify when realization occurs in specific circumstances. Realization is a factual determination that, while closely aligned with the all events test, has different meanings in different contexts.

Section 451 is a timing provision and the amendments to section 451(b)(1)(A) by TCJA were intended to modify the timing of income to require an accrual method taxpayer with an AFS to treat the right to income as fixed, under the all events test, no later than the time at which the item (or portion thereof) is taken into account in its AFS. The statute thus reflects Congress’ intent to incorporate timing concepts from the financial reporting rules in the tax timing rules for including items in gross income. It does not seek to answer whether the AFS income inclusion has been realized. Accordingly, the focus of the final regulations is on the appropriate taxable year of AFS income inclusion.

B. Scope of AFS Income Inclusion Rule

1. Proposed §1.451-3(b): General rule

The general AFS Income Inclusion Rule in the proposed section 451(b) regulations provides that, if a taxpayer includes an item of gross income, or portion thereof, in revenue in the taxpayer’s AFS, the taxpayer must include the item in gross income under section 451(b). In addition to commenting that the general rule in the proposed section 451(b) regulations potentially overrides the realization requirement, contrary to footnote 872 of the Conference Report, commenters suggested that the rule is overbroad and could cause taxpayers to incur a tax liability without having the money to pay the liability.

The Treasury Department and the IRS note that the potential to incur a tax liability without having the money to pay the

liability is inherent in the accrual method. However, the Treasury Department and the IRS acknowledge that the proposed AFS Income Inclusion Rule could exacerbate this situation and that the proposed rule could result in inclusions that would be inconsistent with footnote 872 of the Conference Report. Accordingly, the final regulations provide that, under the AFS Income Inclusion Rule, the all events test under §1.451-1(a) for any item of gross income, or portion thereof, is met no later than when that item, or portion thereof, is “taken into account as AFS revenue.” In determining when an item of gross income is “taken into account as AFS revenue,” AFS revenue is reduced by amounts that the taxpayer does not have an enforceable right to recover if the customer were to terminate the contract on the last day of the taxable year. The determination of whether the taxpayer has an enforceable right to recover amounts of AFS revenue is governed by the terms of the contract and applicable Federal, state, or international law, and includes amounts recoverable in equity and liquidated damages.

The revised rule is designed to reconcile the intended preservation of the realization concept, consistent with footnote 872 of the Conference Report, with the intended scope of section 451(b), as illustrated in footnote 874 of the Conference Report. The revised rule is also consistent with concepts illustrated in Example 4 in the Joint Committee on Taxation, General Explanation of Public Law 115-97 (JCS-1-18) at 163 (Dec. 20, 2018) (Blue Book). In the example, the taxpayer enters into a contract with a customer for a customized piece of machinery. Under the contract, the taxpayer will not invoice the customer until the item is delivered to the customer, the customer accepts the machinery, and title to the machinery has transferred to the customer. The contract specifically provides that, if the customer withdraws from the agreement, the taxpayer has an enforceable right to payment as the work is performed, even if the contract is not completed. The taxpayer does not complete the machinery in year one but includes an amount in revenue in its AFS in year one. Example 4 concludes that, under the AFS Income Inclusion Rule, the taxpayer is required to recognize the amount in year one. The revised AFS Income In-

clusion Rule in the final regulations incorporates the key elements reflected in Example 4.

To reduce any additional compliance burdens, the final regulations provide an alternative method to determine when an item of gross income is treated as “taken into account as AFS revenue” under the AFS Income Inclusion Rule. Under the “alternative AFS revenue method”, the taxpayer does not reduce AFS revenue by amounts that the taxpayer lacks an enforceable right to recover if the customer were to terminate the contract on the last day of the taxable year. The alternative AFS revenue method is a method of accounting that applies to all items of gross income in the trade or business that are subject to the AFS income inclusion rule. Taxpayers using the alternative AFS revenue method may also use the AFS cost offset method provided in the final regulations.

Under the final regulations two additional adjustments to AFS revenue are made in determining whether an item of gross income is treated as “taken into account as AFS revenue.” These adjustments apply both under the AFS Income Inclusion Rule and under the alternative AFS revenue method. First, if the transaction price, as defined in §1.451-3(a) (14), was increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, then any AFS revenue attributable to such increase is disregarded. In such situations, total AFS revenue taken into account over the term of the contract exceeds the stated consideration in the contract and such excess is, for AFS purposes, offset by a corresponding interest expense. Because such excess is generally not imputed income for Federal income tax purposes and a deduction for the AFS interest expense is generally not imputed for Federal income tax purposes, it is necessary to adjust AFS revenue to prevent the improper acceleration, or overreporting, of gross income. If situations arise in which imputed income and imputed deductions are also required for Federal income tax purposes, an adjustment to AFS revenue is still appropriate as the amount and timing of the imputed income would be outside the scope of section 451 and the regulations thereunder.

Second, to the extent that AFS revenue reflects a reduction for (1) amounts that are cost of goods sold or liabilities that are required to be accounted for under other provisions of the Code, such as section 461, including liabilities for allowances, rebates, chargebacks, rewards issued in credit card and other transactions and other reward programs, and refunds (for example, estimated returns based on historic practice), regardless of when any such amount is incurred (Liability Amounts); or (2) amounts anticipated to be in dispute or anticipated to be uncollectable, the taxpayer must increase AFS revenue by such amounts. The Treasury Department and the IRS have determined that adjustments for such amounts are necessary to prevent the taxpayer from effectively taking such amounts into account for Federal income tax purposes in a taxable year prior to the taxable year in which they are otherwise permitted to be taken into account under other provisions of the Code. Additionally, if AFS revenue is not adjusted for Liability Amounts in the taxable year that such amounts are otherwise permitted to be taken into account, then a taxpayer may obtain an improper double benefit by taking such amounts into account to reduce taxable income under another provision of the Code while also deferring an equal amount of gross income to a later year under §1.451-3. The AFS revenue adjustments in the final regulations do not preclude a taxpayer from accounting for trading stamps and premium coupons under §1.451-4. However, the Treasury Department and the IRS are still evaluating whether the rules in §1.451-4 should be modified or clarified in light of certain financial reporting changes under ASC 606.

On a separate issue relating to the scope of the AFS Income Inclusion Rule, taxpayers questioned, in light of the realization discussion in footnote 872, whether the AFS Income Inclusion Rule applies to the sale of goods. Since Example 4 of the Blue Book involves the sale of goods, it is reasonable to conclude that Congress intended for the AFS Income Inclusion Rule, as revised, to extend to contracts for the sale of goods. Accordingly, as with the proposed section 451(b) regulations, the final regulations provide that the AFS Income Inclusion Rule applies to contracts for the sale of goods.

2. Proposed §1.451-3(b): Cost offset for AFS income inclusions

Proposed §1.451-3(b) does not provide for a cost offset when an amount is included under the AFS Income Inclusion Rule. The preamble to the proposed section 451(b) regulations discusses reasons for not providing a cost offset, including the potential for income distortions and Congressional intent that a cost offset not be provided. The preamble to the proposed section 451(b) regulations requests comments on this issue.

Multiple commenters proposed allowing an offset for the cost of goods sold (COGS) when income is included under the AFS Income Inclusion Rule. Commenters pointed out that the term “item of gross income” generally means total sales net of COGS. See, for example, §1.61-3(a). Commenters also described situations where income might be distorted by inclusions in early years of a multi-year contract with the costs being allowed in later years without income to offset. Commenters expressed concern that, in these situations, or more generally, the AFS Income Inclusion Rule might operate as a tax on gross receipts.

One commenter suggested that the statute uses the AFS as a backstop to timing recognition of revenue because the AFS provides a good standard by which to determine when a taxpayer receives an economic benefit. The commenter acknowledged that there has been a policy interest in achieving greater book-tax conformity in a variety of areas. The commenter recommended that, if the final regulations use the AFS to measure the receipt of an economic benefit, then the final regulations also should reflect the AFS standards that require certain items of income be reported “net” of offsetting items.

Commenters also noted that, for AFS purposes, credit card issuers generally report interchange fees net of estimated reward costs and report credit card late fees net of estimated uncollectable amounts. Commenters explained that reward costs and uncollectable credit card late fees “are so closely aligned with the realization of income that AFS standards require those items to be presented separately in the revenue section of the income statement but concurrently as to timing.” One com-

menter expressed concern that not reducing interchange fees by estimated reward costs and credit card late fees by estimated uncollectable amounts in determining the amount of income recognized under the AFS Income Inclusion Rule would result in the inclusion of more income for Federal income tax purposes than was reported on the AFS.

Accordingly, commenters recommended that the final regulations provide that the all events test and the economic performance requirement under section 461 should be deemed to be met for items that are “closely aligned” with income amounts recognized under the AFS Income Inclusion Rule. Commenters explained that section 461 should be deemed to be met for items such as estimated reward costs and estimated uncollectable late fees to the extent these items are reported on the revenue section of the AFS as a reduction to amounts subject to the AFS Income Inclusion Rule. One commenter further explained that this treatment would be consistent with the clear reflection of income doctrine of section 446. Alternatively, one commenter recommended modifying the definition of transaction price under proposed §1.451-3(c)(6) to reduce interchange fees by the amount of reward costs that satisfy section 461 and credit card late fees by amounts that are considered uncollectable for AFS purposes.

The Treasury Department and the IRS have considered these comments and have determined that a cost offset based on estimates of future costs would be inappropriate. As discussed in the preamble to the proposed section 451(b) regulations, allowing a cost offset based on estimated costs would be inconsistent with sections 461, 263A, and 471, and the regulations under those sections of the Code. In addition, a cost offset based on estimated costs would increase the possibility of income distortions as the costs of goods would effectively be recovered, through income deferral, prior to the taxable year in which the cost was actually incurred.

However, the Treasury Department and the IRS agree with comments suggesting that taxpayers should be afforded the flexibility of applying an offset for costs incurred against AFS income inclusions from the future sale of inventory, the “AFS cost offset method.” Accordingly,

a taxpayer that uses the AFS cost offset method determines the amount of gross income includible for a year prior to the year in which ownership of inventory transfers to the customer by reducing the amount of revenue it would otherwise be required to include under the AFS Income Inclusion Rule for the taxable year (AFS inventory inclusion amount) by the cost of goods related to the item of inventory for the taxable year, the “cost of goods in progress offset.” The net result is the amount that is required to be included in gross income for that year under the AFS Income Inclusion Rule. The deferred revenue, that is, the revenue that was reduced by the cost of goods in progress offset for a taxable year prior to the taxable year that ownership of the item of inventory is transferred to the customer, is generally taken into account in the taxable year in which ownership of the item of inventory is transferred to the customer.

The final regulations provide that the cost of goods in progress offset for each item of inventory for the taxable year is calculated as (1) the cost of goods incurred through the last day of the taxable year, (2) reduced by the cumulative cost of goods in progress offset amounts attributable to the items of inventory that were taken into account in prior taxable years, if any. However, the cost of goods in progress offset cannot reduce the AFS inventory inclusion amount for the item of inventory below zero. Further, the cost of goods in progress offset attributable to one item of inventory cannot reduce the AFS inventory inclusion amount attributable to a separate item of inventory. Any cost of goods that were not used to offset AFS inventory inclusion amounts because they were subject to limitation are considered when the taxpayer determines the cost of goods in progress offset for that item of inventory in a subsequent taxable year.

The cost of goods in progress offset is determined by reference to the costs and expenditures related to each item of inventory produced or acquired for resale, which costs have been incurred under section 461 and have been capitalized and included in inventory under sections 471 and 263A or any other applicable provision of the Code at the end of the year. However, the cost of goods in progress offset does not reduce the costs that are capitalized

to the item of inventory produced or acquired for resale by the taxpayer under the contract. That is, while the cost of goods in progress offset reduces the AFS inventory inclusion amount, it does not affect how and when costs are capitalized to inventory under sections 471 and 263A or any other applicable provision of the Code or when those capitalized costs will be recovered. Instead, the cost of goods in progress offset serves only to reduce or “offset” any AFS income inclusion amounts for the item of inventory and defer such amounts to the taxable year in which ownership of the item of inventory is transferred to the customer.

The costs of goods comprising the cost of goods in progress offset must be determined by applying the inventory accounting methods used by the taxpayer for Federal income tax purposes. A taxpayer must calculate its cost of goods in progress offset by reference to all costs that the taxpayer has permissibly capitalized and allocated to items of inventory under its inventory method, but may not consider costs that are not properly capitalized under such method.

In the taxable year in which ownership of the item of inventory is transferred to the customer, any revenue deferred by way of a prior year cost offset is included in gross income in the year of the transfer along with any additional revenue that is otherwise required to be included in gross income under the AFS Income Inclusion Rule for such year. Although no cost offset is permitted in such year, the taxpayer would recover costs capitalized and allocated to the item of inventory transferred as cost of goods sold in such year in accordance with sections 471 and 263A or any other applicable provision of the Code. However, if in a taxable year prior to the taxable year in which ownership of the item of inventory is transferred to the customer, either (A) the taxpayer dies or ceases to exist in a transaction other than a transaction to which section 381(a) applies, or (B) the taxpayer’s obligation to the customer with respect to the item of inventory ends other than in a transaction to which 381(a) applies or certain section 351(a) transactions between members of the same consolidated group, then all payments received for the item of inventory that were not previously included in gross

income as a result of the application of the cost offset rules are required to be included in gross income in such year.

The Treasury Department and the IRS adopted this approach in the final regulations because the AFS cost offset method provides options for taxpayers. All taxpayers that are required to account for income from the sale of inventory under the AFS income inclusion rule and that report AFS revenue in a taxable year prior to the taxable year in which ownership of the item of inventory is transferred to the customer will generally be required to accelerate income inclusions under such rule. However, taxpayers have the option of using the AFS cost offset method to reduce the amount of income they are required to accelerate under such rule. The AFS cost offset allows taxpayers to reasonably match income inclusions and incurred cost of goods, and more clearly reflects income.

The final regulations adopt a cost of goods sold offset based on incurred costs because the approach is consistent with §1.61-3 and more objective than a cost of goods sold offset based on projected future costs. In addition, the AFS cost offset method provides a degree of parity for sellers of goods with service providers who deduct costs as incurred without capitalizing the costs to inventory. A cost offset based on projected future cost of goods sold was rejected because it is inconsistent with sections 461(h), 263A and 471, and the regulations under those sections of the Code. Further, Congress rejected the deferral method for advance payments in former §1.451-5(c), which contained a cost of goods sold offset for estimated future costs. See Conf. Rep. at 429 fn. 880.

The AFS cost offset method is a method of accounting that applies to all items of income eligible for the AFS cost offset method in the trade or business. The method applies to items at the trade or business level so that taxpayers can choose to apply the method only to trades or businesses where the burden of determining costs incurred relative to the related reduction in AFS income inclusion amount warrants the adoption of the method. If a taxpayer uses the AFS cost offset method for a trade or business it must use the method for all eligible items in that trade or business. Further, if a taxpayer uses the AFS

cost offset method, it must also use the advance payment cost offset method in §1.451-8(e). The advance payment cost offset method is discussed later in this preamble. Special coordination rules exist for taxpayers that use the AFS cost offset method and the advance payment cost offset method and that have income from the sale of an item of inventory that is required to be accounted for under both §§1.451-3 and 1.451-8 because certain payments received for such item meet the definition of an advance payment under §1.451-8(a)(1). See §1.451-3(c)(1) for such coordination rules.

The AFS cost offset method reduces the amount of income from the sale of an item of inventory that is required to be accelerated under the AFS Income Inclusion Rule by an amount of incurred cost of goods related to the item. However, the offsets to interchange fees and credit card late fees recommended by the commenters are based on estimated reward costs and uncollectable late fees rather than incurred costs of goods. Accordingly, the final regulations do not allow a cost offset for interchange fees, credit card late fees, and similar items of revenue that are subject to the AFS Income Inclusion Rule and reported net of estimated future amounts for AFS purposes.

3. Proposed §1.451-3(c)(4) and (c)(6)(ii): Revenue, transaction price and increases in consideration

Proposed §1.451-3(c)(4) provides that, for the AFS Income Inclusion Rule, revenue means all transaction price amounts includible in gross income under section 61 of the Code. Proposed §1.451-3(c)(6) provides that the transaction price is the gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes in exchange for transferring goods, services, or other property, but not including, among other things, “increases in consideration” to which a taxpayer’s entitlement is contingent on the occurrence or nonoccurrence of a future event for the period in which the amount is contingent.

Commenters expressed confusion about the phrase “increases in consideration” because the definition of transaction price otherwise refers to “amounts”

and does not distinguish between increases and decreases. Commenters asserted that there is no reason to treat “increases” in consideration different from other consideration because all consideration is not realized until the taxpayer has a fixed right to payment. Commenters concluded that any portion of the contract price subject to a contractual contingency, for example, a future performance, is excluded from the transaction price until the contingency is satisfied. In addition, one commenter noted that it is unclear when there is a contingent “increase” in consideration, and taxpayers could revise the contract terms to meet this requirement.

The Treasury Department and the IRS agree with these comments. The term “increases in consideration” was meant to signal income items that are subject to a condition precedent, such as bonus payments that require complete performance before the taxpayer is entitled to the bonus payment. The final regulations have been revised to remove the reference to “increases in consideration” entirely. The concept is now subsumed by the general rule that, to determine when an item of gross income is “taken into account as AFS revenue” under the AFS Income Inclusion Rule, AFS revenue is reduced by amounts that the taxpayer does not have an enforceable right to recover if the customer were to terminate the contract at the end of the taxable year. If an amount is contingent due to a condition precedent, such as with some bonus payments, and the taxpayer would not have an enforceable right to recover such amount if the customer were to terminate the contract at the end of the taxable year, the AFS Income Inclusion Rule does not require the taxpayer to include such amount in gross income in the current year.

4. Proposed §1.451-3(c)(6)(ii): Rebuttable presumption

Proposed §1.451-3(c)(6)(ii) provides a rebuttable presumption that amounts included in revenue in an AFS 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.

Commenters requested that the final regulations remove the rebuttable presumption regarding contingent consideration. Commenters reasoned that the rebuttable presumption imposes a higher standard of proof upon taxpayers than is ordinarily required to establish that consideration is contingent. Additionally, commenters noted that basing the presumption on the treatment of the consideration for financial reporting purposes is not sensible because the financial accounting rules do not make the conclusion dependent on whether the consideration is or is not contingent on the occurrence or non-occurrence of a future event. Rather, under the Financial Accounting Standards Board (FASB) and International Accounting Standards Board,

Accounting Standards Codification (ASC) Topic 606 and International Financial Reporting Standards (IFRS) 15, *Revenue from Contracts with Customers* (collectively, ASC 606), the recognition of contingent consideration is based on a determination of the likely outcome of the contingency. Accordingly, commenters recommended that the final regulations eliminate the presumption in favor of non-contingency.

As noted earlier, the final regulations have been revised to remove the reference to “contingent consideration” entirely. The concept is now subsumed by the general rule that, to determine when an item of gross income is “taken into account as AFS revenue” under the AFS Income Inclusion Rule, AFS revenue is reduced by amounts that the taxpayer does not have an enforceable right to recover if the customer terminates the contract at the end of the taxable year. Given this change, the final regulations remove the rebuttable presumption that a taxpayer has an enforceable right to amounts included in AFS revenue.

5. Proposed §1.451-3(c)(6)(ii): Enforceable right to payment

Commenters requested that the final regulations clarify or remove the rule in proposed §1.451-3(c)(6)(ii) that treats amounts for which the taxpayer has an “enforceable right to payment” for perfor-

mance completed to date as not contingent on the occurrence or nonoccurrence of a future event. First, commenters reasoned that the rule is ambiguous, resulting in controversies with exam. Second, commenters asserted that, assuming the phrase “enforceable right to payment” is based on the financial statement rules in ASC 606, this standard effectively overrides the tax realization requirement requiring a fixed, unconditional right to payment. Further, commenters reasoned that the rule is inconsistent with the exception for increases in consideration to which a taxpayer’s entitlement is contingent on the occurrence or nonoccurrence of a future event.

The Treasury Department and the IRS agree with these comments. As discussed earlier, the final regulations modify the general AFS Income Inclusion Rule by reducing the AFS revenue that is accelerated and included in gross income. Under the AFS Income Inclusion Rule, to determine when the item of gross income is “taken into account as AFS revenue,” AFS revenue is reduced by amounts that the taxpayer does not have an “enforceable right” to recover if the customer were to terminate the contract on the last day of the taxable year. The term “enforceable right” is specifically defined in §1.451-3(a)(9) as any right that a taxpayer has under the terms of a contract or under applicable federal, state, or international law, including rights to amounts recoverable in equity or liquidated damages.

6. Proposed §1.451-3(c)(6)(iii): Reductions for amounts subject to section 461 and disputed income

Proposed §1.451-3(c)(6)(iii) provides that the “transaction price” does not include reductions for amounts subject to section 461, including amounts anticipated to be in dispute, returns, and rewards issued in credit card transactions. One commenter recommended that the final regulations clarify that rewards issued in credit card transactions are subject to section 461 and do not reduce original issue discount (OID) income in any circumstance, regardless of the structure of the credit card program. The commenter requested this clarification because taxpayers have taken different positions on the treatment of these rewards while the

IRS has taken the position that rewards do not reduce OID income. The commenter stated that the better approach is to treat these rewards as liabilities under section 461. The commenter further explained that treating these rewards as amounts subject to section 461 in all circumstances would create uniformity among credit card issuers, reduce controversy between taxpayers and the IRS, and ease the compliance burden on taxpayers by eliminating the need for a facts and circumstances analysis of each credit card program. The Treasury Department and the IRS agree with the commenter and have modified the final regulations in §1.451-3(b)(2)(i)(A)(I) to clarify that rewards issued in a credit card transaction are items subject to section 461.

Commenters also questioned whether the AFS Income Inclusion Rule modifies the treatment of income amounts subject to an actual dispute or a clerical error (disputed income amounts). The AFS Income Inclusion Rule does not modify the treatment of disputed income amounts. The principles set forth in Revenue Ruling 2003-10, 2003-1 C.B. 288, continue to apply. For example, an accrual method taxpayer does not accrue gross income in the taxable year of sale if, during the year of sale, the customer disputes its liability to the taxpayer. In addition, if an accrual method taxpayer overbills a customer due to a clerical mistake, and the customer disputes the liability in the subsequent taxable year, the taxpayer must accrue gross income in the taxable year of sale for the correct amount. Lastly, if a taxpayer ships excess quantities of goods and the customer does not dispute the shipment and agrees to pay for the excess quantities of goods, the taxpayer accrues gross income in the amount of the agreed payment in the taxable year of the sale.

In response to these comments, the final regulations clarify that, under the AFS Income Inclusion Rule, to the extent that AFS revenue was reduced for amounts anticipated to be in dispute or anticipated to be uncollectable, AFS revenue is increased by such amounts. Accordingly, although ASC 606 reduces the transaction price for anticipated disputes to determine the amount of revenue to include on an AFS, see ASC 606-10-32-6, AFS revenue is increased for amounts anticipated to be

in dispute or anticipated to be uncollectable, because those amounts are included in gross income until they are actually disputed.

C. Proposed §1.451-3(c)(5): Special method of accounting

Proposed §1.451-3(c)(5) provides a non-exhaustive list of examples of special methods of accounting to which the AFS Income Inclusion Rule generally does not apply. Commenters requested that the final regulations include the methods of accounting for notional principal contracts under §1.446-3 and the timing rules for stripped bonds under section 1286 as examples of special methods of accounting. The Treasury Department and the IRS adopt these comments in the final regulations and have added additional special methods for clarification purposes. The list of special methods of accounting remains non-exhaustive.

D. Proposed §1.451-3(d): Exceptions to the AFS Income Inclusion Rule

Proposed §1.451-3(d) describes the exceptions to the AFS Income Inclusion Rule. The proposed rule clarifies that the AFS Income Inclusion Rule does not apply unless all of the taxpayer's entire taxable year is covered by an AFS. In addition, the AFS Income Inclusion Rule does not cover items of income in connection with a mortgage servicing contract. A commenter requested that an exception be added for any amount that has not yet been realized for Federal income tax purposes. As discussed earlier, the Treasury Department and the IRS decline to adopt this suggestion because providing rules on realization is beyond the scope of these final regulations.

E. Proposed §1.451-3(g): Contracts with multiple performance obligations

1. Proposed §1.451-3(g): Allocation of transaction price to contracts with multiple performance obligations subject to section 451(b)

Proposed §1.451-3(g) provides that if a taxpayer's contract with a customer has multiple performance obligations subject

to section 451(b), transaction price is allocated to performance obligations as transaction price is allocated to performance obligations in the taxpayer's AFS.

The final regulations clarify that each performance obligation yields an item of gross income that must be accounted for separately under the AFS Income Inclusion Rule. When a contract contains multiple performance obligations, to determine the amount of gross income allocated to each performance obligation, the transaction price determined under the taxpayer's applicable accounting principles, is allocated to each corresponding item of gross income in accordance with how the transaction price is allocated to each performance obligation for AFS purposes. If the accounting standards used to prepare the AFS identify a single performance obligation that yields more than one corresponding item of gross income, the portion of the transaction price amount that is allocated to the single performance obligation for AFS purposes must be further allocated among the corresponding items of gross income using any reasonable method.

The final regulations simplify the definition of transaction price. The final regulations define the term transaction price to mean the total amount of consideration to which a taxpayer is, or expects to be, entitled from all performance obligations under a contract. The transaction price is determined under the standards the taxpayer uses to prepare its AFS. Accordingly, adjustments to the transaction price that were reflected in the transaction price definition in the proposed regulations have, to the extent relevant under these final regulations, been moved to operative rules to ensure clarity. See §1.451-3(b)(2) and (d)(3).

In addition, the final regulations clarify how the transaction price should be allocated to the extent the transaction price includes a reduction for liabilities, amounts anticipated to be in dispute or anticipated to be uncollectable, or a significant financing component that is deemed to exist under the standards the taxpayer uses to prepare its AFS. The final regulations clarify that the taxpayer must determine the specific performance obligation to which such reduction relates and increase the transaction price allocable to

the corresponding item of gross income by the amount of the reduction (specific identification approach). If it is impracticable from the taxpayer's records to use the specific identification approach, the final regulations allow taxpayers to use any reasonable method to allocate the amount to the items of gross income in the contract. The final regulations also provide that a pro-rata allocation of this amount across all items of gross income under the contract based on the relative transaction price amounts allocated to the items for AFS purposes is a reasonable method.

Similarly, the final regulations clarify how the transaction price should be allocated if the transaction price was increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS. In this situation, the taxpayer must determine the specific performance obligation to which such amount relates and decrease the transaction price amount allocable to the corresponding item of gross income by such amount (the "specific identification approach"). If it is impracticable from the taxpayer's records to use the specific identification approach, the taxpayer may use any reasonable method to allocate such amount to the items of gross income in the contract. The final regulations provide that a pro-rata allocation of such amount across all items of gross income under the contract based on the relative transaction price amounts allocated to the items for AFS purposes is a reasonable method.

2. Proposed §1.451-3(g): Contracts with income subject to §1.451-3 and income subject to a special method of accounting

In the proposed regulations, the Treasury Department and the IRS requested comments on the allocation of the transaction price for contracts that include both income subject to section 451 and income subject to a special method of accounting provision, specifically, section 460. A commenter to the proposed regulations suggested that the allocation provisions under section 460 and the regulations thereunder, and not section 451(b)(4), should control the amount of gross income from a long-term contract that is accounted for under section 460. The commenter noted that using this approach

is appropriate in light of section 451(b)(2), which reflects Congress's intent to not disturb the treatment of amounts for which the taxpayer uses a special method of accounting.

The Treasury Department and the IRS believe that a rule is necessary to address the application of section 451(b)(2) and (4) to contracts with income that is accounted for in part under §1.451-3 and in part under a special method of accounting and suggested rules for public comment in the preamble of a separate notice of proposed rulemaking published in the Federal Register on August 5, 2020 (85 FR 47508). The suggested rules provided that if an accrual method taxpayer with an AFS has a contract with a customer that includes one or more items of gross income subject to a special method of accounting (as defined in proposed §1.451-3(c)(5)) and one or more items of gross income subject to section 451, the allocation rules under section 451(b)(4) do not apply to determine the amount of each item of gross income that is accounted for under the special method of accounting provision. Rather, the taxpayer first allocates the transaction price to the item(s) of gross income subject to a special method of accounting (as determined under the special method of accounting). The remainder of the transaction price, the "residual amount", is then allocated to the items of gross income that are subject to §1.451-3. To the extent the contract contains more than one item of gross income that is subject to section 451, the residual amount would be allocated to each such item in proportion to the amounts allocated to the corresponding performance obligations for AFS purposes. The Treasury Department and the IRS requested comments on these suggested allocation rules. However, no formal comments were received regarding these suggested rules.

The final regulations largely adopt the rules suggested in the preamble to the separate notice of proposed rulemaking published in the Federal Register on August 5, 2020 (85 FR 47508). Accordingly, the final regulations provide that the transaction price allocation rule in §1.451-3(d)(1) does not apply to determine the amount of each item of gross income that is subject to a special method of accounting. Rather, the final regulations provide that the trans-

action price is first allocated to items of gross income subject to a special method of accounting, as determined under the special method of accounting. For this purpose, a special method of accounting has the meaning set forth in §1.451-3(a)(13), except as otherwise provided in guidance published in the Internal Revenue Bulletin (see §601.601(d)).

To determine the transaction price allocated to items of gross income subject to a special method of accounting, the taxpayer must first adjust the AFS transaction price by the amounts described in the final paragraph of part II.B.1 of this Summary of Comments and Explanation of Revisions. Accordingly, if the AFS transaction price includes a reduction for cost of goods sold, liabilities, amounts expected to be in dispute or anticipated to be uncollectible, or a significant financing component that exists under the standards the taxpayer uses to prepare its AFS, the taxpayer must increase the transaction price amount by the amount of such reduction. If the AFS transaction price has been increased because a significant financing component exists under the standards the taxpayer uses to prepare its AFS, the taxpayer must decrease the transaction price amount by the amount of such increase.

After the taxpayer makes the adjustments to the transaction price described earlier, the taxpayer first allocates such amount to the item(s) of gross income subject to a special method of accounting, and then allocates the remainder (residual amount) to the item(s) of gross income that are subject to §1.451-3. If the contract, contains more than one item of gross income that is subject to §1.451-3, the taxpayer allocates the residual amount to these items in proportion to the amounts allocated to the corresponding performance obligations for AFS purposes or as otherwise provided in guidance published in the Internal Revenue Bulletin (see §601.601(d)).

F. Proposed §1.451-3(i): Special ordering rule for certain items of income for debt instruments.

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 corresponding regulations. Proposed §1.451-3(i)(2) provides three examples of specified fees: credit card late fees, credit card cash advance fees, and interchange fees (specified credit card fees). Interchange fees are sometimes labeled merchant discount in certain private label credit card transactions.

Commenters requested that the final regulations provide that promotional discount, which also is sometimes labeled merchant discount, is not a specified fee. Promotional discount arises when a credit card issuer charges a fee to a merchant as compensation for accepting a below market interest rate on a credit card balance during a promotional period. Commenters explained that promotional discount is generally included in income over a promotional or similar period on a taxpayer's AFS and, despite possible alternative labeling, is, in substance, an adjustment to the yield of a debt instrument for AFS purposes. The Treasury Department and the IRS agree that any fee that adjusts the yield of a debt instrument for AFS purposes over the life of the instrument or another period should not be a specified fee. Therefore, the final regulations do not include the phrase "over the life of the instrument" in the definition of a specified fee but add the phrase "spread over a period of time" to clarify the definition. Thus, a fee that adjusts the yield of a debt instrument over a promotional or similar period for AFS purposes, such as promotional discount, is not a specified fee under the final regulations.

One commenter agreed that section 451(b) was not intended to affect the application of the general OID timing rules to OID other than for certain fees that are not treated as discount for AFS purposes, including the specified credit card fees. Accordingly, the commenter agreed with the rules in proposed §1.451-3(i) and the inclusion of the general OID timing rules as a special method of accounting. Except as provided in the preceding paragraph, the definition of specified fees in the pro-

posed regulations is adopted in the final regulations.

G. Proposed §1.451-3(k): Cumulative rule for multi-year contracts

The proposed regulations provide that for a multi-year contract, a taxpayer must take into account the cumulative amounts included in income in prior taxable years on the contract in order to determine the amount to be included for the taxable years remaining in the contract. The proposed regulations contain two examples that illustrate this rule.

The final regulations clarify that if the item of gross income from a multi-year contract is from the sale of an item of inventory and the taxpayer uses the AFS cost offset method, the taxpayer must first determine the “AFS inventory inclusion amount” for the taxable year. The taxpayer determines the AFS inventory inclusion amount for the taxable year by first taking the greater of: (1) the cumulative amount of revenue from the item of inventory that satisfies the all events test under §1.451-1(a) through the last day of the taxable year, less the portion of any advance payment received that is deferred to a subsequent taxable year under §1.451-8, if applicable, or (2) the cumulative amount of revenue from the item of inventory that is treated as taken into account as AFS revenue through the last day of the taxable year and identifies the larger of the two amounts or if the two amounts are equal, the equal amount. The taxpayer then reduces such amount by the prior year AFS inventory inclusion amount for that item of inventory, if any, to determine the AFS inventory inclusion amount for the current taxable year. Lastly, the taxpayer reduces the AFS inventory inclusion amount for the taxable year by the cost of goods in progress offset for the taxable year (which generally equals the costs of goods in progress for the item of inventory as of the end of the year less the portion of such costs that were taken into account as a cost of goods in progress offset for a prior taxable year). This net amount is the amount required to be included in gross income in the taxable year. However, in the taxable year in which ownership of the item of inventory is transferred to the customer, the taxpayer performs the same “greater of”

computation noted earlier, but rather than subtract the prior year AFS inventory inclusion amount for the item of inventory (which is gross of cost offsets) from the result of the “greater of” computation, the taxpayer subtracts all prior year gross income inclusions for the item of inventory from the result of the “greater of” computation. This net amount is the amount required to be included in gross income in the taxable year of ownership transfer. The effect of this computation is that any revenue reduced by a cost offset in a prior year is included in gross in the taxable year in which ownership of the item of inventory is transferred to the customer. Although no cost offset is permitted in such year, the taxpayer would recover costs capitalized and allocated to the item of inventory transferred as cost of goods sold in such year in accordance with sections 471 and 263A or any other applicable provision of the Code.

In the case of any other item of gross income from a multi-year contract, the taxpayer first compares the cumulative amount of the item of gross income that satisfies the all events test under §1.451-1(a) through the last day of the taxable year with the cumulative amount of revenue from the item of gross income that is treated as taken into account as AFS revenue through the last day of the taxable year and identifies the larger of the two amounts (or, if the two amounts are equal, the equal amount). The taxpayer then reduces such amount by all prior year inclusion amounts attributable to the item of gross income, if any, to determine the amount required to be included in gross income in the current taxable year. Special coordination rules for applying §1.451-8 are also provided to the extent certain payments received under a multi-year contract are advance payments. The analysis in the examples is updated to reflect the clarifications to the rule.

H. Proposed §1.1275-2(l): OID rule for income item subject to section 451(b)

Under proposed §1.1275-2(l), 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 for a debt instrument is subject to the timing rules in proposed

§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. Commenters agree with these rules and note that these rules confirm that the current treatment of items other than specified fees will not be affected by section 451(b). The commenters also note that removing specified fees, including 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 OID rules, thereby reducing taxpayer compliance burdens. Accordingly, the Treasury Department and the IRS adopt the rules in proposed §1.1275-2(l) in the final regulations.

I. Other comments

1. Burial plots and interment rights

Commenters request clarification on the treatment of income from contracts with customers for the sale of burial plots or interment rights, on a pre-need basis (pre-need contracts). The terms of the pre-need contracts typically require the customer to make an initial down payment and pay the balance of the sales price over several years. If the purchaser cancels or fails to perform under the contract before the entire purchase price is paid, commenters represent that, under every state law, the taxpayer’s sole remedy is to keep all or a portion of the installment payments previously received from the customer as liquidated damages. Commenters highlighted that there may be an extended period of time between the date the pre-need contract is executed and the date the taxpayer collects the full sales price from the customer.

Commenters represented that ASC 606 requires the entire transaction price from a pre-need contract, net of costs, to be included in revenue in the year in which the parties execute the contract. However, for Federal income tax purposes, commenters requested that the final regulations clarify that taxpayers with pre-need contracts should not include the unpaid balance

of the transaction price in income in the taxable year the contract is executed under the AFS Income Inclusion Rule. In commenters' view, the sale of a burial plot should not be treated as a completed sale for tax purposes until the entire sales price of the burial plot is paid by the customer and ownership rights in the burial plot are transferred. Further, the taxpayer does not have an enforceable right to payment for the entire transaction price of the plot if the customer cancels or fails to perform under the contract.

Commenters concluded that these taxpayers should be entitled to recover any allocable cost basis in the burial plot before including in gross income any of the installment payments received from the customer. Commenters viewed the sale of a burial plot as the sale of an interest in real property and assert that the basis recovery rules of sections 1016 and 1001 apply to prepayments for burial plots. Under this approach, prepayments for the purchase price of a burial plot before the sale of the plot first decrease the taxpayer's basis in the burial plot. See §1.1016-2(a). When the prepayments exceed the taxpayer's basis in the burial plot, the taxpayer recognizes the excess amount as gain. See §1.1001-1(c)(1). Accordingly, commenters requested that the final regulations clarify the application of sections 1001 and 1016 to the sale of pre-need burial plots.

Commenters also requested clarification on the income recognition treatment of pre-need contracts with customers for the sale of interment rights. Commenters noted that the ASC 606 treatment for pre-need contracts for the sale of interment rights resemble the treatment for pre-need contracts for the sale of burial rights. Commenters viewed the receipt of any installment payments prior to the transfer of those rights and prior to the payment of the entire transaction price to be controlled by sections 1001 and 1016, rather than by sections 451 and 471. Under this rationale, a taxpayer's treatment of the down payment and the installment payments from pre-need contracts in its AFS should not determine the timing of income for tax purposes. Instead, commenters suggested that the amounts received before the transfer of the interment rights should be viewed as a return of capital and

a reduction in the taxpayer's basis in the interment space.

The IRS and the Treasury Department agree that the sale of burial plots and interment rights are governed by sections 1001 and 1016 but consider the determination of whether a sale has occurred to be a factual issue. If a sale has occurred under the facts and circumstances, any income resulting from the sale is realized under section 1001 and the right to the income is fixed, therefore the AFS Income Inclusion Rule does not result in the acceleration of AFS revenue. If the sale has not occurred, and the right to the future payments is extinguished if the customer cancels the contract, the AFS Income Inclusion Rule does not require acceleration because there is no enforceable right to the future payments if the contract is cancelled by the customer provided that the taxpayer is not using the alternative AFS revenue method in §1.451-3(b)(2)(ii).

2. Book percentage-of-completion method (Book PCM)

One commenter expressed interest in a Book PCM option as a special method of accounting that taxpayers with contracts accounted for using an over-time method of accounting for revenue under ASC 606 could elect to include the full amount of revenue reported on its AFS without regard to any offset or exception provided in these regulations, but with an offset for the allocable costs reported on its AFS, with some potential tax adjustments. Under ASC 606, the over-time method, where taxpayers recognize revenue over time (as opposed to at a point in time) is used for the following contracts where control over promised goods or services is transferred over time: (1) where the customer controls the asset as it is created or enhanced by the entity's performance under the contract; (2) where the customer receives and consumes the benefits of the entity's performance as it performs under the contract; or (3) where the entity's performance creates or enhances an asset that has no alternative use to the entity, and the entity has the right to receive payment for work performed to date and expects to fulfill the contract as promised. An entity using an "over-time method" recognizes revenue using either: (1) an output method, which

measures the value of the goods and services transferred to date to the customer (for example, units produced); or (2) an input method, which recognizes revenue based on the entity's efforts or inputs (for example, labor hours expended, costs incurred) as compared to the expected total costs to satisfy the performance obligation.

Other commenters expressed concern about allowing a Book PCM option. Some commenters suggested that limiting a Book PCM option to only taxpayers that must report revenue on a particular over-time basis, such as an input cost-incurred method, could create more complexity, not less. Other commenters suggested that, while a Book PCM option might achieve some book-tax conformity, they would still want the opportunity to take advantage of tax rules that provide more beneficial timing than available under Book PCM, such as additional first year depreciation. The Treasury Department and the IRS will continue studying the feasibility and efficacy of an optional Book PCM approach. At this time, however, the Treasury Department and the IRS decline to adopt the Book PCM option set forth by commenters because of the concerns raised regarding the complexity and the desire by some taxpayers to obtain more beneficial timing under tax rules when using a Book PCM method.

3. AFS Issues

No formal comments were received regarding the definition of AFS in proposed §1.451-3(c)(1). Accordingly, the definition of AFS remains largely unchanged in these final regulations. See §1.451-3(a)(5). One commenter questioned the statutory language in section 451(b) regarding financial statements prepared using international financial reporting standards (IFRS). Specifically, section 451(b)(3)(B) provides that a financial statement made on the basis of IFRS is an AFS for section 451(b) if the financial statement is filed with a foreign government agency that is equivalent to the United States Securities and Exchange Commission (SEC) and has financial reporting standards not less stringent than the standards imposed by the SEC. Proposed §1.451-3(c)(1)(iii)(A) and the final regulations §1.451-3(a)

(5)(ii)(A) mirror the statutory language. The commenter questioned whether the requirement in section 451(b)(3)(B) that the financial reporting standards of a foreign agency or government be not less stringent than the standards required by the SEC, refers solely to reporting standards related to revenue or if it also refers to reporting standards for other items that are not related to revenue. The statutory language does not distinguish the reporting standards between revenue and other items that are not related to revenue. Additionally, Revenue Procedure 2004-34, which was the model for the definition of AFS in section 451(b)(3), did not have similar language. Accordingly, based on the plain language of the statute, if the financial reporting standard for any item is less stringent than SEC reporting standards, even if that standard does not relate to revenue reporting, the statement will not be an AFS under proposed §1.451-3(c)(1)(iii)(A) or §1.451-3(a)(5)(ii)(A) of the final regulations. However, the financial reporting standards relativity requirement does not prevent the IFRS financial statements from qualifying as an AFS under proposed §1.451-3(c)(1)(iii)(B) or (C) or §1.451-3(a)(5)(ii)(B) or (C) of the final regulations.

No formal comments were received regarding the AFS issues addressed in proposed §1.451-3(h)(1). Accordingly, the rules regarding an AFS that covers a group of entities (consolidated AFS rules) and mismatched reporting periods remain largely unchanged in these final regulations. However, the Treasury Department and the IRS are aware of questions regarding the application of certain aspects of the consolidated AFS rules. Under proposed §1.451-3(h)(1)(i), if a taxpayer's results are reported on the AFS for a group of entities, the taxpayer's AFS is the group's AFS. Proposed §1.451-3(h)(3) provides that 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.

Under the proposed regulations, it was unclear whether the portion of the AFS revenue allocable to the taxpayer includes amounts that are subsequently eliminated in the group's AFS (consolidated AFS). Accordingly, the final regulations clarify

that, if the consolidated AFS does not separately state items, the portion of the AFS revenue allocable to the taxpayer is determined by relying on the taxpayer's separate source documents used to create the consolidated AFS and includes amounts that are subsequently eliminated in the consolidated AFS.

III. *Comments and revisions regarding §1.451-8*

A. Proposed §1.451-8(b)(1)(i): Definition of advance payment

1. Prepayments for pre-need burial plots

Under section 451(c)(4)(A), the term advance payment means any payment that meets the following three requirements: (1) the full inclusion of the payment in gross income in the year of receipt is a permissible method of accounting; (2) any portion of the advance payment is included in revenue in an AFS for a subsequent tax year; and (3) the advance payment is for goods, services, or such other items that the Secretary has identified. Proposed §1.451-8(b)(1)(i) largely mirrors the definition of an advance payment in section 4.01 of Revenue Procedure 2004-34, which expands upon the goods, services, and other items for which a payment can qualify as an advance payment.

One commenter requested that the Secretary exercise the authority to broaden the definition of advance payment to include prepayments for the sale of an interest in real property, including pre-need burial plots. If the comment is adopted, prepayments for pre-need burial plots would be eligible for the one-year deferral of income.

Commenters agreed that taxpayers in the death care industry uniformly treat the entire amount of the sales price for pre-need burial plots as income on an AFS in the year the pre-need contract is executed. To qualify as an advance payment, a portion of the prepayment must be included in revenue by the taxpayer in an AFS for a subsequent taxable year. Section 451(c)(4)(A)(ii). Since prepayments for pre-need burial plots cannot meet this requirement, these prepayments cannot qualify as advance payments. For this reason, the Treasury Department and the IRS decline

to adopt this comment in the final regulations.

No other requests were received to expand the definition of advance payment. Accordingly, the list of items that are included in the definition of advance payment under proposed §1.451-8(b)(1)(i) is unchanged.

2. Amount of payment included in AFS revenue in a subsequent year

Under section 451(c)(4)(A) and proposed §1.451-8(a)(1)(i), for a payment to qualify as an advance payment, a portion of the payment must be included in revenue in an AFS for a subsequent tax year. The final regulations clarify that to determine the amount of the payment that is taken into account as AFS revenue, the taxpayer must adjust AFS revenue for any amounts described in §1.451-3(b)(2)(i)(A), (C), and (D). As a result, to the extent that AFS revenue in the taxable year of receipt reflects, for example, a reduction for liabilities that are required to be accounted for under provisions such as section 461 or amounts anticipated to be in dispute, AFS revenue in the taxable year of receipt must be increased by such amounts.

The final regulations make similar clarifying changes to the deferral method for taxpayers with an AFS in §1.451-8(c). Under §1.451-8(c), a taxpayer that uses the deferral method must include all or a portion of the advance payment in gross income in the taxable year of receipt to the extent "taken into account as AFS revenue" as of the end of the taxable year of receipt, and include the remaining portion of the advance payment in gross income in the following taxable year. To determine the extent that an advance payment is treated as "taken into account as AFS revenue" as of the end of the taxable year of receipt, the taxpayer must adjust AFS revenue by the amounts described in §1.451-3(b)(2)(i)(A), (C), and (D). Accordingly, to the extent that AFS revenue reflects a reduction for liabilities that are accounted for under other provisions of the Code such as section 461 or amounts anticipated to be in dispute, AFS revenue is increased by such amounts. Further, if the transaction price, as defined in §1.451-3(a)(14), was increased because a significant financing component is deemed to exist under the

standards the taxpayer uses to prepare its AFS, then any AFS revenue attributable to such increase is disregarded.

B. Proposed §1.451-8(b)(1)(ii)(H): Specified Good Exception

Proposed §1.451-8(b)(1)(ii) lists exceptions to the definition of an advance payment. Specifically, proposed §1.451-8(b)(1)(ii)(H) provides that an advance payment does not include a payment received in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery date for a specified good. Proposed §1.451-8(b)(8) defines the “contractual delivery date” as the month and year of delivery listed in the written contract to the transaction. A “specified good” is defined in proposed §1.451-8(b)(9) as a good for which: (1) the taxpayer does not have the goods of a substantially similar kind and in a sufficient quantity at the end of the taxable year the upfront payment is received; and (2) the taxpayer recognizes all of the revenue from the sale of the good in its AFS in the year of delivery. If the prepayment satisfies the specified good exception, the prepayment is analyzed under section 451(b) and §1.451-1.

1. Contractual delivery date requirement

Some commenters generally requested that the Treasury Department and the IRS re-examine the contractual delivery date requirement. One commenter requested that the definition of contractual delivery date be broadened to include contracts where the delivery date can be reasonably determined based on all the facts and circumstances as provided in the contract. Another commenter requested that the exception be modified to cover any contract for the sale or production of goods where, based on all of the facts and circumstances, it is reasonably certain that the taxpayer’s performance to which the advance payment relates will in fact take place. The same commenter also suggested that if the definition of the contractual delivery date was broadened, the requirement regarding the period of time between when an advance payment is received and the delivery date

for a specified good could be modified to require that the expected delivery date occur more than 24 months after the advance payment is received.

The Treasury Department and the IRS decline to adopt the comments to broaden the definition of contractual delivery date in the final regulations because the suggested approaches would decrease administrability and increase uncertainty for taxpayers and the potential for litigation. Therefore, the definition of contractual delivery date in the final regulations continues to be limited to situations where the written contract provides the month and year of delivery for the goods.

In addition, because the Treasury Department and the IRS are not broadening the definition of contractual delivery date, it is not necessary to limit the specified good exception to situations where there is more than 24 months between the date the advance payment is received and the contractual delivery date. The recommended rule is more restrictive than the rule in the proposed regulation which requires the payment to be received in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery date. Accordingly, the Treasury Department and the IRS decline to adopt this recommendation.

2. Requirement that AFS revenue must be recognized in the year of delivery

One commenter questioned why the specified good exception in the proposed section 451(c) regulations is restricted to situations where all the revenue from the sale of the good is recognized in the taxpayer’s AFS in the year of delivery. The commenter requested that the exception be expanded to include situations where the taxpayer recognizes the revenue for Federal income tax purposes no later than the time when the revenue related to the production of the goods is recognized for financial accounting purposes. As a result, taxpayers using the over-time method to report revenue under ASC 606 could be eligible for the exception.

Payments that qualify for the specified good exception are subject to the general accrual method of accounting rules under section 451(a) and (b), including the all

events test under section 451(b)(1)(C) and §1.451-1(a) and the existing case law that addresses the all events test. The specified good exception was narrowly crafted to allow a taxpayer meeting the requirements to evaluate its treatment of qualifying payments under the all events test under section 451(b)(1)(C) and §1.451-1(a) and the existing case law that addresses the all events test. Taxpayers that meet the specified good exception criteria, unlike those taxpayers that use the over-time method to report revenue from the sale of goods under ASC 606, are generally not required to test the payment for inclusion under the AFS income inclusion rule in section 451(b)(1)(A), as the payment is not taken into account as AFS revenue until the specified good is delivered to the customer, and is only required to analyze the payment for inclusion under the all events test in section 451(b)(1)(C). Additionally, taxpayers that use the over-time method under ASC 606 generally incur production costs as AFS revenue is recognized and can therefore benefit from the advance payment cost offset method under §1.451-8(e). However, taxpayers that use the point-in-time method to report revenue from the sale of goods under ASC 606 and that meet the rest of the specified good exception criteria generally don’t incur production costs until closer to the delivery date and may not be able to benefit from the advance payment cost offset method under §1.451-8(e). For these reasons, the Treasury Department and the IRS decline to expand the specified good exception to situations where taxpayers are using the over-time method to report revenue under ASC 606.

For this reason, the Treasury Department and the IRS do not adopt this comment. Therefore, the definition of specified good in the final regulations retains the requirement that the taxpayer recognizes all of the revenue from the sale of the good in its AFS in the year of delivery.

3. Integral services

A commenter requested that the definition of “specified good” in proposed §1.451-8(b)(8) be expanded to include “integral services” furnished for the good. However, the commenter provided

no definition of integral services, a term which could be broadly construed resulting in audit controversies. Moreover, the Conference Report expresses Congress' intent for section 451(c) to override former §1.451-5, which defined an advance payment to include prepayments for services that were integral to the sale or disposition of goods. See H.R. Rep. No. 115-466, at 429 fn. 880 (2017) (Conf. Rep.). For these reasons, the Treasury Department and the IRS decline to accept this comment.

4. Reasonable estimate of unused net operating loss (NOL)

One commenter requested that, if certain proposed changes to the specified good exception are not adopted, the Treasury Department and the IRS should include an exclusion to the definition of "advance payment" for prepayments where the taxpayer reasonably estimates, based on the facts at the time the agreement is entered into, that it will have a NOL that remains unused for the 5-year period after the year the prepayments received are included in the taxpayer's taxable income. The requested rule would be difficult to administer because it requires a taxpayer to estimate that it will have an NOL that remains unused for a 5-year period after the advance payments are included in gross income. Accordingly, the Treasury Department and the IRS decline to adopt this comment in the final regulations.

5. Tax consequences of meeting the specified good exception

Several commenters provided examples in which payments that qualify for the specified good exception in proposed §1.451-8(a)(1)(ii)(H) are deferred and included in gross income when the payment is recognized as revenue in the taxpayer's AFS in the year the good is delivered. As mentioned in part III.B.2 of this Summary of Comments and Explanation of Revisions and for additional clarification, payments that qualify for the specified good exception are subject to the general accrual method of accounting rules under section 451(a) and (b), including the all events test under section 451(b)(1)(C) and §1.451-1 and the existing case law that addresses the all events test.

6. Method to treat prepayments satisfying the specified good exception as advance payments

One commenter asked that the specified good exception be made optional, particularly if meeting the specified good exception does not result in deferral of the prepayment to match the book timing of the payment. The commenter noted that some taxpayers may prefer the section 451(c) regime, especially if there is some uncertainty whether the contract meets the specified good exception. Further, some taxpayers that had the choice of a longer deferral under §1.451-5 or a one-year deferral under Revenue Procedure 2004-34 still chose the 1-year deferral.

The Treasury Department and the IRS agree with this comment. Accordingly, the final regulations allow taxpayers to treat all prepayments that satisfy the specified good exception as advance payments subject to section 451(c), the "specified good section 451(c) method." See §1.451-8(f). The requested election provides flexibility for taxpayers. If the taxpayer does not use the specified good section 451(c) method, payments satisfying the specified good exception are not eligible for the deferral method provided in section 451(c) and §1.451-8 but are subject to section 451(b) and §1.451-1(a). If the taxpayer uses the specified good section 451(c) method, the prepayment is generally deferred for one year; however, if a taxpayer also uses the advance payment cost offset method under §1.451-8(e) to account for such prepayments, a portion of the prepayment may be deferred until the year in which ownership of the good is transferred to the customer.

The specified good section 451(c) method is a method of accounting. The method applies to all payments that satisfy the specified good exception that are received by each trade or business that uses the method. The use of this method results in the adoption of, or a change in, a method of accounting under section 446. See §1.451-8(g).

C. Proposed §1.451-8(c)(2)(i)(B): Acceleration of Advance Payments

Under proposed §1.451-8(c)(2)(i)(B), a taxpayer that uses the deferral method

generally includes an advance payment in gross income when it satisfies its obligation for the advance payment. Example 11 of proposed §1.451-8(c)(8)(xi) provides an example of a travel agent that received commission income when it purchased and delivered the ticket to the customer but did not include the commission in revenue in its AFS until the following year. The example concludes that the commission is not an advance payment because it was not earned by the taxpayer in a subsequent taxable year.

Example 11 incorrectly concludes that the payment for the commission is not an advance payment. The payment for the commission income is an advance payment because it meets the definition of an advance payment under section 451(c)(4), including the requirement that a portion of the payment is included in the taxpayer's revenue in an AFS for a subsequent taxable year. However, the commission income is included in income in the year of receipt because the taxpayer's obligation with respect to the advance payment was satisfied in that year. Accordingly, in the final regulations, this example has been moved and revised into an example of the rules on the acceleration of advance payments. In addition, the analysis has been changed to clarify that (1) the commission income is an advance payment, and (2) the taxpayer's satisfaction of its obligation for the advance payment caused the commission to be included in income in the year of receipt.

D. Proposed §1.451-8(c)(5): Contracts with Multiple Performance Obligations

Section 451(c)(4) provides that for purposes of the rules for advance payments, rules similar to the rules in section 451(b)(4), which allocate transaction price among multiple performance obligations, apply. Proposed §1.451-8(c)(5) provides rules for taxpayers with an AFS for allocating the transaction price when there is more than one performance obligation in a contract. Specifically, those taxpayers allocate the transaction price based on the method in proposed §1.451-3(g), namely, using the allocation in the taxpayer's AFS. No formal comments were received on this provision.

Under the proposed regulations it was not clear whether the taxpayer was re-

quired to allocate the payment to multiple performance obligations based on their relative transaction price or based on the payment allocation used for AFS purposes. Accordingly, the final regulations clarify that advance payments received under a contract with multiple performance obligations are allocated to the corresponding item of gross income in the same manner that the payments are allocated to the performance obligations in the taxpayer's AFS. This rule is consistent with the requirement in section 451(c)(4)(D) that "rules similar to the rules in [section 451](b)(4) shall apply," because it follows the manner in which the taxpayer allocates the payment for AFS purposes.

The rule for taxpayers without an AFS remains unchanged. See §1.451-8(d)(4).

2. Proposed §1.451-8(c)(6): Contracts with advance payments that include items subject to a special method of accounting.

The proposed regulations requested comments on the allocation of a payment when the contract includes income subject to section 451(c) and income subject to section 460, but no comments were received.

Consistent with the objective criteria standard under Section 5.02(4) of Rev. Proc. 2004-34, the final regulations provide that if (1) a contract with a customer includes item(s) of gross income subject to a special method of accounting and item(s) of gross income described in §1.451-8(a)(1)(i)(C), and (2) the taxpayer receives an allocable payment, then the taxpayer must determine the portion of the payment allocable to the items of gross income described in §1.451-8(a)(1)(i)(C) based on objective criteria. The taxpayer is deemed to satisfy the objective criteria standard when it allocates the payment to each item of gross income in proportion to the amounts determined in §1.451-3(d)(5) or as otherwise provided in guidance published in the Internal Revenue Bulletin (see §601.601(d)).

This rule is consistent with the requirement in section 451(c)(4)(D) that "rules similar to the rules in [section 451](b)(4) shall apply." The final regulations also provide a similar allocation rule for taxpayers using the non-AFS deferral method.

E. Cost offset for advance payments

The proposed regulations do not provide for a cost offset. The preamble to the proposed regulations explains the rationale for rejecting a cost offset and requests comments on this issue.

As they did with respect to the proposed section 451(b) regulations, commenters requested that the final regulations under section 451(c) provide a cost offset, such as a COGS offset for expected future costs against advance payments for the sale of goods. Commenters asserted that a COGS offset is supported by the definition of "receipt" in section 451(c)(4)(C), which refers to an "item of gross income." Under section 61 and §1.61-3(a), for the sale of goods, an item of gross income generally means total sales revenue minus the cost of goods sold. Commenters cited *Hagen Advertising Displays, Inc. v. Commissioner*, 407 F.2d 1105 (6th Cir. 1969), as support for this position. In *Hagen Advertising*, the Sixth Circuit Court of Appeals acknowledged that, to determine the proper amount of gross income for advance payments for the sale of goods to be delivered in the future, it would be appropriate for a taxpayer to reduce the amount of the advance payment by the estimated cost of the goods to be delivered. Otherwise, denying an offset for related COGS would tax the return of capital. *Id.* at 1110. Accordingly, commenters asserted that denying a COGS offset could result in an impermissible tax on gross receipts.

Commenters also asserted that not allowing a cost offset could result in a mismatch of revenue and costs and fails to clearly reflect income. According to commenters, a taxpayer would be required to report the full amount of an advance payment in income, in excess of the expected profit associated with that portion of the total contract price being reported. When the costs are actually incurred in subsequent years, the taxpayer would report losses with no associated revenue, which, in extreme cases where the losses cannot be used, could result in a permanent loss of the tax benefit of the cost. For a limited-life business, the acceleration of revenue recognition may result in NOLs that are permanently lost, as expenses trail income throughout the life cycle of the business. The commenters pointed out

that this mismatch of income and associated costs does not reflect the reality of the overall amount of gross income realized by the taxpayer on the contract as a whole.

Further, commenters reasoned that allowing a cost offset under section 451(c) will not violate the economic performance requirement of section 461(h). Since the acceleration of advance payments under section 451(c) is a departure from accrual method accounting, the costs related to the payments should also depart from accrual method concepts. Commenters pointed out that the allowance of a cost offset for expected future COGS against substantial advance payments under former §1.451-5(c), based on *Hagen Advertising*, coexisted with section 461(h) for over 33 years. In addition, the purpose of section 461(h) was not to eliminate an offset for estimated COGS for inventory to be delivered in the near future, but to defer a deduction for costs where the obligation was fixed but was going to be performed many years in the future. Here, commenters asserted that a COGS offset would help to determine the proper amount of gross income to be accelerated, which is not what the economic performance requirement was intended to prevent.

Commenters also reasoned that section 451(c) was not meant to codify all aspects of Revenue Procedure 2004-34, including the lack of a cost offset in Revenue Procedure 2004-34. Announcement 2004-48, 2004-1 C.B. 998, explains that a COGS offset was not permitted in Revenue Procedure 2004-34 because it was inconsistent with the simplification that the revenue procedure was meant to achieve, and taxpayers could still qualify for a COGS offset under former §1.451-5(c). Commenters also found it significant that the term "receipt" in section 451(c) uses the specific term "an item of gross income," while the definition of received in Revenue Procedure 2004-34 uses the general term "income."

The Treasury Department and the IRS have considered these comments and have determined that a cost offset based on estimates of future costs would be inappropriate. As discussed in the preamble to the proposed section 451(c) regulations, allowing a cost offset based on estimated costs would be inconsistent with sections 461, 263A, and 471, and the regulations

under those sections of the Code and difficult for the IRS to administer. Additionally, allowing a cost offset based on estimated costs is inconsistent with Congress' intent to override former §1.451-5(c). Former §1.451-5(c) permitted a cost offset for both incurred and estimated costs against certain advance payments that were required to be included in gross income in a taxable year prior to the year in which ownership of the item of inventory was transferred to the customer, and was recently withdrawn in final regulations published in the Federal Register on July 15, 2019. See H.R. Rep. No. 115-466, at 429 fn. 880 (2017) (Conf. Rep.); see also, 84 FR 33691 (July 15, 2019). However, the Treasury Department and the IRS agree with comments suggesting that taxpayers should be afforded the flexibility of applying an offset for costs incurred against advance payments for the future sale of inventory. In this case, the final regulations provide that a taxpayer determines the amount of the advance payment that is included in gross income for the taxable year by reducing the amount that would otherwise be included in gross income for such taxable year under the taxpayer's full inclusion method or deferral method, as applicable (advance payment inventory inclusion amount) by the cost of goods related to the item of inventory, the "cost of goods in progress offset." The method allows taxpayers to offset advance payments included in income under either the full inclusion method or under the deferral method. The portion of any advance payment that is offset by a cost of goods in progress offset for a taxable year is deferred and generally included in gross income in the taxable year in which ownership of the item of inventory is transferred to the customer.

Specifically, the final regulations provide that the cost of goods in progress offset for an item of inventory for each taxable year is calculated as the cost of goods incurred for such item through the last day of the taxable year, reduced by the cumulative cost of goods in progress offset amounts in prior taxable years, if any. However, the cost of goods in progress offset cannot reduce the advance payment inventory inclusion amount for the taxable year below zero. Further, the cost of goods

in progress offset attributable to one item of inventory cannot reduce the advance payment inventory inclusion amount attributable to a separate item of inventory. Any incurred costs that were not used to offset the advance payment for the item of inventory because they were subject to limitation are considered when the taxpayer determines the cost of goods in progress offset in a subsequent taxable year. In addition, the cost of goods in progress offset does not apply to the advance payment inventory inclusion amount that is included in gross income as a result of the acceleration rules in §1.451-8(c)(4), and any advance payments previously deferred by way of a cost of goods in progress offset in a prior year are accelerated under such rule.

The cost of goods in progress offset is determined by reference to the costs and expenditures related to items of inventory produced or acquired for resale, which costs have been incurred under section 461 and have been capitalized and included in inventory under sections 471 and 263A or any other applicable provision of the Code as of the end of the year. The taxpayer must be able to demonstrate that the costs are properly capitalizable under the Code to the items of inventory produced or acquired for resale under the contract to which the taxpayer is applying the cost of goods in progress offset. For a sale of a gift card or customer reward program points, this requirement cannot be met, and no cost of goods in progress offset is permitted. However, the cost of goods in progress offset does not reduce the costs that are capitalized to the items of inventory produced or acquired for resale by the taxpayer under the contract. That is, while the cost of goods in progress offset reduces the amount of the advance payment included in income, it does not affect how and when costs are capitalized to inventory under sections 471 and 263A or any other applicable provision of the Code or when those capitalized costs will be recovered.

The costs of goods comprising the cost of goods in progress offset must be determined by applying the taxpayer's inventory accounting methods. A taxpayer must calculate its cost of goods in progress offset by reference to all costs that the

taxpayer has permissibly capitalized and allocated to items of inventory under its method of accounting for inventories for federal income tax purposes, but may not consider costs that are not properly capitalized under such method.

The Treasury Department and the IRS provided this cost offset method in the final regulations because it provides a reasonable matching of income from advance payments and incurred cost of goods, and more clearly reflects income. The advance payment cost offset method is a method of accounting that applies to all advance payments received by a trade or business for items of inventory that satisfy the criteria in §1.451-8(e). If a taxpayer chooses to use the advance payment cost offset method for a trade or business, it must also use the AFS cost offset method in §1.451-3(c) for that trade or business. See prior discussion regarding coordination between the AFS cost offset method and the advance payment cost offset method. Additional guidance on the cost offset method for advance payments may be provided in guidance published in the Internal Revenue Bulletin (see §601.601(d)).

F. Continued application of Revenue Procedure 2004-32 and Revenue Procedure 79-38

Commenters requested clarification of whether Revenue Procedure 2004-32, 2004-1 C.B. 988, and Revenue Procedure 79-38, 1997-2 C.B. 501, remain in effect after the enactment of section 451(c). Revenue Procedure 2004-32 allows an accrual method taxpayer to account for income from credit card annual fees ratably over the period covered by the fees, as described in section 4 of Revenue Procedure 2004-32. Revenue Procedure 79-38 generally allows accrual method manufacturers, wholesalers, and retailers of motor vehicles or other durable goods to include a portion of an advance payment related to the sale of a multi-year service warranty contract in gross income over the life of the service warranty obligation. Revenue Procedure 2004-32 and Revenue Procedure 79-38 remain effective after the enactment of section 451(c) and may be relied upon after these regulations are finalized.

Effect on other documents

The preamble to proposed §1.451-3 requested comments on the proposed obsolescence of Revenue Procedure 2004-33, 2004-1 C.B. 989 (relating to credit card late fees), Revenue Procedure 2005-47, 2005-2 C.B. 269 (relating to credit card cash advance fees), Revenue Procedure 2013-26, 2013-22 I.R.B. 1160 (relating to a safe harbor method of accounting for OID on a pool of credit card receivables), and Chief Counsel Notice CC-2010-018 (relating to interchange). Instead of obsoleting Revenue Procedure 2013-26, commenters recommended limiting the scope of Revenue Procedure 2013-26 to OID that is not subject to the timing rules in proposed §1.451-3(i) and thus, not excluded from the OID rules under proposed §1.1275-2(l). Commenters explained that retaining Revenue Procedure 2013-26 would allow taxpayers to continue to use the proportional method described in the revenue procedure as a safe harbor method of accounting for certain amounts that are not OID under section 1272, such as bond premium and market discount, as well as certain kinds of OID such as promotional discount. See discussion of promotional discount in part II.F. of the Summary of Comments and Explanation of Revisions. The Treasury Department and the IRS agree with the recommendations not to obsolete Revenue Procedure 2013-26. In addition, the Treasury Department and the IRS intend to modify Revenue Procedure 2013-26 to make clear that the safe harbor method does not apply to any specified fees, including the specified credit card fees. However, based on section 451(b) and the final regulations, Revenue Procedure 2004-33, Revenue Procedure 2005-47, and Chief Counsel Notice CC-2010-018 no longer provide current guidance on the treatment of the specified credit card fees. Accordingly, these items are obsolete as of January 1, 2021.

In addition, Revenue Procedure 2004-34, Revenue Procedure 2011-18, Revenue Procedure 2013-29 and Notice 2018-35 are obsolete for taxable years beginning on or after January 1, 2021. Taxpayers that relied on the now obsoleted guidance should determine whether a change

in method of accounting occurs once they cease to use the obsoleted guidance.

Applicability dates

In general, the rules in §§1.451-3 and 1.451-8 apply for taxable years beginning on or after January 1, 2021. However, the rules in §1.451-3(j) for specified fees that are not specified credit card fees apply for taxable years beginning on or after January 6, 2022. Also, for a specified credit card fee as defined in §1.451-3(j) (2), §1.1275-2(l)(1) applies for taxable years beginning on or after January 1, 2021, and, for a specified fee that is not a specified credit card fee, §1.1275-2(l)(1) applies for taxable years beginning on or after January 6, 2022.

However, pursuant to section 7805(b) (7), taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may apply the rules in these final regulations, in their entirety and in a consistent manner, to a taxable year beginning after December 31, 2017, and before January 1, 2021, provided that, once applied to such a taxable year, such rules are applied in their entirety and in a consistent manner to all subsequent taxable years. Notwithstanding the preceding sentence, pursuant to section 7805(b)(7), taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may apply the rules in these final regulations that apply to specified credit card fees in their entirety and in a consistent manner, to a taxable year beginning after December 31, 2018, and before January 1, 2021, provided that, once applied to such a taxable year, such rules are applied in their entirety and in a consistent manner to all subsequent taxable years. Taxpayers that choose to apply the rules in the final regulations to a taxable year beginning before January 1, 2021 must follow the rules for changes in method of accounting under section 446 and the applicable procedural guidance.

Alternatively, a taxpayer may rely on the proposed regulations for taxable years beginning after December 31, 2017 (or December 31, 2018, in the case of specified credit card fees) and before January 1, 2021.

In the case of a specified fee that is not a specified credit card fee, a taxpayer may

neither choose to apply the final regulations to, nor rely on the proposed regulations for, a taxable year beginning after December 31, 2018, and before January 6, 2022.

Statement of Availability of IRS Documents

The IRS Notices, Revenue Rulings, and Revenue Procedures cited in this document 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 Analyses

I. Regulatory Planning and Review – Economic Analysis

Executive Orders 12866, 13563, and 13771 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, of reducing costs, of harmonizing rules, and of promoting flexibility. For purposes of E.O. 13771 this rule is regulatory.

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

A. Need for the Final Regulations

The Tax Cuts and Jobs Act (TCJA) substantially modified the statutory rules of section 451, which generally governs

when income is recognized for Federal tax purposes. As a result of those changes, the Treasury Department and the IRS recognized that questions were likely to arise regarding the definitions and rules that taxpayers are required to apply in calculating a business's gross income. To provide greater specificity, the Treasury Department and the IRS previously issued separate proposed regulations related to section 451(b) and 451(c) on September 9, 2019.

The proposed regulations regarding section 451(b): (1) clarify how section 451(b) applies to multi-year contracts; (2) provide rules for taxpayers whose financial results are included on an Applicable Financial Statement (AFS) covering a group of entities; (3) describe and clarify the definition of transaction price and revenue; (4) specify the allocation of a transaction price in the case of a contract which contains multiple performance obligations; and (5) specify rules for certain debt instruments.

The proposed regulations for section 451(c) describe the deferral rules for advance payments for taxpayers with and without an AFS; (2) provide acceleration rules for taxpayers that cease to exist; (3) clarify the treatment of financial statement adjustments for taxpayers with 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. They also list items excluded from the definition of an advance payment. In response to taxpayer comments received during the development of the proposed regulations, that list includes goods for which (1) the taxpayer does not have goods of a substantially similar kind and in a sufficient quantity at the end of the taxable year the upfront payment is received; and (2) the taxpayer recognizes all of the revenue from the sale of the good in its AFS in the year of delivery.

Comments were received on the proposed regulations for 451(b) and 451(c) requesting further clarification of or changes to those regulations. Based on these comments, the Treasury Department and the IRS determined that final regulations are needed to bring clarity to in-

stances where the statute may be subject to multiple interpretations in the absence of further guidance and to respond to comments received on the proposed regulations. Among other benefits, the final regulations provide greater certainty and consistency in the application of section 451 by taxpayers and the IRS.

B. Background and Overview of Final Regulations

Under section 451(a) of the 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 items 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 the amount of income can be determined with reasonable accuracy (all events test).

The timing of income recognition on a firm's financial statement may deviate from these principles. Both the U.S. generally accepted accounting principles (GAAP) and the international financial reporting standards (IFRS) provide income recognition rules that differ from tax reporting rules under certain circumstances. For example, 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. New accounting standards released by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) in 2014 further accelerated the timing of income recognition for financial reporting purposes, widening the gap between financial and tax reporting.

The timing of income recognition for tax purposes may also deviate from the all-events test in certain circumstances. For instance, 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 on the taxpayer's AFS. Such payments are referred to as "advance payments."

Prior to the enactment of TCJA on December 22, 2017, 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. Under prior law, the period over which an advance payment was deferred varied depending on the alternative regulatory treatment chosen (Revenue Procedure 2004-34 or §1.451-5) and, within §1.451-5, the type of good for which an advance payment was accepted (inventoriable goods versus non-inventoriable goods).

Under Revenue Procedure 2004-34, a taxpayer who receives an advance payment includes the advance payment in taxable income in the year of receipt to the extent that the payment is earned (if the taxpayer does not have an AFS) or, if the taxpayer has an AFS, to the extent that the payment is included in revenues in the AFS. The taxpayer includes the remaining amount of the advance payment in taxable income in the next taxable year, unless the next taxable year is a short year of 92 days or less. In the event of such a short year, the taxpayer includes in taxable income the part of the advance payment included in revenue in the AFS for the short tax year or, in the case of a taxpayer that does not have an AFS, the part of the advance payment which is earned in the short tax year. The remaining balance of the advance payment is included in income for the taxable year following the short tax year. Revenue Procedure 2004-34 applies to numerous types of advance payments beyond advance payments for the provision of services and sales of goods. For example, it applies to advance payments for the use of intellectual property and software, the occupancy or use of property if the occupancy or use is ancillary to the provision of services, guaranty or warranty contracts, subscriptions, memberships in organizations, and eligible gift card sales.

Under §1.451-5, advance payments were defined more narrowly than under

Revenue Procedure 2004-34 to include payments received by an accrual-method taxpayer for the future sale of goods held by the taxpayer in the ordinary course of trade or business and as payments for the building, installing, constructing, or manufacturing of goods by the taxpayer in a future taxable year. Such advance payments were generally included in taxable income either in the year of receipt or in the year in which the payment was properly accruable under the taxpayer's method of accounting.

An exception to this general rule occurred in the case of certain advance payments for certain goods properly held in inventory by the taxpayer. In the case of such goods, the receipt of a substantial advance payment required that all previously unrecognized advance payments be included in taxable income by the end of the second taxable year following the taxable year in which the substantial advance payment was received. The taxpayer was considered to have received a substantial advance payment if the sum of the advance payment received in the current taxable year and prior taxable years for the same contract was greater than or equal to total inventoriable costs and expenditures.

The TCJA substantially amended section 451 providing, among other things, new rules addressing deviations from the all-events test. The amended section 451(b) more closely aligns when income is recognized for Federal tax purposes with when it is recognized on businesses' financial accounting statements. In particular, section 13221 of the TCJA amends section 451(b), such that an item of gross income must be included in gross income no later than the period when the item is included in revenue on an AFS. 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). For these taxpayers, income recognition is accelerated for tax purposes when income has been recognized for financial accounting purposes before the all events test has been satisfied.

The amendments made to section 451(b) only apply to taxpayers that use accrual accounting and have an AFS.

Neither the statutory changes to 451(b) nor the final regulations regarding 451(b) change the time at which income is recognized for accrual method taxpayers without an AFS.

Section 451(c), added by the TCJA, allows accrual-method taxpayers to elect to recognize as income only a portion of 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.) The new section 451(c), a subject of the final regulations, addresses how advance payments are defined and when they need to be recognized in a business's gross income.

C. Economic Analysis

1. Baseline

In this analysis, the Treasury Department and the IRS assess the benefits and costs of the final regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these final regulations.

2. Summary of Economic Effects

The final regulations provide certainty and consistency in the application of sections 451(b) and 451(c) by providing definitions and clarifications regarding the statute's terms and rules. In the absence of the guidance provided in these final regulations, the chance 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. Similar situations may arise

under each of the provisions addressed by these regulations. Certainty and clarity over tax treatment generally also reduce compliance costs for taxpayers.

An economic loss might also arise if all taxpayers have similar interpretations under the baseline of the tax treatment of particular items of income but those interpretations differ slightly from the interpretation Congress intended for these income streams. For example, the final regulations may specify a tax treatment that few or no taxpayers would adopt in the absence of specific guidance but that nonetheless advances Congressional intent. In these cases, guidance provides value by bringing economic decisions closer in line with the intent and purpose of the statute.

While no guidance can curtail all differential or inaccurate interpretations of the statute, the final regulations significantly mitigate the chance for differential or inaccurate interpretations and thereby increase economic efficiency.

Because the final regulations clarify the tax treatment of items of gross income for certain taxpayers, there is the possibility that business decisions may change as a result of these regulations. The final regulations generally have the effect of delaying the timing of tax liability, thus reducing effective tax rates for affected taxpayers. This reduction in effective tax rates, viewed in isolation, will generally lead to an increase in economic activity by these taxpayers.

This delay in the timing of tax liability, viewed in isolation, will also decrease Federal tax revenue. A decrease in Federal tax revenue either increases the deficit or necessitates increases in other taxes or a reduction in spending. This revenue effect will be mitigated to some degree by improved economic performance (and accompanying tax revenues) under these regulations due to (i) the enhanced alignment in the timing of taxes on income and costs; (ii) the enhanced certainty and clarity provided by the final regulations as described previously; and (iii) enhanced economic activity due to lower effective tax rates for affected taxpayers.

The Treasury Department and the IRS have not estimated these effects relative

to the no-action baseline or alternative regulatory approaches because they do not have readily available data or models that measure: (i) the volume of cost offsets allowed under the final regulations;¹ (ii) the effect on economic activity by affected taxpayers from the enhanced alignment of income and costs under the final regulations relative to the no-action baseline or alternative regulatory approaches; (iii) the tax positions that taxpayers would take on other provisions of the final regulations, relative to the no-action baseline or alternative regulatory approaches; or (iv) the economic activities that taxpayers would engage in under those tax positions.

The Treasury Department and the IRS have also not made projections of any change in compliance costs arising from the final regulations, relative to the no-action baseline. Treasury generally projects that compliance costs will be lower under the final regulations relative to the no-action baseline because enhanced clarity and certainty reduce compliance costs. The Treasury Department and the IRS recognize that some taxpayers may take advantage of favorable provisions in the final regulations and that this decision could increase their compliance costs. Taxpayers would not take advantage of these provisions, however, unless the overall treatment was beneficial to the taxpayer.

The proposed regulations noted that the economic analysis of the final regulations under section 451(c) would 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 was issued between the proposed and final regulations. Since the release of the proposed regulations on September 5, 2019, no such regulatory guidance has been issued.

The proposed regulations for 451(b) and 451(c) solicited comments on the economic effects of the proposed regulations. No such comments were received.

3. Number of Affected Taxpayers

The Treasury Department and the IRS estimate that between 174,000 and 299,000 entities are likely to be affected by the final regulations.

Section 451(b) and (c) and the regulations under §1.451-3 affect only those business entities that (i) use an accrual method of accounting, and (ii) have an AFS. One provision in §1.451-8 applies to accrual method taxpayers without an AFS. Regarding the accrual method of accounting, section 13102 of TCJA modified section 448 to expand the number of taxpayers eligible to use the cash receipts and disbursements method of accounting (cash method of accounting). In general, C corporations and partnerships with a C corporation partner are now permitted to use the cash method of accounting if average annual gross receipts are \$25 million or less for taxable years beginning in 2018 (up from \$5 million or less in 2017). This amount was adjusted for inflation for taxable years beginning after December 31, 2018. The amount was \$26 million in taxable year 2019.

The statute and the regulations generally affect only those entities that also have an AFS although one provision in the regulations under §1.451-8 applies to non-AFS taxpayers. The Treasury Department and the IRS do not have readily available data to measure the prevalence of these affected entities. 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. Schedule M-3 is required to be filed only by entities with at least \$10 million of assets. This population is more likely to possess an AFS and, conversely, entities that do not file Schedule M-3 are less likely to possess an AFS or otherwise be affected by the regulations as owners and/or creditors of such smaller entities are less likely to require the entity to certify its financial results via a financial statement audit. Data are currently available only for electronic filers.

The Treasury Department and the IRS estimated the number of affected taxpayers separately for entities with gross receipts of \$26 million or less and those with gross receipts above \$26 million. For taxable year 2017, 89 percent of accrual-method entities filing Forms 1120, 1120-S, and 1065 with gross receipts of \$26 million or less were filers of electronic tax forms. About 11 percent, or 288,000 returns, included a Schedule M-3. About 40 percent of the returns with Schedule M-3, or 113,000, 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 127,000 (113,000/0.89) entities with gross receipts of \$26 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 251,000 of these entities are potentially impacted by the final regulations.

For entities with gross receipts above \$26 million and that are accrual method entities, the comparable calculations are that 95 percent of returns are e-filed and that 73 percent of those included a Schedule M-3. Based on the assumption that filers of paper tax forms have the same incidence as electronic filers and that entities that do not include a Schedule M-3 generally do not have an AFS, the Treasury Department and the IRS estimate that 47,000 (45,000/0.95) entities with gross receipts above \$26 million 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 48,000 of these entities are potentially affected by these regulations.

Together, these calculations imply that between 174,000 and 299,000 entities are potentially affected by the final regulations.

¹ Cost offsets are not reported on current tax returns and will not be separately reported on future tax returns.

² 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 2017; thousands of returns)

	Entities with gross receipts not greater than \$26 million			Entities with gross receipts greater than \$26 million		
	E-Filed	Paper-Filed	Total	E-Filed	Paper-Filed	Total
Returns	2,503	307	2,810	73	4	77
Returns with a Schedule M-3	288	35*	323*	62	3*	65*
Returns with a Schedule M-3 and an audited income statement	113	14*	127*	45	2*	47*
Returns without a Schedule M-3	2,215	272*	2,487*	11	1*	12*
Returns without a Schedule M-3, but with an audited income statement (estimated)	111**	13**	124**	1**	0**	1**
Returns with an audited income statement	224**	27**	251**	46**	2**	48**

*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 percent of returns without a Schedule M-3 have an audited income statement.

***This table does not include sole proprietorships because the number of sole proprietorships with gross receipts above \$26 million that used accrual accounting was statistically indistinguishable from zero in 2017. The number of sole proprietorships with gross receipts of \$26 million or below that are affected by these regulations is projected to be minimal.

Source: Data compiled by the IRS Research, Applied Analytics and Statistics Division using data from the Compliance Data Warehouse. The total number of accrual method returns of corporations and partnerships may differ slightly from other estimates due to different data sources.

4. Economic Effects of Provisions under Section 451(b)

a. Provisions Substantially Revised from the Proposed Section 451(b) Regulations

i. Cost offset under section 451(b)

Section 451(b) as amended by TCJA addresses the timing of revenue recognition for tax purposes but makes no mention of the timing of cost recognition. The Treasury Department and the IRS considered three options for addressing the treatment of costs under section 451(b): (i) do not allow a cost offset; (ii) allow a cost offset for incurred costs; and (iii) expand the allowance for incurred costs by further allowing a cost offset for projected costs. The proposed regulations did not provide a cost offset for the AFS income inclusion rule.

In the proposed section 451(b) regulations (in this part C.4, *proposed regulations*), the Treasury Department and the IRS argued that allowing a cost offset would be inconsistent with the economic performance rules under section 461 and inventory accounting rules under section

471. The proposed regulations further argued that Congress did not make clear any intention to alter those sections of the Code or their associated regulations. The proposed regulations stated, however, that the subject was still under consideration and requested comments addressing appropriate cost offset rules.

In response to the comments received, the Treasury Department and the IRS have decided to include in the final regulations an offset for the cost of goods in progress (cost offset). This cost offset allows taxpayers to reduce the amount of revenue from the sale of inventory that is otherwise required to be included in gross income under the AFS income inclusion rule in a taxable year prior to the year in which ownership of the inventory is transferred to the customer and defer such revenue to the taxable year in which the ownership of the inventory is transferred to the customer. The amount of such reduction, or cost offset, is determined by reference to the inventoriable costs incurred to date. The offset applies only to incurred costs, not estimated or projected costs. Further, the cost offset cannot reduce the amount of revenue that is included in gross income

under the AFS inclusion rule below zero. Any incurred costs subject to this limitation may be carried forward to determine the cost offset in subsequent taxable years.

The cost offset in the final regulations generally reduces the amount of revenue that is required to be included in gross income in a taxable year prior to the year in which ownership of inventory is transferred to the customer relative to the proposed regulations. An improved match of income and cost timing is generally held to provide a more accurate measure of economic activity and thus would lead to a more efficient tax system than under the proposed regulations, within the context of the statute and the overall Code.

This enhanced alignment in the tax treatment of revenue and costs can be expected to reduce financing costs for at least some projects and taxpayers. This reduction in financing costs relative to the proposed regulations may arise because in some cases under the proposed regulations, the inability of taxpayers to match the timing of revenue and cost associated with a project leads to a large, front-loaded tax liability, which may require a costly rebalancing of other assets, particularly for

liquidity-constrained taxpayers. Taxpayers who experience a reduction in financing costs as a result of these final regulations, relative to the proposed regulations, may, as a result, increase other expenditures, including investment. The provision of the cost offset in the final regulations may further encourage longer-run projects relative to the proposed regulations.

The Treasury Department and the IRS considered expanding the cost offset to allow for projected costs, with several possible formats for how projected costs would be accounted for. Allowing an offset for projected costs would entail a higher administrative burden than the offset (only) for incurred costs and would not definitively improve the alignment of when income and costs are recognized for tax purposes relative to the offset for incurred costs. The Treasury Department and the IRS project that under an offset for projected costs, more disputes would likely arise over the projected costs because taxpayers would have an incentive to overstate projected costs in order to delay income recognition.

The Treasury Department and the IRS have not estimated the difference in compliance costs, administrative burden, or income-cost alignment (and any subsequent effects on economic activity) between the final regulations and alternative regulatory approaches using projected costs. The Treasury Department and the IRS have not undertaken this estimation because they do not have sufficiently detailed data or models that capture possible differences in cost offset formats that use incurred costs versus projected costs.

ii. Scope of the AFS income inclusion rule

The final regulations also address concerns raised by commenters regarding recent changes to the financial accounting standards. The commenters suggested that the AFS inclusion rule is overly broad in light of these new standards, which generally accelerate AFS revenue recognition relative to the prior standards, and could cause taxpayers to incur a tax liability before they receive, or have a fixed right to receive, the money to pay the liability. Accordingly, the final regulations provide that under the AFS inclusion rule, amounts taken into account as AFS revenue include

only those amounts that the taxpayer has an enforceable right to recover if the customer were to terminate the contract at the end of the taxable year.

The final regulations further provide, however, that a taxpayer may treat any amount reported as AFS revenue as being taken into account as AFS revenue regardless of whether the taxpayer has an enforceable right to recover such amounts. The Treasury Department and the IRS project that this option will lead to reduced compliance burden, reduced administrative burden, and to fewer taxpayer disputes relative to an alternative regulatory approach under which amounts taken into account as AFS revenue include only those amounts that the taxpayer has an enforceable right to recover if the customer were to terminate the contract at the end of the taxable year. Under this “enforceable right” approach, taxpayers would be required to analyze each contract to determine amounts for which the taxpayer has an enforceable right to recover if the customer were to terminate the contract at the end of the year; this analysis would be potentially costly.

The Treasury Department and the IRS also considered an alternative regulatory approach under which taxpayers would be permitted to defer “increases” in the transactions price that are taken into account as AFS revenue in a given year but to which a taxpayer’s entitlement is contingent on a future event (contingent transaction price approach). This alternative regulatory approach was reflected in the proposed regulations. However, commenters expressed confusion as to what constitutes an “increase” in the transaction price and the types of contingencies that were intended to be included within the scope of the rule. Because of the uncertainties created by the contingent transaction price approach, and the potential for multiple interpretations, the Treasury Department and the IRS decided against this approach. The enforceable right standard adopted by the final regulations may accelerate income inclusion relative to the contingent transaction price approach, although the Treasury Department and the IRS recognize that the opposite result may hold for some taxpayers.

The Treasury Department and the IRS have not estimated the differences in income inclusion between the final regulations and this alternative regulatory ap-

proach because they do not have readily available data on the income inclusion timing differences under an enforceable right standard versus the contingent transactions price approach. Because of this lack of data, the Treasury Department and the IRS have further not estimated the difference in compliance costs between the final regulations and the alternative regulatory approach.

b. Provisions Not Substantially Revised from the Proposed Section 451(b) Regulations

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

The final 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 annual approach and (ii) a cumulative approach. Under an annual approach, for each taxable year under the contract a taxpayer would compare the amount of income taken into account as AFS revenue for that taxable year and the amount of income that meets the requirements for recognition under the all events test for that same taxable year to determine its gross income inclusion for that taxable year; that is, the taxpayer would include the larger of the two amounts. The total amount of gross income recognized under the contract through the end of such taxable year is not to exceed the total contract price.

In contrast, under a cumulative approach, in each taxable year a taxpayer would compare the cumulative amount of revenue included in its AFS up to and including that taxable year with the cumulative amount of income that meets the requirements for recognition under the all events test up to and including that taxable year. The taxpayer would then take the larger of the two amounts and reduce it for any prior taxable year income inclusions with respect to that item of gross income to determine the amount that is required to be included in gross income in the current taxable year.

The difference between the annual approach and the cumulative approach are illustrated by the following example. In 2021, D, an engineering services provider, enters into a non-severable contract with a customer to provide engineering services through 2024 for a total of \$100x. Under

the contract, D receives payments of \$25x in each calendar year of the contract. For its AFS, D reports \$50x, \$0, \$20x, and \$30x of AFS revenue from the contract for 2021, 2022, 2023, and 2024, respectively. D has an enforceable right, as defined in §1.451-3(a)

(9), to recover all amounts reported as AFS revenue through the end of a given contract year if the customer were to terminate the contract on the last day of such year. The \$25x payment received for 2023 is an advance payment, as defined in §1.451-8(a)

(1), because \$5x of the \$25x payment is reported as AFS revenue for 2024. D uses the full inclusion method for advance payments.

The accompanying table shows the treatment of gross income under the two approaches.

	2021	2022	2023	2024	Total
Payments	\$25x	\$25x	\$25x	\$25x	\$100x
AFS Revenue	\$50x	\$0x	\$20x	\$30x	\$100x
Gross Income (cumulative approach)	\$50x	\$0x	\$25x	\$25x	\$100x
Gross Income (annual approach)	\$50x	\$25x	\$25x	\$0x	\$100x

An annual 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 2022 the fact that cumulative AFS revenue of \$50x had been recognized as taxable gross income in 2021. Accordingly, the annual approach would require that an additional \$25x of income be recognized in 2022, since a payment of that amount was received in that year. In effect, an annual approach would accelerate the recognition of \$25x from 2023 to 2022 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 annual approach would be excessive relative to the cumulative approach when considered against the intent and purpose of the statute. The final regulations therefore adopt the cumulative approach.

The Treasury Department and the IRS have not estimated the difference in compliance costs, administrative burden, or economic activity between the final regulations and an alternative regulatory approach of using an annual comparison. The Treasury Department and the IRS have not undertaken this estimation because they do not have sufficiently detailed data or models that capture possible differences in taxpayers' income inclusions under these two alternative regulatory approaches.

ii. Applicable Financial Statement covering a group of entities

The final regulations provide rules for taxpayers whose financial results are in-

cluded 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 final 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 final 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 final regulations describe and clarify the definition of AFS revenue to broadly include amounts characterized as revenue in a taxpayer's AFS as well as amounts reported in other comprehensive income or retained earnings provided such amounts relate to an item of gross income that is subject to the rules under section 451(b) and (c). 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 final regulations is consistent with the current application of the all events test under §1.451-1(a) and ensures that all relevant 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. 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 final regulations implement this provision by providing a non-exhaustive list of special methods of account-

ing, and by clarifying how section 451(b) applies to certain credit card receivables. The final 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 TCJA (see Conference Report, p. 276), the final regulations provide that credit card late fees, credit card cash advance fees, and interchange fees are subject to the AFS income inclusion rule. The final regulations further specify that if these credit card fees are subject to the AFS income inclusion rule, 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 final 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.

5. Economic Effects of Provisions under 451(c)

a. Provisions Substantially Revised from the Proposed Section 451(c) Regulations

i. Cost offset for advance payments

The Treasury Department and the IRS considered three options for addressing the treatment of costs under section 451(c): (i) no cost offset; (ii) a cost offset for incurred costs; and (iii) a cost offset that further allowed for projected costs. The proposed section 451(c) regulations (in this part C.5, *proposed regulations*) did not provide for a cost offset for advanced payments. At the time, the Treasury Department and the IRS argued 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. Taxpayers commenting on the proposed regulations were concerned that the failure to provide a cost offset rule in 451(c) would cause a mismatch of income and expenses and result in the taxation of gross receipts. For example, if a business has a multi-year contract to build or manufacture a highly customized good, it would report any advance payment in income in the year of receipt or in the following taxable year. If it uses the advance payment to purchase materials and to pay workers as part of the project, it would recover those costs only when the sale takes place. Under the proposed regulations, the statute would generate a tax on the total amount of the advance payment in the first years of the contract with all related costs being recovered later in the contract.

In response to these comments on the proposed regulations, the Treasury Department and the IRS have written the final regulations to include an offset for cost of goods in progress (cost offset). This cost offset allows taxpayers to reduce the amount of an advance payment for the future sale of inventory that is required to be included in gross income in a year prior to the year in which ownership of the inventory is transferred to the customer. The amount of such reduction,

or cost offset, is equal to the inventoriable costs incurred as of the end of the taxable year in which the advance payment is required to be included in gross income under the taxpayer's method of accounting for advance payments. This provision of the final regulations allows taxpayers to offset advance payments included in income under either the full inclusion method or the deferral method. However, the cost of goods in progress offset cannot reduce the amount of the advance payment income inclusion below zero. Any incurred costs subject to this limitation may be carried forward to determine the cost of goods in progress in subsequent taxable years.

The cost offset in the final regulations generally reduces the amount of the advance payment that is required to be included in gross income in a taxable year prior to the year in which ownership of the inventory is transferred to the customer relative to the proposed regulations. An improved match of income and cost timing is generally held to provide a more accurate measure of economic activity and thus provide a more efficient tax system than under the proposed regulations. For further discussion of the economic effects of the cost offset for advance payments and for income more generally see 4.a.i.

The Treasury Department and the IRS considered expanding the cost offset to allow for projected costs, with several possible formats being considered for how projected costs would be treated. Allowing an offset for projected costs would entail a higher administrative burden than the offset for incurred costs and may not definitively improve the alignment of when income and costs are recognized for tax purposes relative to the offset for incurred costs.

The Treasury Department and the IRS have not estimated the difference in compliance costs, administrative burden, or income-cost alignment (and any subsequent effects on economic activity) between the final regulations and alternative regulatory approaches using projected costs associated with advance payments. The Treasury Department and the IRS have not undertaken this estimation because they do not have sufficiently detailed data or models that capture possible differences in cost offset formats that use incurred costs versus projected costs.

b. Provisions not Substantially Revised from the Proposed 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 and final 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.

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 final 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 the remaining amount may never be included in income, thus 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 and final regulations treat the expanded set of accelerated transactions consistently with similar types of transactions based on the timing and structure of the payments involved.

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 were upheld, taxpayers could convert an income “deferral” amount into an income “exemption” amount. To address this issue and avoid this possibility, the proposed and final 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.

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 and final 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.

v. Performance Obligations for Non-AFS Taxpayers

A performance obligation is generally 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. Further, each performance obligation in a contract generally yields a separate item of gross income. The Treasury Department and the IRS interpret the statute as requiring taxpayers to allocate payments attributable to multiple items of gross income in the same manner as such payments are allocated to the corresponding performance obligations 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 and final regulations provide allocation rules for non-AFS taxpayers consistent with a similar rule in Revenue Procedure 2004-34. That rule specifies that a payment that is attributable to multiple items of gross income is required to be allocated to such items in a manner that is based on objective criteria. The objective criteria standard will be satisfied if the allocation method is based on payments the taxpayer regularly receives for an item or items that are regularly sold or provided separately. The Treasury Depart-

ment 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 relative to the rules provided in the final regulations. While the allocation rules for AFS taxpayers and non-AFS taxpayers differ to some degree under the final regulations, the chosen provision 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.

vi. Specified Good Exception

Section 451(c) provides that certain items are excluded from the definition of an advance payment. Those items 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. This list of items excluded from the definition of an advance payment is generally comparable to the list of items excluded from the definition of an advance payment in Revenue Procedure 2004-34.

Prior to release of the proposed regulations, several commenters requested that the list of excluded items be expanded to include certain goods that require a significant amount of capital to produce and that 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 and the title and risk of loss have transferred to the customer.

To address this issue, the proposed regulations crafted a narrow specified-goods exception for taxpayers who receive advance payments but do not perform the work or deliver the good for several years in the future. Specifically, an exclusion was introduced 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 final regulations make one minor modification to the specified good exception. In response to comments, the final regulations give taxpayers the option to treat upfront payments that satisfy the criteria for the specified good exception as a typical advance payment under section 451(c). In other words, taxpayers have the option of including the advance payment in gross income under the full inclusion method or the deferral method. This flexibility in the section 451(c) regime reduces uncertainty for taxpayers who may be unsure if a contract meets the specified good exception relative to the proposed regulations. It also allows taxpayers using the 1-year deferral under Revenue Procedure 2004-34 prior to the passage of the TCJA the option to continue to do so.

The Treasury Department and the IRS considered as an alternative not using the

authority granted to the Secretary in section 451(c)(4)(B)(vii) to exclude certain payments. For manufacturers of highly customizable goods with a delivery date more than two years after the upfront payment, the one-year deferral period has the potential to increase book-tax accounting differences relative to the final regulations. For some companies, a one-year deferral period may require the creation of separate records to track advance payments for accounting and tax purposes. Thus, for these taxpayers, the final regulations may provide greater conformity between accounting (book) income and taxable income to the extent that applicable case law would defer the inclusion of income related to the specified goods exception.

II. Paperwork Reduction Act

These 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. Instead, because section 451(b) and section 451(c) and these regulations provide various methods of accounting affecting the timing of income inclusion, taxpayers without an existing method of accounting for these items may initially adopt such method without the consent of the Commissioner. However, the consent of the Commissioner under section 446(e) and the accompanying regulations is required before implementing method changes from one method to another method. See §§1.451-3(l) and 1.451-8(g). Some of the methods of accounting referenced by and discussed in these regulations are represented in the following chart.

Section	Brief Description of Method
§1.451-3(b)(2)(i)	Application of AFS income inclusion rule by making all AFS revenue adjustments
§1.451-3(b)(2)(ii)	Application of AFS income inclusion rule by making certain AFS revenue adjustments (Alternative AFS Revenue method)
§1.451-3(c)	AFS cost offset method
§1.451-3(i)(4)	Computing revenue when the AFS and taxable years are mismatched
§1.451-3(l)	Change in the method of recognizing revenue in an AFS
§1.451-8(c)	Deferral method for taxpayers with an AFS
§1.451-8(d)	Deferral method for taxpayer without an AFS
§1.451-8(e)	Advance payment cost offset method
§1.451-8(f)	Election for the specified goods exception to not apply.
§1.451-8(g)	Change in the method for recognizing advance payments on an AFS.

Taxpayers request consent to use a method in these regulations by filing Form 3115, *Application for Change in Accounting Method* (Parts I, II, IV and Schedule B). Filing of Form 3115 and any statements attached thereto (for taxpayers who are required to do so or who elect certain methods of accounting described in the regulations) is the sole collection of information requirement imposed by the statute and the regulations.

For the Paperwork Reduction Act (PRA), the reporting burden associated with the collections of information in these regulations will be reflected in the IRS Form 3115 PRA Submissions (OMB control numbers 1545-0074 for individual filers, 1545-0123 for business filers, and 1545-2070 for all other types of filers).

In 2018, the IRS released and invited comment on a draft of Form 3115 to give the public the opportunity to benefit from certain specific revisions 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. Form 3115 applies to changes of accounting methods generally and is therefore broader than section 451(b).

On November 25, 2019, the Treasury Department and the IRS published Revenue Procedure 2019-43, 2019-28 I.R.B. 1107, which updated Revenue Procedure 2018-31, and provides a global list of automatic method change procedures, including procedures for taxpayers to comply with various provisions in section

451(b) and (c) and the proposed regulations. Under the procedures, taxpayers can request permission to change to a method of accounting to comply with the various provisions in section 451(b) and (c) and the proposed regulations 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.

The current status of the PRA submissions that will be revised as a result of the information collections in these regulations is provided in the accompanying table. As described earlier, the reporting burdens associated with the information collections in these 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 filers subject to Revenue Procedure 2018-31). The overall burden estimates associated with the OMB control numbers identified later 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 these regulations. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by these 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 TCJA.

No burden estimates specific to the forms affected by these 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 these 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 TCJA and those that arise out of discretionary authority exercised in these regulations 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 these regulations, including estimates for how much time it would take to comply with the paperwork burdens described earlier 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.

Form/ Revenue Procedure	Type of Filer	OMB Number(s)	Status
Form 3115	All other Filers (mainly trusts and estates) (Legacy system)	1545-2070	Published in the Federal Register on 2/15/17. Public comment period closed on 4/17/17.
	Link: https://www.federalregister.gov/documents/2017/02/15/2017-02985/proposed-information-collection-comment-request		
	Business (NEW Model)	1545-0123	Published in the Federal Register on 10/8/18. Public comment period closed on 12/10/18.
	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		
	Individual (NEW Model)	1545-0074	Limited scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 2019.
Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031			

Form/ Revenue Procedure	Type of Filer	OMB Number(s)	Status
Revenue Procedure 2018-31	IRS Research estimates	1545-0123	Published in the Federal Register on 9/30/19. Public Comment period closed on 12/23/19.
	Link: https://www.federalregister.gov/documents/2019/10/22/2019-23009/proposed-collection-comment-request-for-rev-proc-2018-31		

III. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), 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 (small entities). This certification can be made because the Treasury Department and the IRS have determined that the regulations may affect a substantial number of small entities but have also concluded that the economic effect on small entities as a result of these regulations is not expected to be significant. Section 451(b) 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 AFS. Due to the revised financial accounting standards for calculating revenue in an AFS under ASC 606, the result of section 451(b) generally will be to move the recognition of income forward by a year or two compared to previous law. Section 451(c) provides rules regarding the treatment of advance payments. These regulations provide general

guidance on the rules, including the scope of the rules, exceptions to the rules, definitions of key terms, and examples demonstrating applicability of the rules.

The Treasury Department and the IRS have estimated the number of small business entities that may be affected by the statute and these regulations. Section 451(b) and (c) and the regulations under §1.451-3 affect only those business entities that (i) use an accrual method of accounting, and (ii) have an AFS. One provision in §1.451-8 applies to accrual method taxpayers without an AFS. The remaining provisions in §1.451-8 apply to accrual method taxpayers with an AFS.

Regarding the accrual method of accounting, section 13102 of TCJA modified section 448 to expand the number of taxpayers eligible to use the cash receipts and disbursements method of accounting (cash method of accounting). In general, C corporations and partnerships with a C corporation partner are now permitted to use the cash method of accounting if average annual gross receipts are \$25 million or less for taxable years beginning in 2018 (up from \$5 million or less in 2017).

The \$25 million figure is considered for adjustment for inflation annually. This amount was adjusted for inflation for taxable years beginning after December 31, 2018. The amount was \$26 million for taxable year 2019. The Treasury Department and the IRS estimate that approximately 3,128,000 business entities with gross receipts of \$26 million or less used an accrual method of accounting in taxable year 2017, which represents approximately 8.5 percent of all business entities with gross receipts of \$26 million or less. The Treasury Department and the IRS project that in future years, the number of entities with gross receipts not greater than \$26 million that will be using the accrual method will be less than 8.5 percent of all entities with gross receipts of \$26 million or less.

Many small business entities use the cash method of accounting, as opposed to an accrual method, and thus are not subject to these regulations. The percent of returns that use an accrual method of accounting, by entity types and for entities with gross receipts not greater than \$26 million, is shown in the accompanying table.

Total returns and returns using accrual method of accounting (Taxable year 2017)			
Entities with gross receipts not greater than \$26 million			
Entity	Total returns (thousands)	Returns using an accrual method of accounting (thousands)	Percent of returns using accrual method of accounting
C corporations	1,570	691	44
S corporations	4,684	1,146	24
Partnerships	3,884	912	23
Sole proprietors and LLCs	26,425	379	1
All entities	36,425	3,128	8.5

Source: Internal Revenue Service, RAAS, KDA

The Treasury Department and the IRS next examined the second condition, that entities with an AFS are affected by section 451(b) and the regula-

tions. The Treasury Department and the IRS do not have readily available data to measure the prevalence of entities with an AFS, as defined in the statute

and in §1.451-3(b)(1). 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, re-

ports whether an entity has a certified audited income statement. The Schedule M-3 is required to be filed only by entities with at least \$10 million of assets. This population is more likely to possess an AFS and, conversely, entities that do not file Schedule M-3 are less likely to possess an AFS as owners and/or creditors of such smaller entities are less likely to require the entity to certify its financial results via a financial statement audit. Data is currently available only for electronic filers.

For taxable year 2017, approximately 89 percent of accrual-method entities filing Forms 1120, 1120-S, and 1065 with gross receipts of \$26 million or less were filers of electronic tax forms. About 11 percent, or 288,000 returns, included a Schedule M-3. About 40 percent of the returns with Schedule M-3, or 113,000, indicated they had a certified audited income statement. 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 127,000 (113,000/0.89) entities with gross receipts of \$26 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 224,000 entities with gross receipts of \$26 million or less are potentially affected by these regulations. These estimates of affected filing entities are reproduced in the following table.

Corporation and Partnership Returns Using An Accrual Method of Accounting Taxable year 2017 (Thousands of returns)			
Entities with gross receipts not greater than \$26 million			
	E-Filed Returns	Paper-Filed Returns	Total Returns
Returns	2,503	307	2,810
Returns with a Schedule M-3	288	35*	323*
Returns with a Schedule M-3 and an audited income statement	113	14*	127*
Returns without a Schedule M-3	2,215	272*	2,487*
Returns without a Schedule M-3, but with an audited income statement	111**	13**	124**
Returns with an audited income statement	224**	27**	251**
*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 Research, Applied Analytics and Statistics KDA Division using data from the Compliance Data Warehouse. The total number of accrual method returns of corporations and partnerships differs slightly from that reported in the earlier table 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 regulations are reflected in modest reporting activities. Taxpayers needing to make method changes pursuant to these 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 (c), and plan to provide streamlined procedures for such taxpayers to change to the methods of accounting described in these regulations. Under the streamlined procedures, eligible taxpay-

ers would either complete only a portion of the Form 3115 or would not complete the Form 3115 at all to comply with the guidance. 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. In addition, contemporaneous with these regulations, the Treasury Department and the IRS are issuing a streamlined procedure 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.

The estimated cumulative annual reporting and/or recordkeeping burden for the statutory method changes relating to the streamlined procedures used to be described under OMB control number 1545-1551. In 2019, OMB number 1545-1551 was merged into OMB number 1545-0123. The estimated number of respondents, after taking into account the streamlined procedures that are being issued is 28,046 respondents, and a total annual reporting and/or recordkeeping burden of 34,279 hours. The estimated annual burden per respondent/recordkeeper under OMB control number 1545-0123 before publication of this revenue procedure var-

ies from 1/6 hour to 8½ hours, depending on individual circumstances, with an estimated average of 1½ hours. The estimated monetized burden for compliance is \$95 per hour. The estimated cumulative annual reporting and/or recordkeeping burden for the method changes described under OMB control number 1545-0123 after the revenue procedure is accounted for is 28,046 respondents, and a total annual reporting and/or recordkeeping burden is 34,279 hours. These burdens are essentially unaffected by these regulations.

Accordingly, the Secretary certifies that the rule will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), the notice of proposed rulemaking preceding this final rule was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business. No comments on the notice were received from the Chief Counsel for the Office of Advocacy of the Small Business Administration.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain 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 section, of \$100 million in 1995 dollars, update annually for inflation. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private section 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 final 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.

VI. *Congressional Review Act*

The Administrator of the Office of Information and Regulatory Affairs of the Office of Management and Budget has determined that this is a major rule for purposes of the Congressional Review Act (5 U.S.C. 801 et seq.). Under 5 U.S.C. 801(a) (3), a major rule takes effect 60 days after the rule is published in the Federal Register.

Notwithstanding this requirement, 5 U.S.C. 808(2) allows agencies to dispense with the requirements of 5 U.S.C. 801 when the agency for good cause finds that such procedure would be impracticable, unnecessary, or contrary to the public interest and the rule shall take effect at such time as the agency promulgating the rule determines. Pursuant to 5 U.S.C. 808(2), the Treasury Department and the IRS find, for good cause, that a 60-day delay in the effective date is contrary to the public interest.

Following the amendments to section 451(b) and (c) by the TCJA, the Treasury Department and the IRS published the proposed regulations to provide certainty to taxpayers. In particular, as demonstrated by the wide variety of public comments in response to the proposed regulations received, taxpayers continue to express uncertainty regarding the proper application of the statutory rules under section 451(b) and (c). This is especially the case for taxpayers in the manufacturing and retail industries producing or reselling inventorable goods because the final regulations allow such taxpayers to more clearly reflect their income for Federal income tax purposes compared to the approach of the proposed regulations. An earlier effective date will allow taxpayers to implement the final regulations earlier to take advantage of certain provisions in the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. 116-136 (March 27, 2020) that were designed to enhance liquidity, such as the 5-year net operating loss carryback provisions. Consistent with Executive Order 13924

(May 19, 2020), the Treasury Department and the IRS have therefore determined that an expedited effective date of the final regulations would more appropriately provide such critical businesses greater liquidity needed to remain open or “re-open by providing guidance on what the law requires.” 85 FR 31353-54. Accordingly, the Treasury Department and the IRS have determined that the rules in this Treasury decision will take effect on the date of filing for public inspection in the **Federal Register**.

Drafting Information

The principal author of these regulations is Jo Lynn Ricks (Office of the Associate Chief Counsel (Income Tax and Accounting)). Other personnel from the Treasury Department and the IRS, including Kate Abdo, John Aramburu, James Beatty (formerly Income Tax and Accounting), David Christensen, Alexa Dubert, Sean Dwyer, Peter Ford, Christina Glendening, Anna Gleysteen, Charlie Gorham, Evan Hewitt, William Jackson, Doug Kim, Tom McElroy, and Karla Meola, Office of the Associate Chief Counsel (Income Tax and Accounting); and William E. Blanchard, Charles Culmer, and Deepan Patel, Office of the Associate Chief Counsel (Financial Institutions and Products), participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order for §§ 1.451-3 and 1.451-8 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), (b)(3)(C) and 461(h).

Section 1.451-8 also issued under 26 U.S.C. 451(c)(2)(A), (3), (4)(A)(iii), (4)(b)(vii), and 461(h).

Par. 2. Section 1.446-1 is amended by adding a parenthetical sentence between the first and second sentences of paragraph (c)(1)(ii)(A) to read as follows:

§1.446-1 General rule for methods of accounting.

(c) ***

(1) ***

(ii) ***

(A) *** (See §1.451-1 for rules relating to the taxable year of inclusion.) ***

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 “; or” in its place, and adding paragraph (a)(2)(i)(G) to read as follows:

§1.446-2 Method of accounting for interest.

(a) ***

(2) ***

(i) ***

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

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

- Adding “(all events test)” to the end of the second sentence of paragraph (a).
- Redesignating paragraphs (b) through (g) as (d) through (i).
- Adding new paragraphs (b) and (c). The additions read as follows:

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

(b) *Timing of income inclusion for accrual method taxpayers with an applicable financial statement.* For the timing of income inclusion for taxpayers that have an applicable financial statement, as defined in §1.451-3(b)(1), and that use an accrual method of accounting, see section 451(b) and §1.451-3.

(c) *Special rule for timing of income inclusion from advance payments.* For the timing of income inclusion for taxpayers

that receive advance payments, as defined in §1.451-8(a)(1), and that use an accrual method of accounting, see section 451(c) and §1.451-8.

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) *Definitions.* The following definitions apply for this section:

(1) *AFS income inclusion amount.* The term *AFS income inclusion amount* means the amount of an item of gross income that is required to be included in gross income under the AFS income inclusion rule in paragraph (b)(1) of this section.

(2) *AFS income inclusion rule.* The term *AFS income inclusion rule* has the meaning provided in paragraph (b)(1) of this section.

(3) *AFS inventory inclusion amount.* The term *AFS inventory inclusion amount* has the meaning provided in paragraph (c)(2)(i)(A) of this section.

(4) *AFS revenue.* The term *AFS revenue* means revenue reported in the taxpayer’s AFS. The characterization of an amount in the AFS is not determinative of whether the amount is AFS revenue. For example, AFS revenue can include amounts reported as other comprehensive income or adjustments to retained earnings in an AFS. See paragraph (b) of this section for adjustments to AFS revenue that may need to be made to apply the rules of this section.

(5) *Applicable financial statement (AFS).* Subject to the rules in paragraph (a)(5)(iv) of this section, the terms *applicable financial statement* and *AFS* are synonymous and mean the taxpayer’s financial statement listed in paragraph (a)(5)(i) through (iii) of this section that has the highest priority, including priority within paragraphs (a)(5)(i)(B) and (a)(5)(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 United States 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;

(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 (IRS);

(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 financial 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;

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

(C) A financial statement, other than a tax return, filed with the Federal Government, Federal agency, a foreign government, or agency of a foreign government, other than the SEC, IRS, or an agency that is equivalent to the SEC or the IRS; 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 including, for example, a financial statement filed with a state agency that regulates insurance companies or the Financial Industry Regulatory Authority. Additional financial statements beyond those included in this paragraph (a)(5)(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 AFS revenue for a taxable year prior to the date that the taxpayer files its Federal income tax return for such taxable year, the restated

AFS must be used instead of the original AFS. If using the restated AFS revenue results in a change in method of accounting, the preceding sentence applies only if the taxpayer receives permission to change its method of accounting to use the restated AFS revenue. In addition, if a taxpayer with different financial accounting and taxable years is required to file both annual financial statements and periodic financial statements covering less than a year with a government or government agency, the taxpayer must prioritize the annual financial statement in accordance with this paragraph (a)(5).

(6) *Cost of goods.* The term *cost of goods* means the costs that are properly capitalized and included in inventory under sections 471 and 263A or any other applicable provision of the Internal Revenue Code (Code) and that are allocable to an item of inventory for which an AFS inventory inclusion amount is calculated. See paragraph (c)(5)(iii) of this section for specific rules for taxpayers using simplified methods under section 263A.

(7) *Cost of goods in progress offset.* The term *cost of goods in progress offset* has the meaning provided in paragraph (c)(3) of this section.

(8) *Cumulative cost of goods in progress offset.* The term *cumulative cost of goods in progress offset* means the cumulative cost of goods in progress offset amounts under paragraph (c) of this section for a specific item of inventory that have reduced an AFS inventory inclusion amount attributable to such item of inventory in prior taxable years.

(9) *Enforceable right.* The term *enforceable right* means any right that a taxpayer has under the terms of a contract or under applicable Federal, state, or international law, including rights to amounts recoverable in equity and liquidated damages. A contract can include, but is not limited to, a statement of work, purchase order, or invoice.

(10) *Equity method.* The term *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 proportionate share of income and losses and such income or losses are reported as

separate items on the investor's statement of income.

(11) *Performance obligation.* The term *performance obligation* means a promise in a contract with a customer to transfer to the customer a distinct good, service, or right; or a series of distinct goods, services, or rights, or a combination thereof, that are substantially the same and that have the same pattern of transfer to the customer. A performance obligation includes a promise to grant or transfer a right to use or access intangible property. Performance obligations in a contract are identified by applying the accounting standards the taxpayer uses to prepare its AFS. Additionally, to the extent the contract with the customer provides the taxpayer with an enforceable right to payment, the revenue from which is not allocated to a performance obligation described in the first two sentences of this paragraph (a)(11) in the taxpayer's AFS but is accounted for as a separate source of revenue in the taxpayer's AFS, such right shall be treated as a separate performance obligation under this section. A fee described in paragraph (j)(2) of this section is an example of an enforceable right that is treated as a separate performance obligation.

(12) *Prior income inclusion amounts.* The term *prior income inclusion amounts* means amounts of an item of gross income that were required to be included in the taxpayer's gross income under this section or §1.451-8 in prior taxable years.

(13) *Special method of accounting.* The term *special method of accounting* means a method of accounting expressly permitted or required under any provision of the Code, the regulations in this part, or other guidance published in the Internal Revenue Bulletin (see §601.601(d) of this chapter) under which the time for taking an item of gross income into account in a taxable year is not determined under the all events test in §1.451-1(a). See, however, paragraph (j) of this section relating to certain items of income for debt instruments. The term special method of accounting does not include any method of accounting expressly permitted or required under this section. The following are examples of special methods of accounting to which the AFS income inclusion rule 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 notional principal contracts under §1.446-3;

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

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

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

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

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

(ix) 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;

(x) Except as otherwise provided in paragraph (j) of this section, timing rules for original issue discount (OID) under section 811(b)(3) or 1272 (and the regulations in this part under section 1272 of the Code), 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;

(xi) 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));

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

(xiii) Timing rules for short-term obligations under sections 1281 through 1283;

(xiv) Timing rules for stripped bonds under section 1286; and

(xv) 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.

(14) *Transaction price amount.* The term *transaction price amount* means the total amount of consideration to which a taxpayer is, or expects to be, entitled from all performance obligations under a contract. The transaction price amount is de-

terminated under the standards the taxpayer uses to prepare its AFS.

(b) *AFS income inclusion rule*—(1) *In general.* Except as otherwise provided in this section, if a taxpayer uses an accrual method of accounting for Federal income tax purposes and has an AFS, the all events test under §1.451-1(a) for any item of gross income, or portion thereof, is met no later than when that item, or portion thereof, is taken into account as AFS revenue (AFS income inclusion rule). See paragraph (b)(2) of this section for rules regarding when an item of gross income, or portion thereof, is treated as *taken into account as AFS revenue* under the AFS income inclusion rule. See paragraph (c) of this section for optional rules to determine the AFS income inclusion amount for an item of gross income from the sale of inventory. See paragraph (d) of this section for rules regarding the allocation of the transaction price amount to multiple items of gross income. See paragraph (e) of this section for rules to determine the AFS income inclusion amount for an item of gross income from a multi-year contract. See paragraphs (f) and (g) of this section for limitations of the AFS income inclusion rule. See paragraph (h) of this section for special rules that may affect the determination of AFS revenue under the AFS income inclusion rule. See paragraph (j) of this section for special ordering rules for certain items of income with respect to debt instruments.

(2) *Amounts taken into account as AFS revenue*—(i) *General rule.* Unless the taxpayer uses the alternative AFS revenue method described in paragraph (b)(2)(ii) of this section, the amount of the item of gross income that is treated as *taken into account as AFS revenue* under paragraph (b)(1) of this section is determined by making adjustments to AFS revenue for the amounts described in paragraphs (b)(2)(i)(A) through (D) of this section.

(A) If AFS revenue reflects a reduction for amounts described in paragraph (b)(2)(i)(A)(I) or (2) of this section, AFS revenue is increased by the amount of the reduction.

(I) Cost of goods sold and liabilities that are required to be accounted for under other provisions of the Code such as section 461, including liabilities for allowances, rebates, chargebacks, rewards

issued in credit card transactions and other reward programs, and refunds, regardless of when any amount described in this paragraph (b)(2)(i)(A)(I) is incurred.

(2) Amounts anticipated to be in dispute or anticipated to be uncollectable.

(B) If AFS revenue includes an amount the taxpayer does not have an enforceable right to recover if the customer were to terminate the contract on the last day of the taxable year (regardless of whether the customer actually terminates the contract), AFS revenue is reduced by such amount.

(C) If the transaction price was increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, then any AFS revenue attributable to such increase is disregarded.

(D) AFS revenue may be increased or reduced by additional amounts as provided in guidance published in the Internal Revenue Bulletin (see §601.601(d) of this chapter).

(ii) *Alternative AFS revenue method.* A taxpayer that chooses to apply the AFS income inclusion rule by using the alternative AFS revenue method described in this paragraph (b)(2)(ii) in lieu of the rules in paragraph (b)(2)(i) of this section, determines the amount of the item of gross income that is treated as *taken into account as AFS revenue* under paragraph (b)(1) of this section by making adjustments to AFS revenue for only the amounts described in paragraphs (b)(2)(i)(A), (C), and (D) of this section. A taxpayer that uses the alternative AFS revenue method for a trade or business must apply the method to all items of gross income in the trade or business that are subject to the AFS income inclusion rule.

(3) *Exceptions.* The AFS income inclusion rule in paragraph (b)(1) of this section does not apply to:

(i) Any item of gross income, or portion thereof, if the timing of income inclusion for that item, or portion thereof, is determined using a special method of accounting;

(ii) Any item of gross income, or portion thereof, in connection with a mortgage servicing contract; or

(iii) Any taxable year that is not covered for the entire year by one or more AFS.

(4) *Examples.* The following examples illustrate the provisions of paragraph (b) of this section. Unless the facts specifically state otherwise, the taxpayer has an AFS, is on a calendar year for Federal income tax purposes and AFS purposes, and uses an accrual method of accounting for Federal income tax purposes. Further, the taxpayer does not use the alternative AFS revenue method under paragraph (b)(2)(ii) of this section or the AFS cost offset method under paragraph (d) of this section, and does not use a special method of accounting:

(i) *Example 1: Provision of installation services*—(A) *Facts.* In 2021, B enters into a 2-year service contract with a customer to install the customer's manufacturing equipment for \$100,000. Throughout the term of the contract, the customer retains control of the equipment. B begins providing the installation services in 2021 and completes the installation services in 2022. Under the contract, B bills the customer \$55,000 in 2021 when installation begins, but does not have a fixed right to receive the remaining \$45,000 until installation is complete and approved by the customer. However, if the customer were to terminate the contract prior to completion, B would have an enforceable right to payment for all services performed prior to the termination date. For its AFS, B reports \$60,000 of AFS revenue for 2021 and \$40,000 of AFS revenue for 2022, in accordance with the services performed in each respective year.

(B) *Analysis.* Under the all events test in §1.451-1(a), B is required to include \$55,000 in gross income in 2021 as B has a fixed right to receive \$55,000 as of the end of 2021. However, under the AFS income inclusion rule, because B has an enforceable right to recover the entire \$60,000 that was reported in AFS revenue for 2021 had the customer terminated the contract on the last day of 2021, the entire \$60,000 is treated as taken into account as AFS revenue in 2021. Accordingly, the all events test is met for the \$60,000 of gross income no later than the end of 2021 and B is required to include \$60,000 in gross income in 2021.

(ii) *Example 2: Provision of goods included in AFS with enforceable right*—(A) *Facts.* In November 2021, 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, the contract provides that C has an enforceable right to be paid for work performed to date if the customer were to terminate the contract prior to delivery. C produces and ships all of the computers in 2021. In 2022, the customer accepts delivery of the computers and C bills the customer. For its AFS, C reports \$80,000 of AFS revenue for 2021.

(B) *Analysis.* Under the all events test in §1.451-1(a), C does not have a fixed right to receive the \$80,000 until the customer accepts delivery of the computers in 2022. However, under the AFS income inclusion rule, because C has an enforceable right to recover the entire \$80,000 of AFS revenue that was reported for 2021 had the customer terminated the contract on the last day of 2021, the entire \$80,000

is treated as “taken into account as AFS revenue” in 2021. Accordingly, the all events test is met for the \$80,000 no later than in 2021 and C is required to include \$80,000 in gross income in 2021.

(iii) *Example 3: Provision of services included in AFS with enforceable right—(A) Facts.* In 2021, D, an engineering services provider, enters into a 4-year contract with a customer to provide services for a total of \$100x. Under the contract, D bills and receives \$25x for each year of the contract. If the customer were to terminate the contract prior to completion, D has an enforceable right to only the billed amounts. For its AFS, D reports \$60x, \$0, \$20x, and \$20x of AFS revenue from the contract for 2021, 2022, 2023, and 2024, respectively.

(B) *Analysis.* Under the all events test in §1.451-1(a), D is required to include \$25x in gross income in 2021 as D has a fixed right to receive \$25x as of the end of 2021. Although D reports \$60x of AFS revenue from the provision of services for 2021, D has an enforceable right to recover only \$25x if the customer were to terminate the contract on the last day of 2021. Accordingly, pursuant to paragraph (b)(2)(i)(B) of this section, of the \$60x of AFS revenue reported for 2021, only \$25x is treated as “taken into account as AFS revenue” under the AFS income inclusion rule. As a result, D is required to include only \$25x in gross income in 2021. Similarly, in 2022, 2023 and 2024, D includes in gross income only the yearly \$25x contract payments under the all events test as only the billed amounts are treated as “taken into account as AFS revenue” under the AFS income inclusion rule.

(iv) *Example 4: Sale of good under cost-plus contract—(A) Facts.* In 2021, E, a manufacturer, enters into a contract with Fire Department for the manufacture and delivery of a fire truck. The fire truck takes 10 months to manufacture at an estimated cost of \$60,000. The contract provides E with an enforceable right to recover costs incurred in manufacturing the fire truck regardless of whether the Fire Department accepts delivery of the fire truck or terminates the contract, and an enforceable right to an additional \$20,000 if the fire truck is accepted by the Fire Department. E does not have an enforceable right to recover any portion of the additional \$20,000 if the Fire Department were to terminate the contract before it accepts the fire truck. E has an obligation to cure any defects if the customer rejects the fire truck. In August 2021, E begins manufacturing the fire truck ordered by Fire Department and incurs \$30,000 of costs for materials and labor for the contract. For its AFS, E reports \$40,000 of AFS revenue for 2021 (\$30,000 costs plus \$10,000 expected profit on the sale of the fire truck).

(B) *Analysis for 2021 taxable year.* Under the all events test in §1.451-1(a), E is required to include \$30,000 in gross income in 2021 as E has a fixed right to receive \$30,000 as of the end of 2021. Although E reports \$40,000 of AFS revenue for 2021, E has an enforceable right to recover only \$30,000 if the Fire Department were to terminate the contract on the last day of 2021. Accordingly, pursuant to paragraph (b)(2)(i)(B) of this section, of the \$40,000 of AFS revenue reported for 2021, only \$30,000 is treated as “taken into account as AFS revenue” under the AFS income inclusion rule. As a result, E is

required to include only \$30,000 in gross income in 2021.

(v) *Example 5: Sale of goods with AFS revenue adjustments—(A) Facts.* In July 2021, F, a manufacturer of automobile parts, enters into a contract to sell 1,000 parts to a customer for \$10 per part, for a total of \$10,000 (1,000 x \$10). The contract also provides that F will receive a \$200 bonus if it delivers all the parts to the customer by February 1, 2022. F delivers 500 non-defective parts to the customer on December 31, 2021 and schedules the remaining 500 parts for delivery to the customer on January 1, 2022. F does not have an enforceable right to recover any portion of the \$200 bonus if the customer were to terminate the contract before all 1,000 parts are delivered. F expects to earn the \$200 bonus and have 5% of the non-defective parts returned. For its AFS, F reports \$4,850 (\$5,000 + \$100 - \$250) of AFS revenue for 2021, which includes a \$100 (50% x \$200) adjustment to increase AFS revenue for the expected bonus and a \$250 (5% x \$5,000) adjustment to decrease AFS revenue for anticipated returns.

(B) *Analysis.* Under the all events test in §1.451-1(a), F is required to include \$5,000, less the corresponding cost of goods sold under sections 263A and 471 as applicable, in gross income in 2021 as F has a fixed right to receive \$5,000 from the delivery of 500 parts to the customer in 2021. However, F does not have a fixed right to receive any portion of the \$200 delivery bonus as of the end of 2021 as the remaining 500 parts had yet to be delivered. Under the AFS income inclusion rule and, specifically, paragraphs (b)(2)(i)(A)(I) and (b)(2)(i)(B) of this section, the amount treated as “taken into account as AFS revenue” for 2021 is also \$5,000, calculated as \$4,850 of AFS revenue that was reported for 2021, decreased by \$100 for the expected delivery bonus that F does not have an enforceable right to recover if the customer were to terminate the contract as of the end of 2021 and increased by \$250 for anticipated return liabilities that are accounted for under section 461 (\$4,850 - \$100 + \$250 = \$5,000). Accordingly, F is required to include \$5,000, less the corresponding cost of goods sold determined under sections 263A and 471 as applicable, in gross income in 2021.

(vi) *Example 6: Chargebacks—(A) Facts.* In November 2021, G, a pharmaceutical manufacturer, enters into a contract to sell 1,000 units to W, a wholesaler, for \$10 per unit, totaling \$10,000 (1,000 x \$10). The contract also provides that G will credit or pay W \$4 per unit (a 40% “chargeback”) for sales W makes to certain qualifying customers. G delivers 600 units to W on December 31, 2021, and bills W \$6,000 under the contract. W does not make any sales to qualifying customers in 2021. For its AFS, G reports \$3,600 (\$6,000 - \$2,400) of AFS revenue for 2021, which includes a reduction of the \$6,000 of sales revenue by \$2,400 (40% x \$6,000) for anticipated chargebacks.

(B) *Analysis.* Under the all events test in §1.451-1(a), G is required to include \$6,000, less the corresponding cost of goods sold under sections 263A and 471 as applicable, in gross income in 2021 as G has a fixed right to receive \$6,000 from the delivery of 600 units to W in 2021. The anticipated chargebacks are liabilities that are accounted for under section 461. Under the AFS income inclusion rule and, specifi-

cally, paragraph (b)(2)(i)(A)(I) of this section, the amount treated as “taken into account as AFS revenue” for 2021 is also \$6,000, calculated as \$3,600 of AFS revenue reported for 2021, increased by \$2,400 of anticipated chargeback liabilities that are accounted for under section 461 (\$3,600 + \$2,400 = \$6,000). Accordingly, G is required to include \$6,000, less the corresponding cost of goods sold under sections 263A and 471 as applicable, in gross income in 2021.

(vii) *Example 7: Sale of property using a special method of accounting.* In 2021, H, a financial services provider, sells a building for \$100,000, payable in five annual payments of \$20,000 together with adequate stated interest, starting in 2021. For its AFS, H reports \$100,000 of AFS revenue for 2021 from the sale of the building. For Federal income tax purposes, H uses the installment method under section 453 for the sale of the building. Because the installment method under section 453 is a special method of accounting under paragraphs (a)(13)(ii) and (b)(3)(i) of this section, the AFS income inclusion rule does not apply to H’s sale of the building. Accordingly, the gain from the sale is included in income as prescribed in section 453.

(viii) *Example 8: Insurance contract renewals—(A) Facts.* J, an insurance agent, is engaged by an insurance carrier to sell insurance. Pursuant to the contract between J and the insurance carrier, J is entitled to receive a \$50 commission from the insurance carrier at the time a policy is sold to a customer. The contract also provides that J is entitled to receive an additional \$25 commission each time a policy is renewed. J does not have an enforceable right to a renewal commission if the insurance carrier terminates the contract before a policy is renewed. J sells 1,000 one-year policies in 2021, of which 800 are expected to be renewed in 2022 and 700 are expected to be renewed in 2023. J does not have any ongoing obligation to provide additional services to the insurance carrier or the customers after the initial sale of the policy. For its AFS, J reports \$87,500 of AFS revenue for 2021, which includes \$50,000 (\$50 x 1,000) of commission income for policies sold in 2021 and an estimate of \$37,500 (\$25 x 1,500) of commission income for the policies expected to be renewed in 2022 and 2023.

(B) *Analysis.* Under the all events test in §1.451-1(a), J is required to include \$50,000 in gross income in 2021 as J has a fixed right to receive \$50,000 of commission income for the policies it sold during 2021. However, as of the end of 2021, J does not have a fixed right to receive any commission income from anticipated policy renewals. Under the AFS income inclusion rule, although J reports \$87,500 of AFS revenue for 2021, J does not have an enforceable right to recover the \$37,500 of anticipated commission income from future policy renewals if the insurance carrier were to terminate the contract on the last day of 2021. Accordingly, pursuant to paragraph (b)(2)(i)(B) of this section, of the \$87,500 of AFS revenue reported for 2021, only \$50,000 is treated as “taken into account as AFS revenue” under the AFS income inclusion rule. As a result, J is required to include \$50,000 in gross income in 2021. Alternatively, if J uses the alternative AFS revenue method in paragraph (b)(2)(ii) of this section, all \$87,500 of AFS revenue reported for 2021 would be treated as “taken into account as AFS revenue” under the AFS

income inclusion rule and J would be required to include \$87,500 of commission income in gross income in 2021.

(ix) *Example 9: Escalating rents—(A) Facts.* (1) K is a landlord in the business of leasing office space.

On January 1, 2021, K enters into a 5-year lease with a tenant that provides for annual rent of \$30,000 for 2021 and increases by 5% each year over the lease term. The annual rents are due at the end of each

year. Accordingly, the rent for each year (rounded to the nearest dollar) is as follows:

Table 1 to paragraph (b)(4)(ix)(A)

Year	Calculation	Total Rent
2021	\$30,000	\$30,000
2022	\$30,000 * 1.05	\$31,500
2023	\$31,500 * 1.05	\$33,075
2024	\$33,075 * 1.05	\$34,729
2025	\$34,729 * 1.05	\$36,465
	Total Rent for Five Years	\$165,769

(2) The lease is not a section 467 rental agreement as defined under section 467(d). If the tenant terminates the lease early, the tenant must pay K the balance of the rent due for the remainder of the termination year. On its AFS, K reports AFS revenue from rents on a straight-line basis over the term of the lease, or approximately \$33,154 per year (\$165,769 total rent / 5 years). Accordingly, for its AFS, K reports \$33,154 of AFS revenue for 2021.

(B) *Analysis.* Under the all events test in §1.451-1(a), K is required to include \$30,000 in gross income in 2021 as K has a fixed right to receive \$30,000 for the 2021 rental period under the terms of the lease agreement. Under the AFS income inclusion rule, although K reports \$33,154 of AFS revenue for 2021, K has an enforceable right to recover only \$30,000 if the tenant were to cancel the lease on the last day of 2021. Accordingly, pursuant to paragraph (b)(2)(i)(B) of this section, of the \$33,154 of AFS revenue reported for 2021, only \$30,000 is treated as “taken into account in AFS revenue” under the AFS income inclusion rule. As a result, K is required to include \$30,000 in gross income in 2021.

(x) *Example 10: Licensing income from digital services—(A) Facts.* M is engaged in the business of licensing media entertainment content packages. M licenses content packages to customers by entering into subscription plans with customers. In January 2021, M enters into a two-year subscription plan with Customer. M charges Customer \$40 per month billed monthly in arrears. If Customer terminates the plan prior to the two-year term, it must pay the balance of the subscription fee for the remaining term of the contract. For its AFS, M reports \$960 (\$40 x 24 months) of AFS revenue for 2021.

(B) *Analysis.* Under the all events test in §1.451-1(a), M is required to include \$480 in gross income in 2021 as M has a fixed right to receive \$480 (\$40 x 12) for the 12 months of media content licensed to Customer in 2021. M does not have a fixed right to receive any portion of the 2022 subscription fee as of the end of 2021 as such fee is not due under the terms of the subscription agreement until 2022 and M has yet to provide the media content for the 2022 subscription period. However, under the AFS income inclusion rule, because M has an enforceable right to recover all \$960 of AFS revenue reported for 2021 if Customer were to terminate the contract at the end of 2021, all \$960 is treated as “taken into account as

AFS revenue” in 2021. Accordingly, M is required to include \$960 in gross income in 2021.

(c) *Cost offsets—(1) In general.* This paragraph (c) provides an optional method of accounting that may be used to determine the AFS income inclusion amount for an item of gross income from the sale of inventory (AFS cost offset method). A taxpayer that uses the AFS cost offset method for a trade or business must apply this method to all items of gross income in the trade or business that meet the criteria in this paragraph (c). Additionally, a taxpayer that uses this method for a trade or business must also use the advance payment cost offset method described in §1.451-8(e) to account for all advance payments received by such trade or business that meet the criteria in §1.451-8(e), if applicable. A taxpayer that uses the AFS cost offset method to account for gross income from the sale of an item of inventory, but not the advance payment cost offset method because it does not receive any advance payments for such item, determines the corresponding AFS income inclusion amount for a taxable year by following the rules in paragraph (c)(2) of this section. A taxpayer that uses the AFS cost offset method and the advance payment cost offset method to account for gross income, including advance payments, from the sale of an item of inventory, determines the corresponding AFS income inclusion amount and the advance payment income inclusion amount, as defined in §1.451-8(a)(2), for a taxable year by following the rules in paragraph (c)(2) of this section rather than the rules under §1.451-8(e). However, if all payments re-

ceived for the sale of an item of inventory meet the definition of an advance payment under §1.451-8(a)(1), a taxpayer that uses the advance payment cost offset method determines the corresponding advance payment income inclusion amount for a taxable year by following the rules in §1.451-8(e).

(2) *AFS cost offset method.* A taxpayer that uses the AFS cost offset method and, if applicable, the advance payment cost offset method, to account for gross income from the sale of an item of inventory determines the AFS income inclusion amount, or, if applicable, the advance payment income inclusion amount, for a taxable year prior to the taxable year in which ownership of the item of inventory is transferred to the customer by following the rules in paragraph (c)(2)(i) of this section, subject to the additional rules and limitations in paragraphs (c)(4) through (6) of this section. Such taxpayer determines the AFS income inclusion amount or, if applicable, the advance payment income inclusion amount, for the taxable year in which ownership of the item of inventory is transferred to the customer by following the rules in paragraph (c)(2)(ii) of this section. A taxpayer described in this paragraph (c)(2) that receives advance payments for the sale of the item of inventory may be required to include in gross income for a taxable year an amount that is comprised of both an AFS income inclusion amount and an advance payment income inclusion amount. In such case, it is not necessary to determine the portion of the total inclusion that is comprised of the AFS income inclusion amount and the portion

of the total inclusion that is comprised of the advance payment income inclusion amount.

(i) *Determining gross income for a year prior to the year of sale.* To determine the amount required to be included in gross income from the sale of an item of inventory for a taxable year prior to the taxable year in which ownership of the item of inventory is transferred to the customer, a taxpayer must first determine the AFS inventory inclusion amount for such item for such year by applying the steps in paragraph (c)(2)(i)(A) of this section. This AFS inventory inclusion amount is then reduced by the cost of goods in progress offset for the taxable year, as determined under paragraphs (c)(3) through (5) of this section. This net amount is required to be included in gross income for the taxable year.

(A) *AFS inventory inclusion amount for a taxable year.* To determine the AFS inventory inclusion amount for an item of inventory for a taxable year:

(1) The taxpayer first takes the greater of the amount described in paragraph (c)(2)(i)(A)(1)(i) of this section, or the amount described in paragraph (c)(2)(i)(A)(1)(ii) of this section (or if the two amounts are equal, the equal amount).

(i) The cumulative amount of revenue from the item of inventory that satisfies the all events test under §1.451-1(a) through the last day of the taxable year, less any advance payment inventory inclusion amount, as defined in §1.451-8(a)(3), with respect to a subsequent taxable year.

(ii) The cumulative amount of revenue from the item of inventory that is treated as “taken into account as AFS revenue” under paragraph (b)(2) of this section through the last day of the taxable year.

(2) The taxpayer then reduces the amount determined under paragraph (c)(2)(i)(A)(1) of this section by the amount computed under paragraph (c)(2)(i)(A)(1) of this section for that item of inventory for the immediately preceding taxable year.

(B) [Reserved]

(ii) *Determining the gross income for the year of sale.* To determine the amount required to be included in gross income from the sale of an item of inventory for the taxable year in which ownership of

the item of inventory is transferred to the customer:

(A) The taxpayer first takes the greater of the amount described in paragraph (c)(2)(ii)(A)(1) of this section, or the amount described in paragraph (c)(2)(ii)(A)(2) of this section (or if the two amounts are equal, the equal amount).

(1) The cumulative amount of revenue from the item of inventory that satisfies the all events test under §1.451-1(a) through the last day of the taxable year, including the full amount of any advance payment received for the item of inventory.

(2) The cumulative amount of revenue from the item of inventory that is treated as “taken into account as AFS revenue” under paragraph (b)(2) of this section through the last day of the taxable year.

(B) The taxpayer then reduces such amount by any prior income inclusion amounts with respect to such item of inventory. This net amount is required to be included in gross income for the taxable year. The taxpayer does not further reduce such amount by a cost of goods in progress offset under paragraph (c)(3) of this section. However, the taxpayer is entitled to recover the costs capitalized to the item of inventory as cost of goods sold in accordance with sections 471 and 263A or any other applicable provision of the Internal Revenue Code. See §1.61-3.

(3) *Cost of goods in progress offset for a taxable year.* The cost of goods in progress offset for the taxable year is calculated as:

(i) The cost of goods allocable to the item of inventory through the last day of the taxable year; reduced by

(ii) The cumulative cost of goods in progress offset attributable to the item of inventory, if any.

(4) *Limitations to the cost of goods in progress offset.* The cost of goods in progress offset is determined separately for each item of inventory. Further, the cost of goods in progress offset attributable to one item of inventory cannot reduce the AFS inventory inclusion amount attributable to a separate item of inventory. The cost of goods in progress offset cannot reduce the AFS inventory inclusion amount for the taxable year below zero.

(5) *Inventory methods*—(i) *Inventory costs not affected by cost of goods in progress offset.* The cost of goods comprising

the cost of goods in progress offset does not reduce the costs that are capitalized to the items of inventory produced or items of inventory acquired for resale by the taxpayer. While the cost of goods in progress offset reduces the AFS inventory inclusion amount, the cost of goods in progress offset does not affect how and when costs are capitalized to inventory under sections 471 and 263A or any other applicable provision of the Internal Revenue Code or when those capitalized costs will be recovered.

(ii) *Consistency between inventory methods and AFS cost offset method.* The costs of goods comprising the cost of goods in progress offset must be determined by applying the taxpayer’s method of accounting for inventory for Federal income tax purposes. A taxpayer using the AFS cost offset method and, if applicable, the advance payment cost offset method must calculate its cost of goods in progress offset by reference to all costs that the taxpayer has permissibly capitalized and allocated to items of inventory under its method of accounting for inventory for Federal income tax purposes, but including no more costs than what the taxpayer has permissibly capitalized and allocated to items of inventory.

(iii) *Allocation of “additional section 263A costs” for taxpayers using simplified methods.* If a taxpayer uses the simplified production method as defined under §1.263A-2(b), the modified simplified production method as defined under §1.263A-2(c), or the simplified resale method as defined under §1.263A-3(d) to determine the amount of its *additional section 263A costs*, as defined under §1.263A-1(d)(3), to be included in ending inventory, then solely to compute the cost of goods in progress offset, the taxpayer must determine the portion of additional section 263A costs allocable to an item of inventory by multiplying its total additional section 263A costs accounted for under the simplified method for all items of inventory subject to the simplified method by the following ratio:

Section 471 costs allocable to the specific item of inventory

Total section 471 costs for all items of inventory subject to the simplified method

(6) *Acceleration of gross income.* A taxpayer that uses the AFS cost offset

method or the advance payment cost offset method must include in gross income for a taxable year prior to the taxable year in which an item of inventory is transferred to the customer, all payments received for the item of inventory that were not previously included in gross income:

(i) 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

(ii) If, and to the extent that, in that taxable year, the taxpayer's obligation to the customer with respect to the item of inventory ends other than in:

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

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

(1) Substantially all assets of the trade or business, including the item of inventory, are transferred;

(2) The transferee adopts or uses, in the year of the transfer, the same methods of accounting for the item of inventory under this section and § 1.451-8 as those used by the transferor; and

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

(7) *Additional procedural guidance.* The IRS may publish procedural guidance in the Internal Revenue Bulletin (see § 601.601(d) of this chapter) that provides alternative procedures for complying with the rules under this paragraph (c), including alternative methods of accounting for cost offsets.

(8) *Examples.* The following examples illustrate the AFS cost offset method. Unless the facts specifically state otherwise, the taxpayer has an AFS, is on a calendar year for both Federal income tax purposes and AFS purposes, uses an accrual method of accounting for Federal income tax purposes, and does not use a special method of accounting. Further, the taxpayer properly applies its inventory accounting method, uses the AFS cost offset method under paragraph (c) of this section, and, except as otherwise provided, does not receive advance payments. Lastly, the taxpayer does not produce unique items, as described in § 1.460-2(a)(1) and (b), or any item that normally requires more than 12 calendar months to complete, as determined under § 1.460-2(a)(2) and (c). Any

production period that exceeds 12 calendar months is due to unforeseen production delays.

(i) *Example 1—(A) Facts.* During 2021, A enters into a contract with Customer to manufacture and deliver a good with a total contract price of \$100x. The costs to produce the good are required to be capitalized under sections 471 and 263A as the good is transferred from A to Customer upon its delivery in 2022. A determines, under paragraph (c)(2)(i)(A) of this section, that its AFS inventory inclusion amount for 2021 is \$20x. A incurs \$12x of costs in 2021, and \$48x of costs in 2022 (\$60x in total) that are permissibly capitalized and allocated to the produced good under sections 471 and 263A. A has a fixed right to receive the \$100x contract price when it delivers the good in 2022. A does not receive any payments from Customer prior to delivery. Further, all \$100x is treated as “taken into account as AFS revenue” as of the last day of 2022.

(B) *Analysis for 2021.* For 2021, A's AFS income inclusion amount, as determined under paragraph (c)(2)(i) of this section, is \$8x (\$20x AFS inventory inclusion amount less \$12x cost of goods in progress offset, which is the cost of goods incurred through December 31, 2021).

(C) *Analysis for 2022.* During 2022, ownership of the good is transferred to Customer. Accordingly, pursuant to paragraph (c)(2)(ii) of this section, A determines the AFS income inclusion amount for 2022 by:

(1) First taking the greater of:

(i) The cumulative amount of revenue that satisfies the all events test under § 1.451-1(a) through the last day of 2022 (\$100x); or

(ii) The cumulative amount of revenue that is treated as “taken into account as AFS revenue” through the last day of 2022 (\$100x) (or if the two amounts are equal, the equal amount).

(2) Then subtracting from such amount (\$100x) the prior income inclusion amounts attributable to the transferred good (\$8x). This net amount of \$92x is the AFS income inclusion amount for 2022. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the \$60x of costs capitalized to the good as cost of goods sold in 2022 in accordance with sections 471 and 263A. See § 1.61-3. Accordingly, A's gross income for 2022 is \$32x.

(ii) *Example 2—(A) Facts.* In December of 2021, A enters into a contract with Customer to manufacture and deliver 10 items of inventory at a price of \$10x per item by the end of 2023. A determines, under paragraph (c)(2)(i)(A) of this section, that the AFS inventory inclusion amount attributable to each item of inventory under the contract is \$3x for 2021. A also incurs \$10x of inventory costs during 2021. Such costs are permissibly capitalized and allocated under sections 471 and 263A and are allocated equally to each item of inventory under the contract (\$1x per item). During 2022, the taxpayer incurs \$18x of costs to finish manufacturing 6 of the 10 items and delivers such items to Customer in October of 2022. Such costs are permissibly capitalized and allocated under sections 471 and 263A and are allocated equally to each of the 6 items delivered in October of 2022 (\$3x per item). Upon

delivering the 6 items, ownership of the delivered items transfers to Customer, A has a fixed right to receive \$60x of the total contract price, and all \$60x is treated as “taken into account as AFS revenue.” A does not incur any inventory costs during 2022 that are allocable to the 4 remaining undelivered items, nor does the taxpayer have an AFS inventory inclusion amount attributable to such items for 2022. During 2023, A incurs \$12x of costs to finish manufacturing the 4 remaining items and delivers such items to Customer. Such costs are permissibly capitalized and allocated under sections 471 and 263A and are allocated equally to each of the 4 items delivered in 2023 (\$3x per item). Upon delivering the 4 remaining items, ownership of the items transfers to Customer, A has a fixed right to receive the remaining \$40x contract price, and all \$40x is treated as “taken into account as AFS revenue.”

(B) *Analysis for 2021* A's AFS income inclusion amount for 2021 is \$2x per item (\$3x AFS inventory inclusion amount per item less \$1x cost of goods in progress offset per item, which is the cost of goods as of December 31, 2021). Accordingly, A's total gross income inclusion for 2021 is \$20x.

(C) *Analysis for 2022.* During 2022, ownership of 6 of the 10 items is transferred to Customer. Accordingly, pursuant to paragraph (c)(2)(ii) of this section, A determines the AFS income inclusion amount for 2022 by:

(1) First taking the greater of:

(i) The cumulative amount of revenue that satisfies the all events test under § 1.451-1(a) through the last day of 2022 (\$10x per item); or

(ii) The cumulative amount of revenue that is treated as taken into account as AFS revenue through the last day of 2022 (\$10x per item) (or if the two amounts are equal, the equal amount).

(2) Then subtracting from such amount (\$10x per item) the prior income inclusion amounts attributable to each transferred item (\$2x per item). This net amount of \$8x per item is the AFS income inclusion amount for each transferred item for 2022. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the \$4x of costs capitalized to each item delivered as cost of goods sold in 2022 in accordance with sections 471 and 263A. Accordingly, on an aggregate basis, A's gross income for 2022 is \$24x (aggregate AFS income inclusion amount for the 6 items delivered in 2022 of \$ 48x less aggregate cost of goods sold of \$24x). A does not include any amounts in gross income for 2022 with respect to the 4 items of inventory that were not delivered to Customer until 2023 as A does not have an AFS inventory inclusion amount attributable to such items for 2022.

(D) *Analysis for 2023.* During 2023, ownership of the 4 remaining items are transferred to Customer. Based on the facts, A did not have an AFS inventory inclusion amount attributable to the 4 remaining items for 2022, nor did it incur any cost for such items in 2022 so the analysis for the 4 remaining items for 2023 is similar to the analysis for the 6 items transferred to the customer in 2022 on a per item basis. Pursuant to paragraph (c)(2)(ii) of this section, A determines the AFS income inclusion amount for 2023 by:

(1) First taking the greater of:

(i) The cumulative amount of revenue that satisfies the all events test under §1.451-1(a) through the last day of 2023 (\$10x per item); or

(ii) The cumulative amount of revenue that is treated as taken into account as AFS revenue through the last day of 2023 (\$10x per item) (or if the two amounts are equal, the equal amount).

(2) Then subtracting from such amount (\$10x per item) the prior income inclusion amounts attributable to each transferred item (\$2x per item). This net amount of \$8x per item is the AFS income inclusion amount for each transferred item for 2023. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the \$4x of costs capitalized to each item delivered as cost of goods sold in 2023 in accordance with sections 471 and 263A. On an aggregate basis, A's gross income for 2023 is \$16x (aggregate AFS income inclusion amount for the 4 items delivered in 2023 of \$32x less aggregate cost of goods sold of \$16x).

(iii) *Example 3—(A) Facts.* In December of 2021, A enters into a contract with Customer to manufacture and deliver a good with a total contract price of \$100x. The costs to produce the good are required to be capitalized under sections 471 and 263A as the good is inventory in the hands of the taxpayer. Ownership of the good is transferred from A to Customer upon its delivery in January of 2023. A determines, under paragraph (c)(2)(i)(A) of this section, that its AFS inventory inclusion amount for 2021 and 2022 is \$40x per year. A incurs \$25x of costs each year (\$75x in total) that are permissibly capitalized and allocated to the manufactured good under sections 471 and 263A. A has a fixed right to receive the \$100x contract price when it delivers the good in January of 2023. A does not receive any payments from Customer prior to delivery. Further, all \$100x is treated as “taken into account as AFS revenue” as of the last day of 2023.

(B) *Analysis for 2021 and 2022.* For 2021, A's AFS income inclusion amount, as determined under paragraph (c)(2)(i) of this section, is \$15x (\$40x AFS inventory inclusion amount for 2021 less the \$25x cost of goods in progress offset for 2021, which is equal to the cost of goods as of December 31, 2021). For 2022, A's AFS income inclusion amount is \$15x (\$40x AFS inventory inclusion amount for 2022 less the \$25x cost of goods in progress offset for 2022, which is the \$50x cost of goods as of December 31, 2022 less the 25x cumulative cost of goods in progress offset amount taken into account in 2021).

(C) *Analysis for 2023.* During 2023, ownership of the good is transferred to Customer. Accordingly, pursuant to paragraph (c)(2)(ii) of this section, A determines the AFS income inclusion amount for 2023 by:

(I) First taking the greater of:

(i) The cumulative amount of revenue that satisfies the all events test under §1.451-1(a) through the last day of 2023 (\$100x); or

(ii) The cumulative amount of revenue that is treated as “taken into account as AFS revenue” through the last day of 2023 (\$100x) (or if the two amounts are equal, the equal amount).

(2) Then subtracting from such amount (\$100x) the prior income inclusion amounts attributable to the transferred good of \$30x (\$15x for 2021 and

\$15x for 2022). This net amount of \$70x is the AFS income inclusion amount for 2023. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the \$75x of costs capitalized to the good as cost of goods sold in 2023 in accordance with sections 471 and 263A. See §1.61-3. Accordingly, A's gross income for 2023 is -\$5x.

(iv) *Example 4—(A) Facts.* In December 2021, A enters into a contract with Customer to manufacture and deliver a good with a total contract price of \$100x. A reports \$5x of AFS revenue for 2021, \$90x of cumulative AFS revenue through the end of 2022, and \$100x of cumulative AFS revenue through the end of 2023. A has an enforceable right to recover all AFS revenue reported through the end of each contract year if Customer were to terminate the contract on the last day of each year. Under the terms of the contract, A is entitled to and receives a payment of \$40x in 2021 and a payment of \$60x when Customer accepts delivery of the good in 2023, which is also when ownership of the good transfers to Customer. The costs to produce the good are required to be capitalized under sections 471 and 263A as the good is inventory in the hands of A. A incurs \$10x of costs in 2021, \$55x of costs in 2022, and \$5x of costs in 2023 (\$70x in total). Such costs are permissibly capitalized and allocated to the produced good under sections 471 and 263A. A uses the AFS cost offset method under paragraph (c) of this section and accounts for advance payments, as defined in §1.451-8(a)(1), under the deferral method and advance payment cost offset method under §1.451-8(c) and (e), respectively.

(B) *Analysis for 2021.* The \$40x payment A receives in 2021 meets the definition of an advance payment under §1.451-8(a)(1) as the full inclusion of \$40x in gross income in the year of receipt is a permissible method of accounting, a portion of the payment (\$35x) is “taken into account as AFS revenue” in a subsequent year, and the payment is for a good. Pursuant to §1.451-8(a)(3), A's advance payment inventory inclusion amount for 2022 is \$35x (the portion of the payment deferred for AFS purposes). Pursuant to paragraph (c)(2)(i) of this section, A must first determine the AFS inventory inclusion amount for 2021 by applying the rules in paragraph (c)(2)(i)(A) of this section. A then reduces such amount by the cost of goods in progress offset for 2021, as determined under paragraphs (c)(3) through (5) of this section.

(I) Pursuant to paragraph (c)(2)(i)(A)(I) of this section, A first takes the greater of:

(i) The cumulative amount of revenue that satisfies the all events test under §1.451-1(a) through the last day of 2021, less any advance payment inventory inclusion amount attributable to a subsequent year (\$5x, determined as the \$40x under the all events test, less the \$35x of advance payment inventory inclusion amount attributable to 2022); or

(ii) The cumulative amount of revenue that is treated as “taken into account as AFS revenue” through the last day of 2021 (\$5x) (or if the two amounts are equal, the equal amount).

(2) Pursuant to paragraph (c)(2)(i)(A)(2) of this section, A then subtracts from such amount (\$5x) the amount determined under paragraph (c)(2)(i)(A)(I) of this section for the item of inventory for the im-

mediately preceding year (\$0). This net amount of \$5x is the AFS inventory inclusion amount for 2021.

(3) Pursuant to paragraph (c)(2)(i) of this section, A reduces this \$5x AFS inventory inclusion amount by the cost of goods in progress offset for 2021 of \$5x, determined as the cost of goods as of December 31, 2021 of \$10x, less the cumulative cost of goods in progress offset taken into account in prior years of \$0, less 5x for the AFS inventory inclusion amount limitation under paragraph (c)(4) of this section. Accordingly, A is required to include \$0 in gross income for 2021.

(C) *Analysis for 2022.* Pursuant to paragraph (c)(2)(i) of this section, A must first determine the AFS inventory inclusion amount for 2022 by applying the rules in paragraph (c)(2)(i)(A) of this section. A then reduces such amount by the cost of goods in progress offset for 2022, as determined under paragraphs (c)(3) through (5) of this section.

(I) Pursuant to paragraph (c)(2)(i)(A)(I) of this section, A first takes the greater of:

(i) The cumulative amount of revenue that satisfies the all events test under §1.451-1(a) through the last day of 2022 (\$40x); or

(ii) The cumulative amount of revenue that is treated as “taken into account as AFS revenue” through the last day of 2022 (\$90x).

(2) Pursuant to (c)(2)(i)(A)(2) of this section, A then subtracts from such amount (\$90x) the amount determined under paragraph (c)(2)(i)(A)(I) of this section for the item of inventory for 2021 (\$5x). This net amount of \$85x is the AFS inventory inclusion amount for 2022.

(3) Pursuant to paragraph (c)(2)(i) of this section, A reduces this \$85x AFS inventory inclusion amount by the cost of goods in progress offset for 2022 of \$60x, determined as the cost of goods as of December 31, 2022 of \$65x, less the cumulative cost of goods in progress offset taken into account in prior years of \$5x. Accordingly, A is required to include \$25x in gross income for 2022.

(D) *Analysis for 2023.* During 2023, ownership of the good is transferred to Customer. Accordingly, pursuant to paragraph (c)(2)(ii) of this section, A determines its gross income inclusion for 2023 by:

(I) First taking the greater of:

(i) The cumulative amount of revenue that satisfies the all events test under §1.451-1(a) through the last day of 2023 (\$100x); or

(ii) The cumulative amount of revenue that is treated as “taken into account as AFS revenue” through the last day of 2023 (\$100x) (or if the two amounts are equal, the equal amount).

(2) Then subtracting from such amount (\$100x) the prior income inclusion amounts attributable to the transferred good of \$25x (\$0 for 2021 plus \$25x for 2022). A is required to include this net amount of \$75x in gross income for 2023. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the \$70x of costs capitalized to the good as cost of goods sold in 2023 in accordance with sections 471 and 263A. See §1.61-3. Accordingly, A's gross income for 2023 is \$5x.

(v) *Example 5—(A) Facts.* The same facts as in paragraph (c)(8)(iv) of this section (*Example 4*) apply, except that in 2022, A's obligation to Customer with respect to the good ends other than in a trans-

action to which section 381(a) applies, or a section 351 transaction described in paragraph (c)(6)(ii)(B) of this section. A does not receive any additional payments in 2022.

(B) *Analysis for 2021.* The analysis for 2021 is the same as in paragraph (c)(8)(iv) of this section (Example 4).

(C) *Analysis for 2022.* Because, in 2022, A's obligation to Customer with respect to the good ends in a transaction other than a transaction described in paragraph (c)(6)(ii)(A) or (B) of this section, A is required to apply the acceleration rules in paragraph (c)(6) of this section. Accordingly, because A received \$40x of payments as of the date of the transaction, but did not include any portion of such payments in gross income in prior years, A is required to include the remaining \$40x of the payments received in gross income in 2022 pursuant to paragraph (c)(6) of this section. A is not permitted to further reduce the \$40x income inclusion by a cost of goods in progress offset under this paragraph (c).

(vi) *Example 6—(A) Facts.* In 2021, A enters into a contract with Customer to produce and deliver a good. The contract provides that A will receive payments equal to AFS costs plus a 100% markup, however, A can only bill the customer on December 31, 2022 and, if the good is not delivered by December 31, 2022, A can also bill Customer upon delivery of the good, for the AFS costs (plus markup) incurred to date, less any amounts previously billed. A recognizes AFS revenue based on a percentage of completion (cost to cost) method. A recognizes AFS revenue of \$100 through the last day of 2021, \$150 through the last day of 2022, and \$300 through the last day of 2023, and has an enforceable right to all AFS revenue reported as of the end of each year if the customer were to terminate the contract on the last day of the year. A bills the customer \$150 on December 31 of 2022 and \$150 in 2023 when A delivers the good and ownership transfers to Customer. The costs to produce the good are required to be capitalized under sections 471 and 263A as the good is inventory in the hands of the taxpayer. A incurs the following costs each year that are permissibly capitalized and allocated to the produced good under sections 471 and 263A: \$125 in 2021; \$0 in 2022; and \$25 in year 2023.

(B) *Analysis for taxable year 2021.* Pursuant to paragraph (c)(2)(i) of this section, A must first determine the AFS inventory inclusion amount for 2021 by applying the rules in paragraph (c)(2)(i)(A) of this section. A then reduces such amount by the cost of goods in progress offset for 2021, as determined under paragraphs (c)(3) through (5) of this section.

(1) Pursuant to paragraph (c)(2)(i)(A)(1) of this section, A first takes the greater of:

(i) The cumulative amount of revenue that satisfies the all events test under §1.451-1(a) through the last day of 2021 (\$0); or

(ii) The cumulative amount of revenue that is treated as "taken into account as AFS revenue" through the last day of 2021 (\$100).

(2) Pursuant to paragraph (c)(2)(i)(A)(2) of this section, A then subtracts from such amount (\$100) the amount determined under paragraph (c)(2)(i)(A)(1) of this section for the item of inventory for the

immediately preceding year (\$0). This net amount of \$100 is the AFS inventory inclusion amount for 2021.

(3) Pursuant to paragraph (c)(2)(i) of this section, A reduces this \$100 AFS inventory inclusion amount by the cost of goods in progress offset for 2021 of \$100. Although A's cost of goods in progress as of the end of 2021 is \$125, the cost of goods in progress offset is limited to \$100, the amount of A's AFS inventory inclusion amount for 2021. Accordingly, A is required to include \$0 in gross income in 2021.

(C) *Analysis for taxable year 2022.* Pursuant to paragraph (c)(2)(i) of this section, A must first determine the AFS inventory inclusion amount for 2022 by applying the rules in paragraph (c)(2)(i)(A) of this section. A then reduces such amount by the cost of goods in progress offset for 2022, as determined under paragraphs (c)(3) through (5) of this section.

(1) Pursuant to paragraph (c)(2)(i)(A)(1) of this section, A first takes the greater of:

(i) The cumulative amount of revenue that satisfies the all events test under §1.451-1(a) through the last day of 2022 (\$150 due under the terms of the contract); or

(ii) The cumulative amount of revenue that is treated as "taken into account as AFS revenue" through the last day of 2022 (\$150) (or if the two amounts are equal, the equal amount).

(2) Pursuant to paragraph (c)(2)(i)(A)(2) of this section, A then subtracts from such amount (\$150) the amount determined under paragraph (c)(2)(i)(A)(1) of this section for the item of inventory for the immediately preceding year (\$100). This net amount of \$50 is the AFS inventory inclusion amount for 2022.

(3) Pursuant to paragraph (c)(2)(i) of this section, A reduces this \$50 AFS inventory inclusion amount by the cost of goods in progress offset for 2022 of \$25, determined as \$125 cost of goods as of December 31, 2022 minus \$100 cumulative cost of goods in progress offset amount taken into account in 2021. Accordingly, A is required to include \$25 in gross income for 2022.

(D) *Analysis for taxable year 2023.* During 2023, ownership of the good is transferred to the customer. Accordingly, pursuant to paragraph (c)(2)(ii) of this section, A determines its gross income inclusion for 2023 by:

(1) First taking the greater of:

(i) The cumulative amount of revenue that satisfies the all events test under §1.451-1(a) through the last day of 2023 (\$300x); or

(ii) The cumulative amount of revenue that is treated as "taken into account as AFS revenue" through the last day of 2023 (\$300x) (or if the two amounts are equal, the equal amount).

(2) Then subtracting from such amount (\$300x) the prior income inclusion amounts attributable to the transferred good of \$25 (\$0 for 2021 plus \$25 for 2022). This net amount of \$275 is the AFS income inclusion amount for 2023. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the \$150 of costs capitalized to the good as cost of goods sold in 2023 in accordance with sections 471 and 263A. See §1.61-3. Accordingly, A's gross income for 2023 is \$125 (\$275 AFS income inclusion amount less \$150 cost of goods sold).

(d) *Contracts with multiple performance obligations—(1) In general.* Each performance obligation generally yields a corresponding item of gross income that must be accounted for separately under the AFS income inclusion rule in paragraph (b)(1) of this section. Except as provided in paragraph (d)(5) of this section, if a contract contains more than one performance obligation, and thus yields more than one corresponding item of gross income, the transaction price amount shall be allocated to each corresponding item of gross income in accordance with the transaction price amount allocated to each performance obligation for AFS purposes, subject to the adjustments to the transaction price amount and special allocation rules in paragraph (d)(3) of this section.

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

(3) *Adjustments to transaction price amount and special allocation rules—(i) Increases to transaction price amount.* If the transaction price amount includes a reduction for amounts described in paragraph (b)(2)(i)(A)(1) or (2) of this section, or has been reduced because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, the taxpayer must determine the specific performance obligation to which such reduction relates and increase the transaction price amount allocable to the corresponding item of gross income by the amount of such reduction (specific identification approach). If it is impracticable from the taxpayer's records to use the specific identification approach, the taxpayer may use any reasonable method to allocate the reduction amount to the items of gross income in the contract. A pro-rata allocation of the reduction amount across all items of gross income under the contract based on the relative transaction price amounts allocated to such items under paragraph (d)(1) of this section is a reasonable method.

(ii) *Decrease to transaction price amount.* If the transaction price amount

has been increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, the taxpayer must determine the specific performance obligation to which such amount relates and decrease the transaction price amount allocable to the corresponding item of gross income by such amount (specific identification approach). If it is impracticable from the taxpayer's records to use the specific identification approach, the taxpayer may use any reasonable method to allocate such amount to the items of gross income in the contract. A pro-rata allocation of such amount across all items of gross income under the contract based on the relative transaction price amounts allocated to such items under paragraph (d)(1) of this section is a reasonable method.

(4) *Examples.* The following examples illustrate the rules of paragraph (d)(1) through (3) of this section. Unless the facts specifically state otherwise, the taxpayer has an AFS, is on a calendar year for Federal income tax purposes and AFS purposes, and uses an accrual method of accounting for Federal income tax purposes.

(i) *Example 1—(A) Facts.* On November 1, 2021, A, a software developer, enters into a contract with a customer to transfer a software license, perform software installation services, and provide technical support for a two-year period for \$100x. The installation service does not significantly modify the software and the software remains functional without the technical support. A receives an additional \$10x bonus if the installation service is performed before February 1, 2022, which A expects to receive. Further, the customer is entitled to a refund of \$2x if technical support does not meet performance standards set forth in the contract, which A expects it will pay to the customer. For its AFS, A identifies three performance obligations in the contract:

- (i) The software license;
- (ii) The installation service; and
- (iii) Technical support.

(2) Also, for its AFS, A determines that the transaction price amount is \$108x, determined as \$100x contract price plus \$10x bonus for installation services minus \$2x customer refund. Finally, for its AFS, A allocates the \$108x transaction price amount to the three performance obligations as follows: \$60x to the software license; \$40x to the installation service (\$30x + \$10x bonus); and \$8x to technical support (\$10x - \$2x refund).

(B) *Analysis.* Pursuant to paragraph (d)(1) of this section, A's contract with the customer has three performance obligations, and each performance obligation yields a corresponding item of gross income that is accounted for separately. Pursuant to paragraph (d)(1) of this section, A is required to allocate the \$108x transaction price amount to each corresponding item

of gross income in accordance with the transaction price amount allocated to each respective performance obligation for AFS purposes. Accordingly, A initially allocates \$60x to the software license item, \$40x to the installation service item, and \$8 to the technical support item. However, because the transaction price amount was reduced by the anticipated refund of \$2x, which relates specifically to the technical support item, A must increase the transaction price allocable to that item of gross income pursuant to the specific identification approach in paragraph (d)(3) of this section. Accordingly, the amount allocated to the item of gross income related to technical support is \$10x.

(ii) *Example 2—(A) Facts.* In 2021, B, a manufacturer and servicer of airplane parts, enters into a contract with a customer to sell airplane parts in 2021 and to service those parts, as necessary, in 2021, 2022, and 2023 for \$100x. B regularly sells the airplane parts and the services separately. For its AFS, B identifies two performance obligations in the contract:

- (i) The sale of airplane parts; and
- (ii) The services for those parts.

(2) The customer receives a refund of \$5x if it does not require a specified level of service for the parts, which B expects it will pay to the customer. Also, for its AFS, B determines that the transaction price amount is \$95x, determined as the \$100x contract price minus the \$5x refund that it expects to pay the customer. Finally, for its AFS, B allocates the \$95x transaction price amount to the two performance obligations as follows: \$40x to the sale of parts and \$55x to the provision of services (\$60x - \$5x refund).

(B) *Analysis.* Pursuant to paragraph (d)(1) of this section, B's contract with the customer has two performance obligations, and each performance obligation yields a corresponding item of gross income that is accounted for separately. Pursuant to paragraph (d)(1) of this section, B is required to allocate the \$95x transaction price amount to each corresponding item of gross income in accordance with the transaction price amount allocated to each respective performance obligation for AFS purposes. Accordingly, B initially allocates \$40x to the sale of parts item and \$55x to the provision of services item. However, because the transaction price amount was reduced by the anticipated refund of \$5x, which relates specifically to provision of services item, B must increase the transaction price allocable to that item of gross income pursuant to the specific identification approach in paragraph (d)(3) of this section. Accordingly, the amount allocated to the item of gross income related to servicing the parts is \$60x.

(iii) *Example 3: Reward points—(A) Facts.* On December 31, 2021, 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. For its AFS, U identifies two performance obligations from the transaction:

- (i) The sale of the TV; and
- (ii) The provision of rewards points.

(2) Also, for its AFS, U allocates \$950 of transaction price amount to the sale of the TV and the remaining \$50 of the transaction price amount to the reward points.

(B) *Analysis.* Pursuant to paragraph (d)(1) of this section, U's contract with the customer has two performance obligations, and each performance obligation yields a corresponding item of gross income that is accounted for separately. Pursuant to paragraph (d)(1) of this section, U is required to allocate the \$1,000 transaction price amount to each corresponding item of gross income in accordance with the transaction price amount allocated to each respective performance obligation for AFS purposes. Accordingly, U allocates the transaction price amount as follows: \$950 to the TV sale item and \$50 to the reward points item. If U reports any portion of the \$50 payment allocated to the reward points as AFS revenue for 2022, or later, the payment is an advance payment, as defined in §1.451-8(a)(1), and may be accounted for under the deferral method if U satisfies the criteria in §1.451-8(c).

(iv) *Example 4: Airline reward miles—(A) Facts.* On January 1, 2021, W, a passenger airline company, sells a customer a \$700 airline ticket to fly roundtrip in 2021. As part of the purchase, the customer receives 7,000 points (air miles) from W to be redeemed for future air travel. For its AFS, W identifies two performance obligations in the contract:

- (i) The sale of the airline ticket; and
- (ii) The provision of air miles.

(2) W also anticipates that it will issue a rebate to the customer for \$10. Also, for its AFS, W determines that the transaction price amount is \$690, determined as the \$700 ticket price minus the anticipated \$10 rebate. Finally, for its AFS, W allocates the \$690 transaction price amount to the separate performance obligations as follows: \$660 to the ticket (\$670 - \$10 rebate = \$660) and \$30 to the air miles.

(B) *Analysis.* Pursuant to paragraph (d)(1) of this section, W's contract with the customer has two performance obligations, and each performance obligation yields a corresponding item of gross income that is accounted for separately. Pursuant to paragraph (d)(1) of this section, W must allocate the \$690 transaction price amount to each corresponding item of gross income in accordance with the transaction price amount allocated to each respective performance obligation for AFS purposes. Accordingly, W initially allocates \$660 to the ticket sale item and \$30 to the air miles item. However, because the transaction price amount was reduced by the anticipated rebate of \$10x, which relates to the ticket sale item, W must increase the transaction price allocable to that item of gross income pursuant to paragraph (d)(3) of this section. Accordingly, the amount allocated to the item of gross income related to the ticket sale is \$670. If W reports any portion of the \$30 payment allocated to the air miles item as AFS revenue for 2022, or later, the payment is an advance payment, as defined in §1.451-8(a)(1), and may be accounted for under the deferral method if W satisfies the criteria in §1.451-8(c).

(v) *Example 5: Contract with significant financing component amounts—(A) Facts.* On January 1, 2021, C, a manufacturer and servicer of airplane parts, enters into a contract with a customer to sell airplane parts in December 2022, and to service those parts, as necessary, through 2024. The contract contains two alternative payment options: payment of \$5,000 in December 2022 when the customer obtains control of the parts or payment of \$4,000 when the con-

tract is signed. The customer pays \$4,000 when the contract is signed, which reflects an implicit interest rate of 11.8% and is C's incremental borrowing rate. C regularly sells the airline parts and the services separately. For its AFS, C identifies two performance obligations in the contract:

- (i) The sale of airplane parts; and
- (ii) The services for those parts.

(2) Also, for its AFS, although the contract only requires the customer to pay \$4,000, the transaction price is increased by \$1,000 to \$5,000 because the customer is deemed to provide financing to C under the standards C uses to prepare its AFS. The \$1,000 increase is attributable to a significant financing component. Finally, for its AFS, C allocates the \$5,000 transaction price amount to the separate performance obligations as follows: \$3,750 to the sale of parts (\$3,000 upfront payment plus \$750 financing component) and \$1,250 (\$1,000 upfront payment plus \$250 financing component) to the provision of services.

(B) *Analysis.* Pursuant to paragraph (d)(1) of this section, C's contract with the customer has two performance obligations, and each performance obligation yields a corresponding item of gross income that is accounted for separately. Pursuant to paragraph (d)(1) of this section, C must allocate the \$5,000 transaction price amount to each corresponding item of gross income in accordance with the transaction price amount allocated to each respective performance obligation for AFS purposes. Accordingly, C initially allocates \$3,750 to the sale of the parts item and \$1,250 to the provision of services item. However, because the transaction price was increased by a significant financing component of \$1,000, \$750 of which was allocated to sale of the parts item and \$250 of which was allocated to the provision of services item, pursuant to paragraph (d)(3) of this section, C must decrease the transaction price amount allocable to the sale of parts item from \$3,750 to \$3,000 and must decrease the transaction price allocable to the provision of services from \$1,250 to \$1,000.

(5) *Contracts accounted for in part under this section and in part under a special method of accounting—(i) In general.* If a taxpayer has a contract with a customer that includes one or more items of gross income that are subject to a special method of accounting and one or more items of gross income that are subject to this section (*special method/451 contract*), the transaction price allocation rule in paragraph (d)(1) of this section does not apply to determine the amount of each item of gross income that is subject to a special method of accounting. For purposes of this paragraph (d)(5)(i), a special method of accounting has the meaning set forth in paragraph (a)(13) of this section, except as otherwise provided in guidance published in the Internal Revenue Bulletin (see §601.601(d) of this chapter). For special method/451 contracts, paragraphs (d)(5)

(ii) and (iii) of this section apply to determine the transaction price amount and the portion of such amount that is allocated to each item of gross income that is subject to this section.

(ii) *Transaction price adjustments.* If the transaction price amount for the special method/451 contract includes a reduction for amounts described in paragraph (b)(2)(i)(A)(I) or (2) of this section, or has been reduced because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, the taxpayer must increase the transaction price amount by the amount of such reduction. If the transaction price amount for the special method/451 contract has been increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, the taxpayer must decrease the transaction price amount by the amount of such increase.

(iii) *Transaction price allocation.* After the taxpayer determines the adjusted transaction price amount for the special method/451 contract under paragraph (d)(5)(ii) of this section, the taxpayer first allocates such amount to the item(s) of gross income subject to a special method of accounting and then allocates the remainder (residual amount) to the item(s) of gross income that are subject to this section. If the contract contains more than one item of gross income that is subject to this section, the taxpayer allocates the residual amount to such items in proportion to the amounts allocated to the corresponding performance obligations for AFS purposes or as otherwise provided in guidance published in the Internal Revenue Bulletin (see §601.601(d) of this chapter).

(iv) *Example—(1) Facts.* B is a calendar-year accrual method taxpayer with an AFS. In 2020, B enters into a \$100x contract to design, build, operate and maintain a toll road. The contract meets the definition of a long-term contract under §1.460-1(b)(1). B determines that the obligations to design and build the toll road are long-term contract activities under §1.460-1(d)(1) and accounts for the gross income from these activities under section 460 and the regulations in this part under section 460 of the Code. In addition, B determines that the obligations to operate and maintain the toll road are non-long-term contract activities under §1.460-1(d)(2) and that the gross income attributable to these activities is required to be accounted for under this section. B determines that of the \$100x transaction price amount, \$60x is properly allocable to the items of gross income that are subject to section 460 and the regulations in this part

under section 460 of the Code. However, for its AFS, B allocates \$55x of the transaction price amount to performance obligations that are long-term contract activities, \$30x to the toll road operation performance obligation and \$15x to the toll road maintenance performance obligation.

(2) *Analysis.* A method of accounting under section 460 is a special method of accounting that is within the scope of paragraph (d)(5) of this section. Pursuant to paragraph (d)(5) of this section, B first allocates \$60x of the transaction price amount to the items of gross income that are subject to section 460 and the regulations in this part under section 460 of the Code and then allocates the residual amount of \$40x to the two items of gross income that are required to be accounted for under this section in proportion to the amounts allocated to the corresponding performance obligations for AFS purposes. Accordingly, B allocates \$26.7x ($\$30x / \$45x \times \$40x$ residual amount) to the toll road operations item of gross income and \$13.3x ($\$15x / \$45x \times \$40x$ residual amount) to the toll road maintenance item of gross income.

(e) *Cumulative rule for multi-year contracts—(1) In general.* In the case of an item of gross income from a multi-year contract, a taxpayer determines the AFS income inclusion amount for a taxable year by applying the steps in paragraph (e)(1)(i) or (ii) of this section. For this paragraph (e), the term *multi-year contract* means a contract that spans more than one taxable year.

(i) *Inventory items.* If the item of gross income is from the sale of an item of inventory and the taxpayer uses the cost offset method under paragraph (c) of this section, see paragraph (c) of this section.

(ii) *Other items of gross income.* For all other items of gross income, the taxpayer first compares the cumulative amount of the item of gross income that satisfies the all events test under §1.451-1(a) through the last day of the taxable year, including the full amount of any advance payment received for such item in a prior taxable year, with the cumulative amount of the item of gross income that is treated as "taken into account as AFS revenue" under paragraph (b)(2) of this section through the last day of the taxable year and identifies the larger of the two amounts (or, if the two amounts are equal, the equal amount). The taxpayer then reduces such amount by all prior year inclusion amounts attributable to the item of gross income, if any, to determine the AFS income inclusion amount for the current taxable year. If, however, the taxpayer receives an advance payment, as defined in §1.451-8(a)(1), that is allocable to an item of gross income from a multi-year contract,

the taxpayer applies the applicable rules in §1.451-8, rather than the rules in this paragraph (e)(1)(ii), to determine the amount of the item of gross income that is required to be included in gross income in the taxable year in which such advance payment is received, or, if applicable, in a short taxable year described in §1.451-8(c)(6).

(2) *Examples.* The following examples illustrate the rules of paragraph (e)(1) of this section. Unless the facts specifically state otherwise, the taxpayer has an AFS, is on a calendar year for both Federal income tax purposes and AFS purposes and uses an accrual method of accounting for Federal income tax purposes. Further, the taxpayer does not use a special method of accounting.

(i) *Example 1: Provision of services included in AFS revenue with full inclusion method for advance payments—(A) Facts.* In 2021, D, an engineering services provider, enters into a nonseverable contract with a customer to provide engineering services through 2024 for a total of \$100x. Under the contract, D receives payments of \$25x in each calendar year of the contract. For its AFS, D reports \$50x, \$0, \$20x, and \$30x of AFS revenue from the contract for 2021, 2022, 2023, and 2024, respectively. D has an enforceable right to recover all amounts reported as AFS revenue through the end of a given contract year if the customer were to terminate the contract on the last day of such year. The \$25x payment received in 2023 is an advance payment, as defined in §1.451-8(a)(1), because \$5x of the \$25x payment is reported

as AFS revenue for 2024. D uses the full inclusion method for advance payments.

(B) *Taxable year 2021.* Under the all events test in §1.451-1(a), D is required to include \$25x in gross income in 2021 as \$25x is due under the terms of the contract and received by D during 2021. D does not have a fixed right to receive any portion of the remaining \$75 as such amount is not due under the terms of the contract until future years and is also contingent on D's completion of the nonseverable services. Under the AFS income inclusion rule, because D has an enforceable right to recover all \$50x reported as AFS revenue for 2021 if the customer were to terminate the contract on the last day of such year, all \$50x is treated as "taken into account as AFS revenue" in 2021. Accordingly, D is required to include \$50x in gross income in 2021.

(C) *Taxable year 2022.* Under the all events test in §1.451-1(a), D is required to include \$50x in gross income through the end of 2022 as \$50x is due under the terms of the contract and received by D as of the end of 2022. D does not have a fixed right to receive any portion of the remaining \$50 as such amount is not due under the terms of the contract until future years and is also contingent on D's completion of the nonseverable services. Under the AFS income inclusion rule, because D has an enforceable right to recover all \$50x reported as AFS revenue through the end of 2022 if the customer were to terminate the contract on the last day of such year, all \$50x is treated as "taken into account as AFS revenue" as of the last day of 2022. Under the cumulative rule in paragraph (e)(1)(ii) of this section, D compares the cumulative all events test amount of \$50x with the cumulative AFS revenue amount of \$50x and selects the larger of the two amounts (or if the two amounts are equal,

the equal amount). From this equal amount of \$50x, D subtracts the prior income inclusion amount of \$50x. Accordingly, under the cumulative rule D is not required to include any amount in gross income in 2022.

(D) *Taxable year 2023.* The payment received during 2023 meets the definition of an advance payment under §1.451-8(a)(1). Accordingly, pursuant to paragraph (e)(1)(ii) of this section, D must determine the amount that is required to be included in gross income in 2023 under the rules in §1.451-8. Because D uses the full inclusion method under §1.451-8(b), D is required to include the \$25x that was due and received during 2023 in gross income in 2023.

(E) *Taxable year 2024.* Under the all events test in §1.451-1(a), D is required to include \$100x in gross income through the end of 2024 as \$100x is due under the terms of the contract and received by D as of the end of 2024. Under the AFS income inclusion rule, because D has an enforceable right to recover all \$100x reported as AFS revenue through the end of 2024 if the customer were to terminate the contract on the last day of such year, all \$100x is treated as "taken into account as AFS revenue" through the last day of 2024. Under the cumulative rule in paragraph (e)(1)(ii) of this section, D compares the cumulative all events test amount of \$100x with the cumulative AFS revenue amount of \$100x and selects the larger of the two amounts (or, if the two amounts are equal, the equal amount). From this equal amount of \$100x, D subtracts the prior income inclusion amount of \$75x (\$50x from 2021 plus \$0x from 2022 plus \$25x from 2023). Accordingly, under the cumulative rule D is required to include \$25 in gross income in 2024. The example in this paragraph (e)(2)(i)(E) is summarized in the following table:

Table 2 to paragraph (e)(2)(i)(E)

	2021	2022	2023	2024	Total
All Events / Full Inclusion Income	\$25x	\$25x	\$25x	\$25x	\$100x
AFS Revenue	\$50x	\$0	\$20x	\$30x	\$100x
Cumulative rule income	\$50x	\$0	\$25x	\$25x	\$100x

(ii) *Example 2: Provision of services included in AFS revenue with deferral method for advance payments—(A) Facts.* The facts are the same as in paragraph (e)(2)(i) of this section (*Example 1*), except D elects to use the deferral method under §1.451-8(c) to account for advance payments.

(B) *Taxable years 2021 and 2022.* The analysis for tax years 2021 and 2022 is the same as in paragraph (e)(2)(i) of this section (*Example 1*).

(C) *Taxable year 2023.* The payment received during 2023 meets the definition of an advance payment under §1.451-8(a)(1). Accordingly, pursuant to paragraph (e)(1)(ii) of this section, D must determine the amount that is required to be included in gross

income in 2023 under the rules in §1.451-8. Because D uses the deferral method under §1.451-8(b), D is required to include \$20x of the \$25x payment in gross income in 2023 as \$20x of such payment was treated as "taken into account as AFS revenue" as of the end of 2023.

(D) *Taxable year 2024.* Under the all events test in §1.451-1(a), D is required to include \$100x in gross income through the end of 2024. Under the AFS income inclusion rule, because D has an enforceable right to recover all \$100x reported as AFS revenue through the end of 2024 if the customer were to terminate the contract on the last day of such year, all \$100x is treated as "taken into account as

AFS revenue" through the last day of 2024. Under the cumulative rule in paragraph (e)(1)(ii) of this section, D compares the cumulative all events test amount of \$100x, which includes the full amount of the \$25 advance payment received in 2023, with the cumulative AFS revenue amount of \$100x and selects the larger of the two amounts (or, if the two amounts are equal, the equal amount). From this equal amount of \$100x, D subtracts the prior income inclusion amount of \$70x (\$50x from 2021 plus \$0x from 2022 plus \$20x from 2023). Accordingly, under the cumulative rule D is required to include \$30x in gross income in 2024. The example in this paragraph (e)(2)(ii)(D) is summarized in the following table:

Table 3 to paragraph (e)(2)(ii)(D)

	2021	2022	2023	2024	Total
All Events Test / Deferral Method Income	\$25x	\$25x	\$20x ¹	\$30x	\$100x
AFS Revenue amount	\$50x	\$0	\$20x	\$30x	\$100x
Cumulative rule income	\$50x	\$0	\$20x	\$30x	\$100x

¹\$5x of the advance payment in 2023 is deferred and taken into income in 2024.

(f) *No change in the treatment of a transaction.* Except as provided in paragraph (j) of this section and §1.1275-2(l), the AFS income inclusion rule does not change the treatment of a transaction or the character of an item for Federal income tax purposes. The following are examples of transactions where the treatment or character for AFS purposes does not change the treatment of the transaction or character of the item 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 or instrument 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, return of capital, or conduit payment that is not gross income for Federal income tax purposes that is treated as AFS revenue.

(g) *No change to exclusion provisions and the treatment of non-recognition transactions—(1) In general.* The AFS income inclusion rule accelerates the time at which the all events test under §1.451-1(a) is treated as satisfied, and therefore does not change the applicability of any exclusion provision, or the treatment of non-recognition transactions, in the Code, the regulations in this part, 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:

(i) Any non-recognition transaction, within the meaning of section 7701(a)(45), including, for example, a liquida-

tion 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

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

(2) *Example: Non-recognition provisions not changed for Federal income tax purposes—(i) Facts.* Taxpayer (Distributing) is a calendar-year accrual method C corporation with an AFS. On December 31, 2021, Distributing:

(A)(1) Contributes assets to a wholly owned subsidiary (Controlled) in exchange for Controlled stock and \$100x; and

(2) Distributes all the Controlled stock pro rata to its shareholders.

(B) 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, 2022, 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 2021 AFS, Distributing recognizes revenue of \$150x related to the D reorganization.

(ii) *Analysis.* For Federal income tax purposes, under section 361, Distributing does not recognize gain on Distributing's:

- (A)(1) Contribution of assets to Controlled;
- (2) Receipt of Controlled stock and cash; and
- (3) Distribution of Controlled stock and cash to Distributing's shareholders.

(B) Pursuant to paragraph (g) of this section, the AFS income inclusion rule does not change the result of this paragraph (g)(2).

(h) *Additional AFS issues—(1) AFS covering groups of entities—(i) In general.* If a taxpayer's financial results are reported on the AFS for a group of entities (consolidated AFS), the taxpayer's AFS is the consolidated AFS. However, if the taxpayer's financial results are also reported on a separate AFS that is of equal or higher priority to the consolidated AFS under paragraph (a)(5) 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 2021, B's financial results are included in P's consolidated financial statement, which is certified as being prepared in accordance with GAAP, and is a Form 10-K filed with the SEC. B also has a separate audited financial statement prepared in accordance with GAAP that is used for credit purposes. B must use its parent corporation's consolidated Form 10-K as its AFS.

(ii) *Example.* Taxpayer B, a reseller of computers and electronics, is a calendar-year accrual method taxpayer. In 2021, B's financial results are included in P's consolidated financial statement, which is certified as being prepared in accordance with GAAP, and is a Form 10-K filed with the SEC. B also has a separate audited financial statement prepared in accordance with GAAP that is used for credit purposes. B must use its parent corporation's consolidated Form 10-K as its AFS.

(2) *Separately listed items.* If a consolidated AFS is treated as the taxpayer's AFS, the taxpayer must include the amount of any items listed separately in the consolidated AFS, including any notes or other supplementary data that is considered part of the consolidated AFS, in determining the amount of AFS revenue allocated to the taxpayer.

(3) *Non-separately listed items.* If a consolidated AFS does not separately list items for the taxpayer, the portion of the AFS revenue allocable to the taxpayer is determined by relying on the taxpayer's separate source documents that were used to create the consolidated AFS and includes amounts subsequently eliminated in the consolidated AFS. Whether a taxpayer that changes the source documents it uses for this purpose from one taxable year to another taxable year has changed its method of accounting is determined under the rules of section 446.

(4) *Computation of AFS revenue for the taxable year 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 following permissible methods of accounting described in paragraph (h)(4)(i)(A) through (C) of this section to determine the AFS income inclusion amount for the taxable year:

(A) The taxpayer computes AFS revenue as if its financial reporting period is the same as its taxable year by conducting an interim closing of its books using the accounting principles it uses to prepare its AFS.

(B) The taxpayer computes AFS revenue by including a pro rata portion of AFS 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 AFS 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 com-

putes AFS revenue for the taxable year based on the AFS revenue reported on the AFS prepared for the financial accounting year ending within the taxpayer's taxable year. For this paragraph (h)(4)(i)(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.

(ii) *Examples.* The following examples illustrate the principles of paragraph (j)(4) of this section.

(A) *Example 1: Interim closing of the books.* A is a calendar year taxpayer. For its AFS, A's financial results are reported on a June 30 fiscal year. Using the method described in paragraph (h)(4)(i)(A) of this section, for the taxable year 2021, A uses the financial results reported on its June 30, 2021 AFS to determine whether an item of gross income is treated as "taken into account as AFS revenue" from January 1, 2021, through June 30, 2021, and uses financial data and accounting procedures from its June 30, 2022 AFS to prepare an interim closing of the books as of December 31, 2021 to determine whether an item of gross income is treated as "taken into account as AFS revenue" from July 1, 2021, through December 31, 2021.

(B) *Example 2: Pro rata approach.* A is a calendar year taxpayer. For its AFS, A's financial results are reported on a June 30 fiscal year. Using the method described in paragraph (h)(4)(i)(B) of this section, for the taxable year 2021, A computes AFS revenue for the 2021 tax year by taking the AFS revenue for the financial accounting year ending June 30, 2021 and multiplying it by a ratio equal to the number of days in the financial accounting year that are part of the 2021 tax year/365 and then adding to that amount the AFS revenue for the financial accounting year ending June 30, 2022 multiplied by the number of days in the financial accounting year that are part of the 2021 tax year/365.

(C) *Example 3: AFS revenue for the taxable year based on AFS ending in taxpayer's taxable year.* The same facts as in paragraph (h)(4)(ii)(B) of this section (*Example 2*) apply, except that A uses the method described in paragraph (h)(4)(i)(C) of this section. For the taxable year 2021, A uses the financial results reported on its June 30, 2021 AFS to determine whether an item of gross income is treated as "taken into account as AFS revenue" as of the end of its 2021 taxable year. Accordingly, any AFS revenue reported on the taxpayer's June 30, 2022 AFS is disregarded when determining whether an item of gross income is treated as "taken into account as AFS revenue" as of the end of the 2021 taxable year.

(i) [Reserved]

(j) *Special ordering rule for certain items of income for debt instruments—(1) In general.* If an item of income, or portion thereof, with respect to a debt instrument is described in paragraph (j)(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 (j)(2) of this section may not be included in income later than when that item, or portion thereof, is treated as *taken into account as AFS revenue*, as determined under paragraph (b)(2) of this section, 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 (j)(2) of this section under the OID rules.

(2) *Specified fees.* Paragraph (j)(1) of this section applies to fees (specified fees) that are not spread over a period of time as discount or as an adjustment to the yield of a debt instrument (such as points) in the taxpayer's AFS and, but for paragraph (j) 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 (j)(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.* C, a credit card issuer, is a calendar-year accrual method taxpayer with a calendar year AFS. In 2021, 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). For its AFS, C reports the \$2 of interchange fees as AFS revenue for 2021. C's \$2 of interchange fees is described in paragraph (j)(2)(iii) of this section. Under paragraph (j)(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 gross income in 2021, the year it is treated as "taken into account as

AFS revenue." Under paragraph (b)(2)(i)(A) 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 2021 (\$2 of interchange fee minus \$1 reward liability), under paragraph (b)(2)(i)(A) of this section, C includes \$2 of interchange revenue in gross income in 2021. See sections 162 and 461(h) for the treatment of the reward by C.

(k) *Treatment of adjustments to deferred revenue in an AFS—(1) In general.* If a taxpayer treats an item of gross 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, AFS revenue for that subsequent taxable year is increased or decreased, as applicable by the amount of that item, or portion thereof, that is written down or adjusted. See §1.451-8(c)(5).

(2) *Example—(i) Facts.* D, a remanufacturer of industrial equipment, is a calendar-year, accrual method taxpayer with a calendar year AFS. On January 1, 2021, D enters into a contract with a customer and receives a payment of \$100x to remanufacture equipment in 2021 and 2022. The contract is not a long-term contract under section 460. For its AFS 2021, D performs remanufacturing services and reports \$40x of the \$100x payment as AFS revenue for 2021, and treats \$60x of the \$100x payment as deferred revenue.

(ii) *Facts for taxable year 2022.* On January 1, 2022, all of the stock of D is acquired by an unrelated third party and D adjusts deferred AFS revenue to \$50x (the expected cost to provide the services) by charging \$10x (\$60x - \$50x = \$10x) to retained earnings. In addition, for 2022, D performs remanufacturing services and reports \$50x of the deferred revenue as AFS revenue.

(iii) *Analysis for taxable year 2022.* Under paragraph (k)(1) of this section, D's \$10x write down to deferred revenue for 2022 is treated as "taken into account as AFS revenue" for 2022.

(l) *Methods of accounting—(1) In general.* Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations in this part under sections 446 and 481 of the Code apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with §1.446-1(e) and follow the administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method. For example, the use of the AFS income inclusion rule under paragraph (b)(1) of this section under which

the taxpayer determines the amount of the item of gross income that is treated as “taken into account as AFS revenue” by making the adjustments provided in paragraph (b)(2)(i) of this section, the use of the AFS income inclusion rule under paragraph (b)(1) of this section under which the taxpayer determines the amount of the item of gross income that is treated as “taken into account as AFS revenue” by making only the adjustments provided in paragraph (b)(2)(ii) of this section (the alternative AFS revenue method), the AFS cost offset method under paragraph (c) of this section, the use of a method of determining AFS revenue under paragraph (i) (4) of this section, are methods of accounting under section 446 and the regulations in this part under section 446 of the Code. In addition, a change in the manner of recognizing revenue in an AFS that changes or could change the timing of the inclusion of income for Federal income tax purposes is generally a change in method of accounting under section 446 and the regulations in this part under section 446 of the Code. However, a change resulting from the restatement of AFS revenue may not always constitute a change in method of accounting under section 446 and the regulations in this part under section 446 of the Code. For example, a restatement of AFS revenue to correct an error described in §1.446-1(e)(2)(ii)(b) does not constitute a change in method of accounting under section 446.

(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 of accounting initiated by the taxpayer under section 481(a)(2). A taxpayer obtains the consent of the Commissioner to make the change in method of accounting by using the applicable administrative procedures that govern changes in method of accounting under section 446(e). See §1.446-1(e)(3).

(ii) *Special rules for OID and specified credit card fees.* The rules of paragraph (l) (2)(i) of this section apply to a qualified change in method of accounting 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 (j)(2) of this section. For paragraph (l) of this section, the section 481(a) adjustment period for any adjustment under section 481(a) for a change in method of accounting described in the preceding sentence is six taxable years.

(iii) *Qualified change in method of accounting.* For 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 Public Law 115-97, 131 Stat. 2054 (2017) (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) *Applicability date*—(1) *In general.* Except as provided in paragraph (m)(2) of this section, this section applies for taxable years beginning on or after January 1, 2021.

(2) *Delayed application with respect to certain fees.* Notwithstanding paragraph (m)(1) of this section, paragraph (j) of this section applies to specified fees (as defined in paragraph (j)(2) of this section) that are not specified credit card fees (as defined in paragraph (j)(2) of this section) for taxable years beginning on or after January 6, 2022.

(3) *Early application of this section*—(i) *In general.* Except as provided in paragraph (m)(3)(ii) of this section, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may apply both the rules in this section and, to the extent relevant, the rules in §1.451-8, in their entirety and in a consistent manner, to a taxable year beginning after December 31, 2017, and before January 1, 2021, provided that, once applied to a taxable year, the rules in this section and, to the extent relevant, the rules in §1.451-8, are applied in their entirety and in a consistent manner to all subsequent taxable years. See section 7508(b)(7) and §1.451-8(h).

(ii) *Certain fees*—(A) *Specified credit card fees.* In the case of specified credit card fees, a taxpayer and its related parties, within the meaning of sections 267(b) and 707(b), may apply both the rules in this section and the rules in §1.1275-2(l), in their entirety and in a consistent manner, to a taxable year beginning after December 31, 2018, and before January

1, 2021, provided that, once applied to a taxable year, the rules in this section and §1.1275-2(l) that apply to specified credit card fees are applied in their entirety and in a consistent manner to all subsequent taxable years (other than the rules applicable to specified fees that are not specified credit card fees). See section 7508(b)(7) and §1.1275-2(l)(2).

(B) *Specified fees.* Paragraphs (m)(3)(i) and (m)(3)(ii)(A) of this section do not apply to specified fees that are not specified credit card fees.

Par. 6. Section 1.451-8 is added to read as follows:

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

(a) *Definitions.* Except as otherwise provided in this section, the following definitions apply for 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 taken into account as AFS revenue for a subsequent taxable year, or, if the taxpayer does not have an applicable financial statement any portion of the payment is earned by the taxpayer in a subsequent taxable year. To determine the amount of the payment that is treated as “taken into account as AFS revenue,” the taxpayer must adjust AFS revenue for any amounts described in §1.451-3(b)(2)(i) (A), (C), and (D);

(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 (a)(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 (a)(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 (a)(1)(i)(C)(8);

(9) An eligible gift card sale;

(10) Any other payment identified by the Secretary of the Treasury or his delegate (Secretary) under section 451(c)(4)(A)(iii), including in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter); or

(11) Any combination of items described in paragraphs (a)(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 for an item or items described in paragraph (a)(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 of the Internal Revenue Code;

(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 C.B. 479 (see §601.601(d)(2) of this chapter);

(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;

(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 (specified good exception) unless the taxpayer uses the method under paragraph (f) of this section;

(I) Any other payment identified by the Secretary under section 451(c)(4)(B)(vii), including in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter); and

(J) Any combination of items described in paragraphs (a)(1)(ii)(A) through (I) of this section.

(2) *Advance payment income inclusion amount.* The term *advance payment income inclusion amount* means the amount of the advance payment that is required to be included in gross income for the taxable year under the applicable rules in this section.

(3) *Advance payment inventory inclusion amount.* The term *advance payment inventory inclusion amount* means the amount of the advance payment from the sale of an item of inventory that, but for the cost of goods in progress offset, would be includable in gross income under paragraph (b), (c), or (d) of this section, as applicable, for the taxable year.

(4) *AFS revenue.* The term *AFS revenue* has the same meaning as provided in §1.451-3(a)(4).

(5) *Applicable financial statement.* The term *applicable financial statement* (AFS) has the same meaning as provided in §1.451-3(a)(5).

(6) *Contractual delivery date.* The term *contractual delivery date* means the month and year of delivery listed in the original written contract to the transaction entered into between the parties prior to initial receipt of any payments.

(7) *Cost of goods.* The term *cost of goods* means the costs that are properly capitalized and included in inventory under sections 471 and 263A or any other applicable provision of the Internal Revenue Code and that are allocable to an item of inventory for which an advance payment inventory inclusion amount is calculated. See paragraph (e)(6) of this section

for specific rules for a taxpayer using the simplified methods under section 263A.

(8) *Cost of goods in progress offset.* The term *cost of goods in progress offset* has the meaning provided in paragraph (e)(4) of this section.

(9) *Cumulative cost of goods in progress offset.* The term *cumulative cost of goods in progress offset* means the cumulative cost of goods in progress offset amounts under paragraph (e) of this section for a specific item of inventory that have reduced an advance payment inventory inclusion amount attributable to such item of inventory in prior taxable years.

(10) *Eligible gift card sale.* The term *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 (a)(1)(i)(C)(1) through (11) of this section.

(11) *Enforceable right.* The term *enforceable right* has the same meaning as provided in §1.451-3(a)(9).

(12) *Performance obligation.* The term *performance obligation* has the same meaning as provided in §1.451-3(a)(11).

(13) *Prior income inclusion amounts.* The term *prior income inclusion amounts* means the amount of an item of gross income that was included in the taxpayer's gross income under this section or §1.451-3 in a prior taxable year.

(14) *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.

(15) *Specified good.* The term *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.

(16) *Transaction price.* The term *transaction price* has the same meaning as provided in §1.451-3(a)(14).

(b) *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.

(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 can determine the extent to which the advance payment is taken into account as AFS revenue as of the end of the taxable year of receipt and, if applicable, a short taxable year described in paragraph (c)(6) of this section. Except as otherwise provided in this section, a taxpayer that uses the deferral method described in this paragraph (c) must:

(i) Include the advance payment, or any portion thereof, in gross income in the taxable year of receipt to the extent *taken into account as AFS revenue* as of the end of such taxable year, as determined under paragraph (c)(2) of this section; 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 (next succeeding year).

(2) *Adjustments to AFS revenue.* The amount of an advance payment that is treated as “taken into account as AFS revenue” as of the end of the taxable year of receipt under paragraph (c)(1)(i) of this section is determined by adjusting AFS revenue by amounts described in §1.451-3(b)(2)(i)(A), (C), and (D), as applicable.

(3) *Examples.* The following examples demonstrate the rules in paragraphs (c)(1) and (2) of this section.

(i) *Example 1: Gift cards not eligible for deferral method.* 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 may not be redeemed for cash and have no expiration date. E does not track the sale date of the gift cards and includes advance payments for gift cards in AFS revenue when redeemed. Because E is unable to determine the extent to which advance payments are taken into account as AFS revenue for the taxable year of receipt, E cannot use the deferral method for these advance payments.

(ii) *Example 2: Gift cards eligible for deferral method.* The same facts as in paragraph (c)(3)(i) of this section (*Example 1*) apply, 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 AFS revenue for the taxable year in which the cards expire. Because E tracks the sale date and the expiration date of the gift cards for its AFS, E can determine the extent to which advance payments are taken into account as AFS revenue for the taxable year of receipt. Therefore, E meets the requirement of paragraph (c)(1) of this section and may elect the deferral method for these advance payments.

(4) *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, 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 for 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) *Examples.* The following examples illustrate the rules in paragraph (c)(4) of this section. In each of the following examples, the taxpayer is a C corporation, uses an accrual method of accounting for Federal income tax purposes and files its returns on a calendar year basis. In addition, the taxpayer has an AFS and uses the deferral method in paragraph (c) of this section.

(A) *Example 1: Ceasing to exist.* A is in the business of selling and licensing off the shelf, fully customized, and semi-customized computer software and providing customer support. On July 1, 2021, 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, 2021, in a transaction that

does not involve a section 351(a) transfer described in paragraph (c)(4)(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 2021 taxable year.

(B) *Example 2: Satisfaction of obligation*—(1) *Facts.* On November 1, 2021, J, a travel agent, receives payment from a customer for an airline flight that will take place in April 2022. J purchases and delivers the airline ticket to the customer on November 14, 2021. J retains the excess of the customer’s payment over the cost of the airline ticket as its commission. 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 2022.

(2) *Analysis.* The payment for commission income is an advance payment. Because J is not required to provide any services after the ticket is delivered to the customer on November 14, 2021, J satisfies its obligation to the customer for its commission when the airline ticket is delivered. Thus, for Federal income tax purposes, J must include the commission in gross income for 2021.

(5) *Financial statement adjustments*—

(i) *In general.* 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 such as retained earnings, or otherwise writes-down or adjusts that item of deferred revenue in a subsequent taxable year, AFS revenue for that subsequent taxable year is increased or decreased, as applicable, by the amount that is written down or adjusted. See §1.451-3(k).

(ii) *Examples.* The following examples illustrate the rules in paragraph (c)(5) of this section. In each of the following examples, the taxpayer is a C corporation, uses an accrual method of accounting for Federal income tax purposes and files its returns on a calendar year basis. In addition, the taxpayer has an AFS and uses the deferral method in paragraph (c) of this section.

(A) *Example 1*—(1) *Facts.* On May 1, 2021, A 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 (\$25) of the advance payment in AFS revenue for 2021, 1/2 (\$50) for 2022, and 1/4 (\$25) for 2023. On August 31, 2021, C, an unrelated corporation that files its Federal income tax return on a calendar year basis and that is a member of a consolidated group, acquired all of the stock of A, and A joined C’s consolidated group. A’s short taxable year ended on August 31, 2021, and, as of that date, A had included 1/4 (\$25) of the advance payment in AFS revenue. On September 1, 2021, 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 is included in revenue on A's AFS in accordance with the method of accounting A uses for financial accounting purposes.

(2) *Analysis.* 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, 2021 and must include the remainder of the advance payment (\$75) (\$65 write down + \$10 future financial statement revenue) in income for its next succeeding taxable year.

(B) *Example 2—(1) Facts.* On May 1, 2021, B received \$100 as an advance payment for a contract to be performed in 2021, 2022, and 2023. On August 31, 2021, D, a corporation that is not a member of a consolidated group for Federal income tax purposes, acquired all of the stock of B. Before the stock acquisition, for 2021, B included \$40 of the advance payment in AFS revenue, and \$60 as a deferred revenue liability. On September 1, 2021, after the stock acquisition and in accordance with purchase accounting rules, B, at D's direction, 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 take into account as AFS revenue any of the \$10 deferred revenue liability in its 2021 AFS. B does include \$5 in revenue in 2022, and \$5 in revenue in 2023.

(2) *Analysis.* For Federal income tax purposes, B must include \$40 of the advance payment into income in 2021 and must include the remainder of the advance payment (\$60) (\$50 write down plus \$10 future financial statement revenue) in income for the 2022 taxable year.

(6) *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 taken into account as AFS revenue as of the end of such taxable year, as determined under paragraph (c)(2) of this section. Any amount of the advance payment not included in gross income in the taxable year of receipt or the short taxable year, must be included in gross income for the taxable year immediately following the short taxable year.

(ii) *Example 1—(A) Facts.* A is a calendar year taxpayer and is in the business of selling and licensing off the shelf, fully customized, and semi-customized computer software and providing customer support. On July 1, 2021, A enters into a 2-year software maintenance contract and receives an advance payment of \$240 under the contract. Under the contract, A will provide software updates if it develops an update within the contract period, as well as provides

online and telephone customer support. A changes its taxable period to a fiscal year ending March 31. As a result, A has a short taxable year beginning January 1, 2022, and ending March 31, 2022. In its AFS, A includes 6/24 (\$60) of the payment in revenue for the taxable year ending December 31, 2021 to account for the six-month period July 1 through December 31, 2021; 3/24 (\$30) in revenue for the short taxable year ending March 31, 2022 to account for the three-month period January 1 through March 31, 2022; 12/24 (\$120) in revenue for the taxable year ending March 31, 2023; and 3/24 (\$30) in revenue for the taxable year ending March 31, 2024.

(B) *Analysis.* Because the taxable year ending March 31, 2021, is 92 days or less, A must include 6/24 (\$60) of the payment in gross income for the taxable year ending December 31, 2021, 3/24 (\$30) in gross income for the short taxable year ending March 31, 2022, and 15/24 (\$150), the remaining amount, in gross income for the taxable year ending March 31, 2023.

(iii) *Example 2—(A) Facts.* On May 1, 2021, B received \$100 as an advance payment for a contract to be performed in 2021, 2022, and 2023. On October 31, 2021, C, an unrelated corporation that files its federal income tax return on a calendar year basis and that is a member of a consolidated group, acquired all the stock of B and B joined C's consolidated group. Before the stock acquisition, for 2021, B included \$40 of the advance payment in AFS revenue, and \$60 as a deferred revenue liability. On November 1, 2021, after the stock acquisition and in accordance with purchase accounting rules, C wrote down B's \$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 2021 AFS. B includes \$5 in revenue in 2022, and \$5 in revenue in 2023.

(B) *Analysis.* For Federal income tax purposes, B must take \$40 of the advance payment into income in its short tax year ending October 31, 2021. B's subsequent tax year, the short tax year ending December 31, 2021, is a tax year that is 92 days or less. Therefore, under paragraph (c)(6)(i) of this section, B generally will include the portion of the advance payment not included in the taxable year of receipt in gross income for this short taxable year to the extent taken into account as AFS revenue. Although for AFS purposes, no amount is recognized in revenue for the short period beginning November 1, 2021 and ending on December 31, 2021, under paragraph (c)(5)(i) of this section, B must treat the amount of the write-down as AFS revenue in the taxable year in which the write-down occurs. Therefore, B must include \$50 of the advance payment into income in the short tax year ending December 31, 2021 (equal to the \$50 write down plus \$0 recognized in B's AFS for the period beginning on November 1, 2021 and ending December 31, 2021), and must include the remainder of the advance payment (\$10) in income for the 2022 taxable year.

(7) *Financial statement conformity requirement.* A taxpayer that uses an AFS to apply the rules under §1.451-3 must use the same AFS and, if applicable, the same method of accounting under §1.451-3(h)

(4), to apply the deferral method in paragraph (c) of this section. Additionally, the AFS rules under §1.451-3(h) also apply for purposes of this section.

(8) *Contracts with multiple performance obligations—(i) General rule.* If a taxpayer is using the deferral method under this paragraph (c) and the taxpayer's contract with a customer has more than one performance obligation, then any payments received under the contract are allocated to the corresponding item of gross income in the same manner as such payments are allocated to the performance obligations in the taxpayer's AFS.

(ii) *Example: Computer software subscription with multiple performance obligations—(A) Facts.* P is in the business of licensing off the shelf, fully customized, and semi-customized computer software and providing customer support. P uses an accrual method of accounting for Federal income tax purposes, files its returns on a calendar year basis, and has an AFS. On July 1, 2021, P receives an advance payment of \$100 for a 2-year software subscription comprised of:

(1)(i) A 1-year "software maintenance contract" under which P will provide software updates within the contract period; and

(ii) A "customer support agreement" for online and telephone customer support.

(2) P reflects the software maintenance contract and the customer support agreement as two separate performance obligations in its AFS and allocates \$80 of the payment to the software maintenance contract and \$20 to the customer support agreement. P includes the \$80 allocable to the software maintenance payment in AFS revenue as follows: 1/4 (\$20) in AFS revenue for 2021; 1/2 (\$40) in AFS revenue for 2022; and the remaining 1/4 (\$20) in AFS revenue for 2023. Regarding the \$20 allocable to the customer support payment, P includes 1/2 (\$10) in AFS revenue for 2021, and the remaining 1/2 (\$10) in AFS revenue for 2022 regardless of when P provides the customer support.

(B) *Analysis.* Since the software maintenance contract and the customer support agreement are two separate performance obligations, each yielding a separate item of gross income, paragraph (c)(8) of this section requires P to allocate the \$100 payment to each item of gross income in the same manner as the payment is allocated to each performance obligation in P's AFS. For Federal income tax purposes, P must include \$30 in gross income for 2021 (\$20 allocable to the software maintenance contract and \$10 allocable to the customer support agreement) and the remaining \$70 is included in gross income for 2022.

(iii) *Contracts with advance payments that include items subject to a special method of accounting—(A) In general.* The portion of the payment allocable to the items of gross income described in paragraph (a)(1)(i)(C) of this section from a contract that includes one or more items of gross income subject to

a special method of accounting and one or more items of gross income described in paragraph (a)(1)(i)(C) of this section must be determined based on objective criteria.

(B) *Allocation deemed to be based on objective criteria.* A taxpayer's allocation method is based on objective criteria if an allocation of the payment to each item of gross income is in proportion to the amounts determined in §1.451-3(d)(5) or as otherwise provided in guidance published in the Internal Revenue Bulletin (see §601.601(d) of this chapter).

(iv) *Example—(A) Facts.* B is a calendar-year accrual method taxpayer with an AFS. In 2020, B enters into a \$100x contract to design, build, operate and maintain a toll road and receives an up-front payment of \$100x. The contract meets the definition of a long-term contract under §1.460-1(b)(1). B properly determines that the obligations to design and build the toll road are long-term contract activities under §1.460-1(d)(1) and accounts for the gross income from these activities under section 460. In addition, B properly determines that the obligations to operate and maintain the toll road are non-long-term contract activities under §1.460-1(d)(2) and that the gross income attributable to these activities is accounted for under section 451(b). B allocates \$60x of the transaction price amount to the long-term contract activities and the remaining \$40x to the non-long-term contract activity pursuant to §1.451-3(d)(5). For AFS purposes, B allocates \$55x of the transaction price amount to the performance obligations that are long-term contract activities and \$45x to the non-long-term contract activities. B uses the deferral method of accounting.

(B) *Analysis.* For Federal income tax purposes, a method of accounting under section 460 is a special method of accounting under paragraph (c)(8)(iv) of this section. Pursuant to paragraph (c)(8)(iv) of this section, B must allocate the payment among the item(s) of gross income that are subject to section 460 and the item(s) of gross income described in paragraph (a)(1)(i)(C) of this section based on objective criteria. B's allocation is deemed to be based on objective criteria if it allocates the payment in proportion to the amounts determined under §1.451-3(d)(5). That is, \$60x to the items of gross income subject to section 460 and \$40x to the items of gross income described in paragraph (a)(1)(i)(C) of this section.

(9) *Special rule relating to eligible gift card sales.* For paragraphs (a)(1)(i)(B) and (c)(1) of this section, if an eligible gift card is redeemable by an entity described in paragraph (a)(10)(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 its AFS revenue to the extent the gift card is redeemed by such entity during the taxable year.

(10) *Examples.* The following examples illustrate the rules of paragraph (c) of this section. In each of the following examples, the taxpayer uses an accrual method of accounting for Federal income tax purposes and files its returns on a calendar year basis. In addition, the taxpayer in each example has an AFS and uses the deferral method under paragraph (c) of this section. Further, the taxpayer does not use the advance payment cost offset method in paragraph (e) of this section.

(i) *Example 1: Services.* On November 1, 2021, A, in the business of giving dancing lessons, receives an advance payment of \$480 for a 1-year contract commencing on that date and providing for up to 48 individual, 1-hour lessons. A provides eight lessons in 2021 and another 35 lessons in 2022. A takes into account 1/6 (\$80) of the payment as AFS revenue for 2021, and 5/6 (\$400) of the payment as AFS revenue for 2022. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, A must include 1/6 (\$80) of the payment in gross income for 2021, and the remaining 5/6 (\$400) of the payment in gross income for 2022.

(ii) *Example 2: Services.* The same facts as in paragraph (c)(10)(i) of this section (*Example 1*) apply. A receives an advance payment of \$960 for a 3-year contract under which A provides up to 96 lessons. A provides eight lessons in 2021, 48 lessons in 2022, and 40 lessons in 2023. A takes into account 1/12 (\$80) of the payment as AFS revenue for 2021, 1/2 (\$480) of the payment as AFS revenue for 2022, and 5/12 (\$400) of the payment as AFS revenue for 2023. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, A must include 1/12 (\$80) of the payment in gross income for 2021, and the remaining 11/12 (\$880) of the payment in gross income for 2022.

(iii) *Example 3: Services.* On June 1, 2021, B, a landscape architecture firm, receives an advance payment of \$100 for landscape services that, under the terms of the agreement, must be provided by December 2022. On December 31, 2021, B estimates that 3/4 of the work under the agreement has been completed. B takes into account 3/4 (\$75) of the payment as AFS revenue for 2021, and 1/4 (\$25) of the payment as AFS revenue for 2022. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, B must include 3/4 (\$75) of the payment in gross income for 2021, and the remaining 1/4 (\$25) of the payment in gross income for 2022, regardless of whether B completes the job in 2022.

(iv) *Example 4: Repair contracts.* On July 1, 2021, C, in the business of selling and repairing television sets, receives an advance payment of \$100 for a 2-year contract under which C agrees to repair the customer's television set. C takes into account 1/4 (\$25) of the payment as AFS revenue for 2021, 1/2 (\$50) of the payment as AFS revenue for 2022, and 1/4 (\$25) of the payment as AFS revenue for 2023. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, C must include 1/4 (\$25) of the payment in gross income for

2021 and the remaining 3/4 (\$75) of the payment in gross income for 2022.

(v) *Example 5: Online website design.* On July 20, 2021, D, a website designer, receives an online payment of \$75 to design a website for Customer to be completed on February 1, 2023. D designs and completes Customer's website on February 1, 2023. D takes into account the \$75 payment for Customer's website as AFS revenue for 2023. The \$75 payment D receives for Customer's website is an advance payment. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, D must include the \$75 payment for the website in gross income for 2022.

(vi) *Example 6: 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, 2021, G receives an advance payment from a subscriber for 1 year of access to its online database, beginning on that date. G takes into account 1/3 of the payment as AFS revenue for 2021 and the remaining 2/3 as AFS revenue for 2022. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, G must include 1/3 of the payment in gross income for 2021 and the remaining 2/3 of the payment in gross income for 2022.

(vii) *Example 7: Membership fees.* On December 1, 2021, H, in the business of operating a chain of "shopping club" retail stores, receives advance payments for membership fees. The membership fees are not prepaid dues income subject to section 456. 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. H takes into account 1/12 of the payment as AFS revenue for 2021 and 11/12 of the payment as AFS revenue for 2022. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, H must include 1/12 of the payment in gross income for 2021, and the remaining 11/12 of the payment in gross income for 2022.

(viii) *Example 8: Cruise.* In 2021, I, in the business of operating tours, receives \$20x payments from customers for a 10-day cruise that will take place in April 2022. Under the agreement, I charts a cruise ship, hires a crew and a tour guide, and arranges for entertainment and shore trips for the customers. I takes into account the \$20x payments as AFS revenue for 2022. For Federal income tax purposes, I must include the \$20x payments in gross income for 2022.

(ix) *Example 9: Broadcasting rights—(A) Facts.* 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 league entered into a 2-year broadcasting contract beginning October 1, 2021. K receives two payments of \$100x on October 1 of each contract year, beginning in 2021. K estimates that for each contract year, 25% of the broadcasting rights are transferred by December 31 of the year of payment, and the remaining 75% of the broadcasting rights are transferred in the following year. K takes into account 1/4 (\$25x) of the first installment payment as AFS revenue for 2021 and 3/4 (\$75x) as AFS revenue for 2022. K takes into account 1/4 (\$25x) of the second payment as AFS

revenue for 2022 and 3/4 (\$75x) as AFS revenue for 2023.

(B) *Analysis.* Each installment payment is an advance payment under paragraph (a)(1) of this section because a portion of each payment is included in AFS revenue for a subsequent taxable year and the payment relates to the use of intellectual property. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, K must include 1/4 (\$25x) of the first \$100x installment payment in gross income for 2021 and 3/4 (\$75x) of the first installment payment in gross income for 2022. In addition, K must include 1/4 (\$25x) of the second \$100x payment in gross income for 2022 and 3/4 (\$75x) of the second installment payment in gross income for 2023.

(x) *Example 10: Insurance claims administration—(A) Facts.* L is in the business of negotiating, placing, and servicing insurance coverage and administering claims for insurance companies. On December 1, 2021, 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, 2022. 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. Since L does not perform any services related to the payment prior to the service year, L does not meet the requirements of §1.451-1(a) for the payment prior to the service year. For example, L is paid on December 1, 2021, for the service year beginning January 1, 2022. L takes into account the first payment as AFS revenue for 2022; the second payment as AFS revenue for 2023; the third payment as AFS revenue for 2024; and the fourth payment as AFS revenue for 2025.

(B) *Analysis.* Each annual payment is an advance payment under paragraph (a)(1) of this section because each payment is taken into account as AFS revenue for a subsequent taxable year and the payment relates to services. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, L must include: the first payment in gross income for 2022; the second payment in gross income for 2023; the third payment in gross income for 2024; and the fourth payment in gross income for 2025.

(xi) *Example 11: Internet services—(A) Facts.* M is a cable internet service provider that enters into contracts with subscribers to provide internet services for a monthly fee that is 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, that is 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 2021, M receives \$100x payments from subscribers for January 2022 internet service and cable modem use. M takes into account the entire \$100x payments as AFS revenue for 2022.

(B) *Analysis.* For Federal income tax purposes, the \$100x payments are advance payments. Because M uses the deferral method in paragraph (c) of this section, M must include \$100x in gross income for 2022.

(xii) *Example 12: License agreement—(A) Facts.* On January 1, 2021, N receives a payment of

\$250 for entering into a 3-year license agreement for the use of N's trademark throughout the term of the agreement. The \$250 payment reflects the first year (2021) license fee of \$100 and the third year (2023) license fee of \$150. The fee of \$125 for the second year is payable on January 1, 2022. N takes into account \$100 of the \$250 upfront payment as AFS revenue for 2021, \$125 as AFS revenue for 2022, and \$150 of the \$250 payment as AFS revenue for 2023.

(B) *Analysis.* For Federal income tax purposes, N received an advance payment of \$150, the 2023 license fee, in 2021. Because N uses the deferral method in paragraph (c) of this section, N must defer the \$150 payment and include it in gross income for 2022.

(xiii) *Example 13: Computer software subscription with one performance obligation—(A) Facts.* On July 1, 2021, O, in the business of licensing off the shelf, fully customized, and semi-customized computer software and providing customer support, receives a payment of \$100 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. O determines that its obligations under the software subscription contract are one performance obligation for financial accounting purposes, which yields one item of gross income. O takes into account 1/4 (\$25) of the payment as AFS revenue for 2021, 1/2 (\$50) as AFS revenue for 2022, and the remaining 1/4 (\$25) as AFS revenue for 2023, regardless of when O provides updates or customer support.

(B) *Analysis.* For Federal income tax purposes, the \$100 payment is an advance payment. Because O uses the deferral method in paragraph (c) of this section, O must include 1/4 (\$25) of the payment in gross income for 2021 and 3/4 (\$75) in gross income for 2022.

(xiv) *Example 14: Gift cards administered by another—(A) General facts.* Q is a corporation that operates department stores and is the common parent of a consolidated group (the Q group). U, V, and W are domestic corporations wholly owned by Q and members of the Q group. X is a foreign corporation wholly owned by Q and not a member of the Q group. 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 members of the Q 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.

(B) *Facts for taxable year 2021.* In 2021, W sells gift cards with a total value of \$900, and, at the end of 2021, the unredeemed balance of the gift cards is \$100. In Q group's AFS, the group includes revenue from the sale of a gift card when the gift card

is redeemed. Accordingly, of the \$900 of gift cards sold in 2021, \$800 were redeemed and taken into account as AFS revenue for 2021. W tracks sales and redemptions of gift cards electronically, determines the extent to which advance payments are taken into account as AFS revenue in Q group's AFS for the taxable year of receipt and meets the requirements of paragraph (c)(1) of this section.

(C) *Analysis.* The payments W receives from the sale of gift cards are advance payments because they are payments for eligible gift cards. Under the deferral method, W must include \$800 of the payments from gift card sales in gross income in 2021 and the remaining \$100 of the payments in gross income in 2022.

(xv) *Example 15: Gift cards of affiliates—(A) Facts.* 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 taken into account as AFS revenue for the taxable year of receipt and meet the requirements of paragraph (c)(1) of this section.

(B) *Analysis.* The payments R receives from the sale of gift cards are advance payments because they are payments for eligible gift card sales. For Federal income tax purposes, R is eligible to use the deferral method. Using the deferral method, in the taxable year of receipt, R must include the advance payment in income to the extent taken into account as AFS revenue and must include any remaining amount in income in the taxable year following the taxable year of receipt. Under paragraph (c)(9) of this section, R is treated as taking into account revenue from the sale of a gift card as AFS revenue when a gift card is redeemed at a participating restaurant.

(xvi) *Example 16: Gift cards for domestic and international hotels—(A) Facts.* S is a corporation that operates for the benefit of its franchisee members, who own and operate domestic and international individual member hotels. S 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, determines the extent to which advance payments are included in AFS revenue for the taxable year of receipt and meets the requirements of paragraph (c) (1) of this section.

(B) *Analysis.* 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. Under the deferral method, in the taxable year of receipt, S must include in income the advance payment to the extent taken into account as AFS revenue and must include any remaining amount in income in the taxable year following the taxable year of receipt.

(xvii) *Example 17: Discount voucher—(A) Facts.* On December 10, 2021, 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% 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 takes into account \$12 of the amount allocated to the discount voucher as AFS revenue for 2021 and includes \$18 of the discount voucher as AFS revenue for 2022.

(B) *Analysis.* For Federal income tax purposes, the \$30 payment allocated to the discount voucher is an advance payment. Using the deferral method, T must include the \$12 allocable to the discount voucher in gross income in 2021 and the remaining \$18 allocated to the discount voucher in gross income in 2022.

(xviii) *Example 18: Rewards—(A) Facts.* On December 31, 2021, 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 the issue date, redemption date, and expiration date of each customer's reward points. Under the terms of U's reward program, when the customer redeems reward points they are deemed to use the earliest issued points first. In its AFS, U treats the rewards points as a separate performance obligation and allocates \$50 of the \$1,000 sales price to the rewards points. U is able to determine the extent to which a payment that is allocated to a reward point is taken into account in AFS revenue in the year of receipt. U does not take any of the amount allocated to the reward points into account as AFS revenue for 2021. U takes into account \$25 of the reward points as AFS revenue for 2022 and \$25 of the reward points as AFS revenue for 2023.

(B) *Analysis.* For Federal income tax purposes, U's treatment of the reward points as a separate performance obligation for AFS purposes yields an item of gross income that must be accounted for separately. The \$50 payment allocated to the reward points item is an advance payment as the full inclusion of the payment in gross income in the year of receipt is

a permissible method of accounting without regard to this section, a portion of the payment is taken into account as AFS revenue in a subsequent taxable year, and the reward points are redeemable for an item described in paragraph (a)(1)(i)(C) of this section (goods). Because the entire amount of the \$50 advance payment is taken into account as AFS revenue in tax years following the year of receipt, U defers the payment and includes the \$50 payment in gross income in 2022.

(xix) *Example 19: Credit card rewards—(A) Facts.* V issues credit cards and has a loyalty program under which cardholders earn reward points when they use V's credit card to make purchases. Each reward point is redeemable for \$1 on any future purchases.

(B) *Analysis.* Payments under credit card agreements, including rewards for credit card purchases, are excluded from the definition of an advance payment under paragraph (a)(1)(ii)(C) of this section. Accordingly, V cannot use the deferral method for these amounts.

(xx) *Example 20: Airline reward miles—(A) Facts.* On January 1, 2021, W, a passenger airline company, sells a customer a \$700 airline ticket to fly roundtrip in 2021. As part of the purchase, the customer receives 7,000 reward points (air miles) from W to be used for future air travel. The reward points are not redeemable for cash and have a 2-year expiration date. W tracks the issue date, redemption date, and expiration date of each customer's reward points. Under the terms of U's reward program, when the customer redeems reward points they are deemed to use the earliest issued points first. In its AFS, W treats the rewards points as a separate performance obligation and allocates \$35 of the \$700 ticket price to the reward points. W is able to determine the extent to which a payment that is allocated to a reward point is taken into account in AFS revenue in the year of receipt. W takes into account all \$35 as AFS revenue in 2023 when the customer redeems the air miles.

(B) *Analysis.* For Federal income tax purposes, W's treatment of the reward points as a separate performance obligation for AFS purposes yields an item of gross income that must be accounted for separately. The \$35 allocated to the reward points item is an advance payment as the full inclusion of the payment in gross income in the taxable year of receipt is a permissible method of accounting without regard to this section, a portion of the payment is taken into account as AFS revenue in a subsequent taxable year, and the reward points are redeemable for an item described in paragraph (a)(1)(i)(C) of this section (services). Because the entire amount of the \$35 advance payment is taken into account as AFS revenue in a tax year following the year of receipt, W defers the payment and includes the \$35 payment in gross income in 2022.

(xxi) *Example 21: Chargebacks—(A) Facts.* In 2021, X, a manufacturer of pharmaceuticals, 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 credit W \$4 per unit (chargeback) for sales W makes to qualifying customers. X delivers 600 units to W on December 31, 2021, and bills W \$6,000 under the contract. X anticipates that all of W's sales will be to

qualifying customers and subject to chargeback. For AFS purposes, X adjusts its 2021 AFS revenue of \$6,000 by \$2,400, the anticipated chargebacks, and reports \$3,600 of AFS revenue.

(B) *Analysis.* For Federal income tax purposes, under paragraph (a)(1)(i)(B) of this section, for a payment to qualify as an advance payment, a portion of the payment must be taken into account as AFS revenue for a subsequent taxable year. Under paragraph (a)(1)(i)(B) of this section, the amount of the payment included in AFS revenue for a subsequent taxable year is \$0, calculated as the \$6,000 payment reduced by \$6,000 that is treated as taken into account as AFS revenue for 2021 (\$3,600 of AFS revenue for 2021 + \$2,400 of anticipated chargebacks (section 461 liabilities) which had reduced AFS revenue for 2021). Because no portion of the \$6,000 is taken into account as AFS revenue in a subsequent taxable year (that is, on an AFS after 2021), the \$6,000 payment received in 2021 is not an advance payment under paragraph (a)(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 of accounting 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 and can determine the extent to which advance payments are earned in the taxable year of receipt and, if applicable, a short taxable year described in paragraph (d)(6) of this section. The determination whether the advance payment is earned in the taxable year of receipt, or a short taxable year described in paragraph (d)(6) of this section, if applicable, is determined on an item by item basis.

(3) *Deferral of advance payments based on when payment is earned—(i) In general.* Except as otherwise provided in this section, a taxpayer that uses the non-AFS deferral method of accounting includes the advance payment in gross income for the taxable year of receipt 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.* Under the non-AFS deferral method, 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 (a)(14) of this section, by the taxpayer. If a taxpayer is unable to de-

termine the extent to which a payment is earned in the taxable year of receipt, or a short taxable year described in paragraph (d)(6) of this section, if applicable, the taxpayer may calculate the amount:

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

(B) On a straight-line basis over the term of the agreement if the taxpayer receives the advance payment under a fixed term agreement and if it is reasonable 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) Using any other method that may be provided in guidance published in the Internal Revenue Bulletin (see §601.601(d) of this chapter).

(4) *Contracts with multiple items of gross income*—(i) *In general.* If a taxpayer receives a payment that is attributable to one or more items described in paragraph (a)(1)(i)(C) of this section, the taxpayer must determine the portion of the payment that is allocable to such item(s) by using an allocation method that is based on objective criteria.

(ii) *Objective criteria.* A taxpayer's allocation method for a payment described in paragraph (d)(4)(i) of this section is deemed to be based on objective criteria if the allocation method is based on payments the taxpayer 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).

(5) *Acceleration of advance payments.* The acceleration rules in paragraph (c)(4) of this section also apply to a taxpayer that uses the non-AFS deferral method under paragraph (d) of this section.

(6) *Short taxable year rule.* 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 non-AFS 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 earned in such taxable year.

Any amount of the advance payment not included in gross income in the taxable year of receipt, or the short taxable year, must be included in gross income for the taxable year immediately following the short taxable year.

(7) *Eligible gift card sale.* For paragraphs (a)(1)(i)(B) and (d)(3) of this section, if an eligible gift card is redeemable by an entity described in paragraph (a)(10)(ii) of this section, 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 such entity during the taxable year.

(8) *Examples.* The following examples illustrate the rules of paragraph (d) of this section. In the examples in this paragraph (d)(8), the taxpayer is a calendar year taxpayer that uses the non-AFS deferral method described in paragraph (d) of this section. None of the taxable years are short taxable years.

(i) *Example 1—(A) Facts.* A, a video arcade operator, receives payments in 2021 for tokens that customers use to play A's arcade games. The tokens cannot be redeemed for cash, are imprinted with the name of the arcade, but 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 2021, 70% of tokens are expected to be used in 2021, 20% of tokens are expected to be used in 2022, and 10% of tokens are expected to never be used. Based on the study, under paragraph (d)(3)(ii)(A) of this section, A determines that 80% of the advance payments are earned for 2021 (70% for tokens expected to be used in 2021 plus 10% for tokens that are expected to never be used).

(B) *Analysis.* For Federal income tax purposes, A must include 80% of the advance payments in gross income for 2021 and 20% of the advance payments in gross income for 2022.

(ii) *Example 2—(A) Facts.* B is in the business of providing internet services. On September 1, 2021, 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. However, at the close of the 2021 taxable year, it is reasonable for B to anticipate that the advance payment will be earned ratably over the term of the agreement.

(B) *Analysis.* For Federal income tax purposes, pursuant to paragraph (d)(3)(ii)(B) of this section, B determines the extent to which the payment is earned in tax year 2021 on a straight-line basis over the term of the agreement and takes that amount into income in 2021. The remaining amount of the advance payment is taken into gross income in the 2022 taxable year.

(e) *Advance payment cost offset method*—(1) *In general.* This paragraph (e) provides an optional method of accounting for advance payments from the sale of inventory (advance payment cost offset method). A taxpayer that chooses to use the advance payment cost offset method for a trade or business must use the method of accounting for all advance payments received by that trade or business that meet the criteria in this paragraph (e). Additionally, a taxpayer that chooses to use this method for a trade or business and that has an AFS must also use the AFS cost offset method described in §1.451-3(c). A taxpayer that uses the AFS cost offset method and the advance payment cost offset method to account for gross income, including advance payments, from the sale of an item of inventory, determines the corresponding AFS income inclusion amount, as defined in §1.451-3(a)(1), and the advance payment income inclusion amount for a taxable year by following the rules in §1.451-3(c)(2) rather than the rules under this paragraph (e). However, if all payments received for the sale of item of inventory meet the definition of an advance payment under paragraph (a)(1) of this section, a taxpayer that uses the advance payment cost offset method determines the corresponding advance payment income inclusion amount for a taxable year by:

(i) Following the rules in paragraph (e)(2) of this section, subject to the additional rules and limitations in paragraphs (e)(5) through (8) of this section, if the taxable year is a taxable year prior to the taxable year in which ownership of the item of inventory is transferred to the customer; and

(ii) Following the rules in paragraph (e)(3) of this section, subject to the additional rules and limitations in paragraphs (e)(5) through (8) of this section, if the taxable year is the taxable year in which ownership of the item of inventory is transferred to the customer.

(2) *Determining the advance payment income inclusion amount in a year prior to the year of sale.* To determine the advance payment income inclusion amount for a taxable year prior to the year in which ownership of the item of inventory is transferred to the customer, the taxpayer must first determine the advance payment inventory inclusion amount for such item

for such year. This advance payment inventory inclusion amount is then reduced by the cost of goods in progress offset for the taxable year, as determined under paragraphs (e)(4), (5), and (8) of this section. This net amount is the advance payment income inclusion amount for the taxable year.

(3) *Determining the advance payment income inclusion amount in the year of sale.* The advance payment income inclusion amount for the taxable year in which ownership of the item of inventory is transferred to the customer is equal to the portion of any advance payment for such item that was not required to be included in gross income in a prior taxable year. This amount is not reduced by a cost of goods in progress offset under paragraph (e)(4) of this section. However, the taxpayer is entitled to recover the costs capitalized to the item of inventory as cost of goods sold in accordance with sections 471 and 263A or any other applicable provision of the Internal Revenue Code. See §1.61-3.

(4) *Cost of goods in progress offset.* The cost of goods in progress offset for the taxable year is calculated as:

(i) The cost of goods allocable to the item of inventory through the last day of the taxable year; reduced by

(ii) The cumulative cost of goods in progress offset attributable to the item of inventory, if any.

(5) *Limitations to the cost of goods in progress offset.* The cost of goods in progress offset is determined separately for each item of inventory. The cost of goods in progress offset attributable to one item of inventory cannot reduce the advance payment inventory inclusion amount attributable to a different item of inventory. Further, the cost of goods in progress offset cannot reduce the advance payment inventory inclusion amount for the taxable year below zero.

(6) *Exception for gift cards.* The cost of goods in progress offset in this paragraph (e) does not apply to eligible gift card sales or payments received for customer reward points.

(7) *Acceleration of advance payments.* The acceleration rules in paragraph (c)(4) of this section also apply to a taxpayer that uses the advance payment cost offset method under this paragraph (e), regardless of whether the taxpayer uses such method in connection with the full inclusion method

under paragraph (b) of this section, or the deferral method under paragraph (c) or (d) of this section. If an advance payment is subject to the acceleration rules, paragraph (e)(2) of this section does not apply to determine the advance payment income inclusion amount for the taxable year described in paragraph (c)(4) of this section. Further, a taxpayer that uses the advance payment cost offset method under this paragraph (e) applies paragraph (c)(4)(i)(B)(2)(ii) of this section by substituting “same advance payment method as the transferor” for “deferral method.”

(8) *Inventory costs for the advance payment cost offset method—(i) Inventory costs not affected by cost of goods in progress offset.* The cost of goods comprising the cost of goods in progress offset does not reduce the costs that are capitalized to the items of inventory produced or items of inventory acquired for resale by the taxpayer. While the cost of goods in progress offset reduces the amount of the advance payment inventory inclusion amount, the cost of goods in progress offset does not affect how and when costs are capitalized to inventory under sections 471 and 263A or any other applicable provision of the Internal Revenue Code or when those capitalized costs will be recovered.

(ii) *Consistency between inventory methods and advance payment cost offset method.* The costs of goods comprising the cost of goods in progress offset must be determined by applying the taxpayer’s methods of accounting for inventory for Federal income tax purposes. A taxpayer using the advance payment cost offset method must calculate its cost of goods in progress offset by reference to all costs that the taxpayer has permissibly capitalized and allocated to items of inventory under its methods of accounting for inventory for Federal income tax purposes, but including no more costs than what the taxpayer has permissibly capitalized and allocated to items of inventory.

(iii) *Allocation of “additional section 263A costs” for taxpayers using simplified methods.* If a taxpayer uses the simplified production method as defined under §1.263A-2(b), the modified simplified production method as defined under §1.263A-2(c), or the simplified resale method as defined under §1.263A-3(d) to determine the amount of its “addition-

al section 263A costs,” as defined under §1.263A-1(d)(3), to be included in ending inventory, then solely for computing the cost of goods in progress offset, the taxpayer must determine the portion of additional section 263A costs allocable to an item of inventory by multiplying its total additional section 263A costs accounted for under the simplified method for all items of inventory subject to the simplified method by the following ratio:

Section 471 costs allocable to the specific item of inventory

Total section 471 costs for all items of inventory subject to the simplified method

(9) *Additional procedural guidance.* The IRS may publish procedural guidance in the Internal Revenue Bulletin (see §601.601(d) of this chapter) that provides alternative procedures for complying with the rules under this paragraph (e), including alternative methods of accounting for cost offsets.

(10) *Examples.* The following examples illustrate the rules of paragraph (e) of this section. In each of the following examples, the taxpayer is a C corporation, has an AFS, uses an accrual method of accounting for Federal income tax purposes, and uses a calendar year for Federal income tax purposes and AFS purposes. In addition, in each example, the taxpayer uses the deferral method and the advance payment cost offset method under paragraph (e) of this section. Lastly, the taxpayer does not produce unique items, as described in §1.460-2(a)(1) and (b), or any item that normally requires more than 12 calendar months to complete, as determined under §1.460-2(a)(2) and (c). Any production period that exceeds 12 calendar months is due to unforeseen production delays.

(i) *Example 1—(A) Facts.* In December 2021, A enters into a contract with Customer to manufacture and deliver a good in 2024, with a total contract price of \$100x. The costs to produce the good are required to be capitalized under sections 471 and 263A as the good is inventory in the hands of A. On the same day, A receives a payment of \$40x from the customer. For its AFS, A reports all of the revenue from the sale of the good as AFS revenue in the year of delivery, which is also the year in which ownership of the good transfers from A to Customer. As of December 31, 2021, A has not incurred any cost to manufacture the good. The payment of \$40x does not satisfy the specified good exception in paragraph (a)(1)(ii)(H) of this section, and thus qualifies as an advance payment. During 2022, A does not receive any additional

payments on the contract and incurs \$10x of costs to manufacture the good. A properly capitalizes and allocates such costs to the manufactured good under sections 471 and 263A.

(B) *Analysis.* Because no portion of the \$40x advance payment is taken into account as AFS revenue as of the end of 2021, A is not required to include any portion of the advance payment in gross income for 2021. For 2022, A's advance payment inventory inclusion amount is \$40x, which is the amount of the advance payment that, but for the cost of goods in progress offset, would be includable in gross income in 2022 under the deferral method. Pursuant to paragraph (e)(2) of this section, A reduces such amount by the \$10x cost of goods in progress offset, determined as the costs of goods through the end of 2022 (\$0 costs incurred in 2021 plus 10x of costs incurred in 2022 = \$10x). A is required to include this net amount of \$30x in gross income in 2022. The remaining portion of the payment (\$10x) is deferred and included in gross income in 2024, the taxable year in which ownership of the good is transferred to Customer.

(i) *Example 2—(A) Facts.* The same facts as in paragraph (e)(10)(i) of this section (*Example 1*) apply. In addition, in 2023, A incurs costs of \$20x to manufacture the good but does not receive any additional payments from Customer.

(B) *Analysis.* A includes \$0 in gross income in 2023. A's cost of goods in progress offset for 2023 is \$20x under paragraph (e)(4) of this section (\$30x costs of goods through the last day of 2023 (\$10x for 2022 plus \$20x for 2023 = \$30x) less \$10x cumulative cost of goods in progress offset amounts taken in prior taxable years). However, because A's advance payment inventory inclusion amount for 2023 is \$0, which is the amount of the advance payment that, but for the cost of goods in progress offset, would be includable in gross income in 2023 under the deferral method, paragraph (e)(5) of this section limits the cost offset to \$0.

(iii) *Example 3—(A) Facts.* The same facts as in paragraph (e)(10)(i) of this section (*Example 1*) apply, except that in taxable year 2022, A incurs additional costs of \$25x to manufacture the good, resulting in total costs of \$35x to manufacture the good in taxable year 2022.

(B) *Analysis.* For 2022, A's advance payment inventory inclusion amount is \$40x, which is the amount of the advance payment that, but for the cost of goods in progress offset, would be includable in gross income in 2022 under the deferral method. Pursuant to paragraph (e)(2) of this section A reduces such amount by the \$35x cost of goods in progress offset, determined as the costs of goods through the end of 2022 (\$0 costs incurred in 2021 plus \$35x costs incurred in 2022 = \$35x). A is required to include this net amount of \$5x in gross income in 2022. The remaining portion of the payment (\$35x) is deferred and included in gross income in 2024, the taxable year in which ownership of the good is transferred to the customer.

(iv) *Example 4—(A) Facts.* The same facts as in paragraph (e)(10)(iii) of this section (*Example 3*) apply, except that for tax year 2023, A receives an additional advance payment of \$60x, and does not incur any costs to manufacture the good in 2023. In

2024, A incurs the remaining \$10x to manufacture the good, and delivers the good to Customer.

(B) *Analysis for 2023.* Because no portion of the \$60x advance payment is taken into account as AFS revenue as of the end of 2023, A is not required to include any portion of the \$60x advance payment in gross income for 2023.

(C) *Analysis for 2024.* In 2024, the ownership of the good is transferred to Customer. Accordingly, pursuant to paragraph (e)(3) of this section, A is required to include \$95x, the remaining portion of all advance payments that were not required to be included in gross income in a prior taxable year (\$100x of total advance payments received less \$5x that was required to be included in gross income in 2022). Although A does not reduce such amount by a cost offset, it reduces gross income in 2024 by recovering the \$45x of costs capitalized to inventory as cost of goods sold (\$35x costs incurred in 2022 plus \$10x costs incurred in 2024) in accordance with sections 471 and 263A. Accordingly, A's gross income for 2024 is \$50x.

(f) *Method treating payments qualifying for the specified goods exception as advance payments—(1) In general.* A taxpayer may choose to use the *specified good section 451(c) method* to treat all payments that qualify for the specified goods exception in paragraph (a)(1)(ii)(H) of this section as advance payments that are eligible to be accounted for under this section. Under the specified good section 451(c) method, an advance payment is a payment received by the taxpayer in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery date for a specified good. A taxpayer that chooses to use the specified good section 451(c) method for a trade or business must apply this method of accounting for all advance payments that meet the criteria described in paragraph (a)(1)(ii)(H) of this section.

(2) *Example: Method for the specified goods exception to not apply.* On May 1, 2021, A, a corporation that files its Federal income tax return on the calendar year basis, receives a prepayment for \$100x, for a contract to manufacture and deliver a good in September of 2023. All of the revenue from the sale of the good is recognized in A's AFS in the year of delivery. During 2021, A 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. The payment of \$100x satisfies the specified good exception. A uses the method under paragraph (f) of this section to treat all payments that otherwise satisfy

the specified good exception as advance payments under this section. For Federal income tax purposes, A must treat the payment of \$100x as an advance payment and account for such payment under the full inclusion method in paragraph (b) of this section, or the deferral method in paragraph (c) of this section, as applicable. Additionally, the taxpayer may choose to apply the advance payment cost offset method in paragraph (e) of this section.

(g) *Election and methods of accounting—(1) Procedures for making election under section 451(c)(1)(B).* An election to apply the deferral method under section 451(c)(1)(B) is made by the taxpayer filing a Federal income tax return reflecting the deferral method in computing its taxable income. If the application of the deferral method under section 451(c)(1)(B) results in the taxpayer changing its method of accounting, the election may only be made by the taxpayer complying with the method change procedures under this paragraph (g).

(2) *Methods of accounting.* A change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations in this part under sections 446 and 481 of the Code apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with §1.446-1(e) and follow the administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method. For example, use of the full inclusion method under paragraph (b) of this section, the AFS deferral method under paragraph (c) of this section, the non-AFS deferral method under paragraph (d) of this section, the advance payment cost offset method under paragraph (e) of this section, and the specified good section 451(c) method under paragraph (f) of this section are adoptions of, or changes in, a method of accounting under section 446 of the Internal Revenue Code or the regulations in this part under section 446 of the Code. 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 regulations in this part under section 446 of the Code.

(h) *Applicability date*—(1) *In general.* The rules of this section apply to taxable years beginning on or after January 1, 2021.

(2) *Early application.* Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may apply both the rules in this section and, to the extent relevant, the rules in §1.451-3, in their entirety and in a consistent manner, to a taxable year beginning after December 31, 2017, and before January 1, 2021, provided that, once applied to a taxable year, the rules in this section and, to the extent relevant, the rules in §1.451-3, are applied in their entirety and in a consistent manner to all subsequent taxable years. See section 7805(b)(7) and §1.451-3(m).

Par. 7. Section 1.1271-0 is amended by adding entries for §1.1275-2(l) and (l)(1) and (2) to read as follows:

§1.1271-0 Original issue discount; effective date; table of contents.

§1.1275-2 Special rules relating to debt instruments.

(l) *OID rule for income item subject to section 451(b).*

(1) *In general.*

(2) *Applicability dates.*

Par. 8. 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 because the item of income is a specified fee described in §1.451-3(j) (such as 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 paragraph (l)(2) (ii) and (iii) of this section, for a specified credit card fee as defined in §1.451-3(j) (2), paragraph (l)(1) of this section applies for taxable years beginning on or after January 1, 2021, and, for a specified fee that is not a specified credit card fee, paragraph (l)(1) of this section applies for taxable years beginning on or after January 6, 2022.

(ii) *Early application.* For a taxable year beginning after December 31, 2018, and before January 1, 2021, a taxpayer and its related parties, within the meaning of sections 267(b) and 707(b), may choose to apply both paragraph (l)(1) of this section and the rules in §1.451-3, in their entirety and in a consistent manner, to all specified credit card fees subject to §1.451-3, provided that once applied to a taxable year the rules in paragraph (l)(1) of this section and the rules in §1.451-3 that apply to specified credit card fees, are applied in their entirety and in a consistent manner for all subsequent taxable years. See section 7508(b)(7).

(iii) *Applicability date for accounting method changes.* Paragraph (l)(1) of this section will not apply in applying section 13221(e) of Public Law 115-97, 131 Stat. 2054 (2017), 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 for a specified credit card fee.

Sunita Lough,
Deputy Commissioner for Services
and Enforcement.

Approved: December 14, 2020.

David J. Kautter,
Assistant Secretary of the Treasury
(Tax Policy).

(Filed by the Office of the Federal Register on December 30, 2020, 4:15 p.m., and published in the issue of the Federal Register for January 6, 2021, 85 FR 810)

T.D. 9942

**DEPARTMENT OF THE
TREASURY
Internal Revenue Service
26 CFR Part 1**

**Small Business Taxpayer
Exceptions Under Sections
263A, 448, 460 and 471**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations to implement legislative changes to sections 263A, 448, 460, and 471 of the Internal Revenue Code (Code) that simplify the application of those tax accounting provisions for certain businesses having average annual gross receipts that do not exceed \$25,000,000, adjusted for inflation. This document also contains final regulations regarding certain special accounting rules for long-term contracts under section 460 to implement legislative changes applicable to corporate taxpayers. The final regulations generally affect taxpayers with average annual gross receipts of not more than \$25 million, as adjusted for inflation.

DATES: *Effective date:* The regulations are effective on January 5, 2021.

Applicability dates: For dates of applicability, see §§ 1.263A-1(a)(2)(i), 1.263A-1(m)(6), 1.263A-2(g)(4), 1.263A-3(f)(2), 1.263A-4(g)(2), 1.263A-7(a)(4)(ii), 1.381(c)(5)-1(f), 1.446-1(c)(3), 1.448-2(h), 1.448-3(h), 1.460-1(h)(3), 1.460-3(d), 1.460-4(i), 1.460-6(k), and 1.471-1(c).

FOR FURTHER INFORMATION CONTACT: Concerning §§1.460-1 through 1.460-6, Innessa Glazman, (202) 317-7006; concerning all other regulations in this document, Anna Gleysteen, (202) 317-7007.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) to implement statutory amendments to sections 263A, 448, 460, and 471 of the Code made by section 13102 of Public Law No. 115-97 (131 Stat. 2054), commonly referred to as the Tax Cuts and Jobs Act (TCJA). These statutory amendments generally simplify the application of the method of accounting rules under those provisions to certain businesses (other than tax shelters) with average annual gross receipts that do not exceed \$25,000,000, adjusted for inflation.

The uniform capitalization (UNICAP) rules of section 263A provide that, in general, the direct costs and the properly allocable share of the indirect costs of real or tangible personal property produced, or real or personal property described in section 1221(a)(1) acquired for resale, cannot be deducted but must either be capitalized into the basis of the property or included in inventory costs, as applicable. Before the enactment of the TCJA, certain types of taxpayers and certain types of property were exempt from UNICAP, but there was no generally applicable exemption based on gross receipts.

Section 448(a) generally prohibits C corporations, partnerships with a C corporation as a partner, and tax shelters from using the cash receipts and disbursements method of accounting (cash method). However, section 448(b)(3) provides that section 448(a) does not apply to C corporations and partnerships with a C corporation as a partner that meet the gross receipts test of section 448(c). Prior to the TCJA's enactment, a taxpayer met the gross receipts test of section 448(c) if, for all taxable years preceding the current taxable year, the average annual gross receipts of the taxpayer (or any predecessor) for any 3-taxable-year period did not exceed \$5 million.

Section 460(a) provides that income from a long-term contract must be determined using the percentage-of-completion method (PCM). A long-term contract is defined in section 460(f) as generally any contract for the manufacture, building, installation, or construction of proper-

ty if such contract is not completed within the taxable year in which such contract is entered into. Subject to special rules in section 460(b)(3), section 460(b)(1)(A) generally provides that the percentage of completion of a long-term contract is determined by comparing costs allocated to the contract under section 460(c) and incurred before the close of the taxable year with the estimated total contract costs. Prior to the TCJA, section 460(e)(1)(B) provided an exemption from the PCM for a long-term construction contract of a taxpayer who estimated that the contract would be completed within the 2-year period from the commencement of the contract (two-year rule), and whose average annual gross receipts for the 3-taxable-year period ending with the year preceding the year the contract was entered into did not exceed \$10 million (Section 460(e) gross receipts test).

Section 471(a) requires inventories to be taken by a taxpayer when, in the opinion of the Secretary of the Treasury or his delegate (Secretary), taking an inventory is necessary to determine the income of the taxpayer. Section 1.471-1 requires the taking of an inventory at the beginning and end of each taxable year in which the production, purchase, or sale of merchandise is an income-producing factor. Additionally, when an inventory is required to be taken, §1.446-1(c)(1)(iv) and (c)(2) require that an accrual method be used for purchases and sales. Prior to the enactment of the TCJA, there were no regulatory exceptions from the requirement to take an inventory under § 1.471-1.

The statutory amendments of the TCJA increase the gross receipts test amount under section 448(c) to \$25,000,000, adjusted for inflation, for eligibility to use the cash method and also exempt taxpayers, other than a tax shelter under section 448(a)(3), meeting the gross receipts test (Section 448(c) Gross Receipts Test) from: (1) the UNICAP rules under section 263A; (2) the requirement to use the percentage-of-completion method under section 460 provided other requirements of section 460(e) are satisfied; and (3) the requirement to take inventories under section 471(a) if their inventory is treated as non-incidentals materials and supplies, or if the method of accounting for their inventory conforms with the method reflect-

ed on their applicable financial statement (AFS), or if they do not have an AFS, their books and records prepared in accordance with their accounting procedures. These amendments generally apply to taxable years beginning after December 31, 2017. The amendments to section 460 apply to contracts entered into after December 31, 2017, in taxable years ending after December 31, 2017.

On August 20, 2018, the Department of the Treasury (Treasury Department) and the IRS issued Revenue Procedure 2018-40 (2018-34 IRB 320), which provided administrative procedures for a taxpayer, other than a tax shelter under section 448(a)(3), meeting the requirements of section 448(c) to obtain the consent to change the taxpayer's method of accounting to a method of accounting permitted by section 263A, 448, 460 or 471. The revenue procedure also requested comments for future guidance regarding the implementation of the TCJA modifications to sections 263A, 448, 460, and 471. The record of public comments received in response to Revenue Procedure 2018-40 may be requested by sending an email to Notice.Comments@irs.gov.

On August 5, 2020, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-132766-18) in the **Federal Register** (85 FR 47608), correction published in the **Federal Register** (85 FR 58307) on September 18, 2020, containing proposed regulations under sections 263A, 448, 460, and 471 (proposed regulations). The proposed regulations reflect consideration of the comments that were received in response to Revenue Procedure 2018-40.

The Treasury Department and the IRS received nine written comments responding to the proposed regulations. The Treasury Department and the IRS received one request to speak at a public hearing, which was later withdrawn. Therefore, no public hearing was held. Comments received before these final regulations were substantially developed, including all comments received on or before the deadline for comments on September 14, 2020, were carefully considered in developing these final regulations.

Copies of the comments received are available for public inspection at <http://www.regulations.gov> or upon request.

After consideration of the comments received, this Treasury decision adopts the proposed regulations as revised in response to such comments. Those comments and the revisions are discussed in the Summary of Comments and Explanation of Revisions section of this preamble.

Summary of Comments and Explanation of Revisions

I. Overview

This Summary of Comments and Explanation of Revisions section summarizes the formal written comments that were received addressing the proposed regulations. However, comments merely summarizing or interpreting the proposed regulations or recommending statutory revisions generally are not discussed in this preamble. These final regulations provide guidance under sections 263A, 448, 460, and 471 to implement the TCJA's amendments to those provisions. These final regulations also modify §§1.381(c)(5)-1 and 1.446-1 to reflect these statutory amendments. The rationale for provisions in these final regulations that are not discussed in this Explanation of Revisions remains the same as described in the Explanation of Provisions section of the preamble to the proposed regulations.

A. Section 263A(i)

1. Costing Rules for Self-Constructed Assets

In response to Revenue Procedure 2018-40, a commenter stated that a small business taxpayer that is exempted from section 263A pursuant to section 263A(i) would be subject to the costing rules prior to the enactment of section 263A (pre-section 263A costing rules) for self-constructed assets used in the taxpayer's trade or business. However, according to the commenter, the pre-section 263A costing rules were unclear as to what costs are capitalizable to self-constructed assets. In light of this comment, the preamble to the proposed regulations requested comments on specific clarifications needed regarding the pre-section 263A costing rules. Only one comment was received in response to this request. The sole commenter noted

that one of the reasons for the enactment of section 263A was that courts had reached different conclusions as to the types of costs that were required to be capitalized under the pre-section 263A costing rules. *Compare Adolph Coors Co. v. Commissioner*, 519 F.2d 1280 (10th Cir. 1975), cert. denied 423 U.S. 1087 (1976) (requiring the full inclusion of all overhead costs in the cost basis of self-constructed assets) with *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275 (1967) (requiring only the inclusion of overhead costs directly attributable to the self-constructed asset). The commenter suggested that taxpayers who used the exemption under section 263A(i) to not capitalize costs under section 263A be permitted to use an incremental costing method to determine the costs of self-constructed assets, consistent with the approach in *Fort Howard Paper*. The commenter stated that identifying indirect costs not directly attributable to the construction of specific self-constructed assets would be difficult.

After considering this comment, the Treasury Department and the IRS have determined that the requested clarification is beyond the scope of these regulations, which is to implement section 263A(i) as enacted by TCJA. For taxpayers that elect under section 263A(i) to not apply section 263A, the requirement to capitalize certain costs to self-constructed assets comes from other provisions of the Code, such as section 263(a). TCJA did not amend such provisions and thus the clarification of permissible capitalization methods and the types of costs required to be capitalized to self-constructed assets under such provisions is beyond the scope of these final regulations.

2. Changes to Regulations under Section 448

Under section 448(a)(3), a tax shelter is prohibited from using the cash method. Section 448(d)(3) cross references section 461(i)(3) to define the term "tax shelter." Section 461(i)(3)(B), in turn, includes a cross reference to the definition of "syndicate" in section 1256(e)(3)(B), which defines a syndicate as a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of that entity during the taxable year are *allocable* to

limited partners or limited entrepreneurs. Sections 1.448-1T(b)(3) (for taxable years beginning before January 1, 2018) and proposed 1.448-2(b)(2)(iii) (for taxable years beginning after December 31, 2017) narrow this definition by providing that a taxpayer is a syndicate only if more than 35 percent of its losses are *allocated* to limited partners or limited entrepreneurs. Consequently, a partnership or other entity (other than a C corporation) may be considered a syndicate under section 448 only for a taxable year in which it has losses.

Proposed §1.448-2(b)(2)(iii)(B) permits a taxpayer to elect to use the allocated taxable income or loss of the immediately preceding taxable year to determine whether the taxpayer is a syndicate under section 448(d)(3) for the current taxable year. Under the proposed regulations, a taxpayer that makes this election must apply the rule to all subsequent taxable years, and for all purposes for which status as a tax shelter under section 448(d)(3) is relevant, unless the Commissioner permits a revocation of the election.

Several comments were received concerning issues related to tax shelters, including the definition of "syndicate," under proposed §1.448-2(b)(2)(i)(B). Some commenters recommend using the authority granted under section 1256(e)(3)(C)(v) to provide a deemed active participation rule to disregard certain interests held by limited entrepreneurs or limited partners for applying the Section 448(c) Gross Receipts Test if certain conditions were met. For example, conditions of the rule could include that the entity had not been classified as a syndicate within the last three taxable years, and that the average taxable income of the entity for that period was greater than zero.

The final regulations do not adopt this recommendation. The Treasury Department and the IRS have determined that it would be inappropriate to provide an exception to the active participation rules in section 1256(e)(3)(C)(v) by "deeming" active participation for small business taxpayers. The Treasury Department and the IRS believe that the deeming of active participation in this context would be overbroad and would run counter to Congressional intent. Sections 448(b)(3) and (d)(3), 461(i)(3) and 1256(e)(3)(C) were not modified by the TCJA, and the legisla-

tive history to section 13012 of the TCJA does not indicate any Congressional intent to modify the definition of “tax shelter” or “syndicate.” By not modifying those provisions, Congress presumably meant to exclude tax shelters, including syndicates, from being eligible to use the cash method of accounting and the small business taxpayer exemptions in section 13102 of the TCJA, even while otherwise expanding eligibility to meet the Section 448(c) Gross Receipts Test.

Other comments requested clarification generally of what “active participation” means and the circumstances, if any, under which a member of a limited liability company is treated as a “limited partner” or “limited entrepreneur” under section 461(k)(4). The Treasury Department and the IRS have determined that such guidance is outside the scope of these final regulations, which are to implement the changes made by section 13102 of the TCJA.

The Treasury Department and the IRS remain aware of the increased relevance of the definition of tax shelter under section 448(d)(3) after enactment of the TCJA and the practical concerns regarding the determination of tax shelter status for the taxable year. To ameliorate these practical concerns, these final regulations modify the syndicate election provided in proposed §1.448-2(b)(2)(iii)(B) to provide additional relief by making the election an annual election. The Treasury Department and the IRS have determined that an annual election appropriately balances the statutory language with the consistency requirement for use of a method of accounting under section 446(a) and §1.446-1. A cash method taxpayer that is generally profitable year-to-year may experience an unforeseen taxable loss for an anomalous year but return to its profitable position in subsequent years. If the taxpayer allocated more than 35 percent of the taxable loss to limited partners or limited entrepreneurs, the taxpayer would be required to change from the cash method to another method for the anomalous year in accordance with section 448(a)(3). However, that taxpayer would otherwise not be prohibited under section 448(a)(3) to use the cash method in the next profitable taxable year. An annual election under §1.448-2(b)(2)(iii)(B) allows a taxpayer to elect in the loss year

to use the allocated taxable income or loss of the immediately preceding taxable year to determine whether the taxpayer is a syndicate under section 448(d)(3) for the current taxable year. The Treasury Department and the IRS have determined that permitting taxpayers to continue to use the cash method, as well as other methods impacted by a determination under section 448(d)(3), in such situations is consistent with the requirements under section 446(a).

This election applies for all provisions of the Code that specifically refer to section 448(a)(3) to define tax shelter, such as the small business exemptions under sections 163(j)(3), 263A(i)(1), 460(e)(1)(B) and 471(c)(1). A taxpayer is required to file a statement with the original timely filed Federal income tax return, with extensions, to affirmatively make this election under § 1.448-2(b)(2)(iii)(B) for such taxable year. The election is valid only for the taxable year for which it is made, and once made, cannot be revoked. The Treasury Department and the IRS intend to issue procedural guidance to address the revocation of an election made under proposed §1.448-2(b)(2)(iii)(B) as a result of the application of the final regulations.

Other commenters noted for some taxpayers who took advantage of the small business exception in section 448(b)(3) to change to the cash method, the change in method of accounting resulted in a negative section 481(a) adjustment, which triggered an allocated loss and made the taxpayer a tax shelter under section 448(a)(3). As a result, the taxpayers became ineligible to use the cash method for the year in which the negative section 481(a) adjustment was recognized but may be otherwise eligible to use the cash method for future years. Under proposed §1.448-2(g)(3), these taxpayers would be ineligible for the automatic change procedures to make a subsequent change back to the cash method once they are no longer tax shelters within a five-year period. The commenters recommend relief for taxpayers with this situation.

The commenters propose an exception to the tax shelter rules for a taxpayer that satisfies the Section 448 Gross Receipts Test if a negative section 481(a) adjustment from a change in method of account-

ing under the small business taxpayer exemptions (for example, sections 263A(i), 471(c), 448(b)) results in the taxpayer being considered a tax shelter under section 448(d)(3) and proposed §1.448-2(b)(2)(iii). These final regulations do not adopt this suggestion. As described in the Preamble to the proposed regulations, the Treasury Department and the IRS have determined that no exception was provided in the TCJA to limit the definition of tax shelter in section 448(d)(3) for taxpayers making method changes related to the small business taxpayer exemptions. However, the Treasury Department and the IRS expect that the annual election under §1.448-2(b)(2)(iii)(B), described earlier, will provide relief for many taxpayers in this situation.

Additionally, the Treasury Department and the IRS have reconsidered the 5-year restriction on automatic method changes in light of these comments. Section 446(a), unmodified by the TCJA, provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer *regularly* computes his income in keeping his books. A taxpayer that changes its method of accounting for the same item with regular frequency (for example, annually or every other taxable year) is not adhering to the consistency requirement of section 446. The consistency requirement of section 446(a) is distinct from the authority granted the Commissioner under section 446(b) to determine whether the method of accounting used by a taxpayer clearly reflects income. *See e.g., Advertisers Exchange, Inc. v. Commissioner*, 25 T.C. 1086, 1092 (1956) (“Consistency is the key and is required regardless of the method or system of accounting used.”) (citations omitted); *Huntington Securities Corporation v. Busey*, 112 F.2d 368, 370 (1940) (“...whatever method the taxpayer adopts must be consistent from year to year unless the Commissioner authorizes a change.”)

The Treasury Department and the IRS are aware that the 5-year restriction in proposed §1.448-2(g)(3) could be burdensome for a small business taxpayer that was required to change from the cash method as a result of section 448(a)(3) or not meeting the Section 448 Gross Receipts Test in a taxable year but that becomes eligible to use the cash method un-

der section 448 in the subsequent taxable year. Proposed §1.448-2(g)(3) would have required this small business taxpayer to request consent to change back to the cash method using the non-automatic change procedures in Revenue Procedure 2015-13 (or successor). These final regulations remove the 5-year restriction on making automatic method changes for certain situations.

Sections 263A(i)(3), 448(d)(7), 460(e)(2)(B) and 471(c)(4) provide that certain changes in method of accounting for the small business exemptions are made with the consent of the Secretary. A taxpayer must follow the applicable administrative procedures related to a change in method of accounting notwithstanding the deemed consent of the Secretary. *See, e.g., Capital One Financial Corporation and Subsidiaries v. Commissioner of Internal Revenue*, 130 T.C. 147, 157 (2008) (“a taxpayer forced to change its method of accounting under section 448 must still file a Form 3115 with its return”). The Treasury Department and the IRS intend to provide procedural rules relating to changes in method of accounting to implement the final regulations using the automatic method change procedures of Revenue Procedure 2015-13. Those procedural rules will address whether a waiver of the 5-year overall method eligibility rule in section 5.01(1)(e) of Revenue Procedure 2015-13 is appropriate for small business taxpayers that were required to change from the cash method in one taxable year but are not subsequently limited by section 448.

The Treasury Department and the IRS have determined that taxpayers that are voluntarily changing (that is, not required by section 448 to no longer use the cash method) between overall methods are distinguishable from taxpayers that are required to change from the cash method to another method because they no longer meet the Section 448(c) Gross Receipts Test or become a tax shelter under section 448(d)(3). The procedural guidance is expected to address both fact patterns. Additionally, the Treasury Department and the IRS intend for the procedural guidance to address similar fact patterns for taxpayers making changes related to the regulations under sections 263A(i), 460(e)(1)(B) and 471(c), as discussed in this Summary of Comments and Explanation of Revisions.

3. Section 471 Small Business Taxpayer Exemptions

A. Inventory Treated as Non-Incidental Materials and Supplies

The preamble to the proposed regulations notes that the Treasury Department and the IRS interpret the statutory language of section 471(c)(1)(B) to mean that the property excepted from section 471(a) by that provision continues to be inventory property even though the general inventory rules under section 471(a) are not required to be applied to that property. Section 471(c)(1)(B) provides that a qualifying taxpayer’s “method of accounting for *inventory* for such taxable year” (emphasis added) will not be treated as failing to clearly reflect income if the method “treats *inventory* as non-incidental materials and supplies” (emphasis added). The Treasury Department and the IRS read the repeated use of the word “inventory” to mean that Congress intended that inventory property remains inventory property while relieving taxpayers from the general inventory rules of section 471(a). To reduce confusion about the nature of property treated as non-incidental materials and supplies under section 471(c)(1)(B)(i), these final regulations refer to the method under that provision of the Code as the “section 471(c) NIMS inventory method.”

The Treasury Department and the IRS interpret section 471(c)(1)(B)(i) as providing three distinct benefits for taxpayers. First, the provision significantly expanded the types of taxpayers permitted to treat their inventory as non-incidental materials and supplies. Under prior administrative guidance, as discussed later in section 3.A.i of this Summary of Comments and Explanation of Revisions, taxpayers with gross receipts of no more than \$1 million and taxpayers in certain industries (generally not producers or resellers) with gross receipts of no more than \$10 million were permitted to treat their inventory as non-incidental materials and supplies. Section 471(c) greatly expanded the availability of this method of accounting to taxpayers in all types of trades or businesses, including producers and resellers, by reference to the increased cap on gross receipts under the Section 448(c) Gross Receipts Test. Second, treating inventory

as non-incidental materials and supplies under § 1.471-1(b)(5) provides simplification and burden reduction for taxpayers by requiring only certain costs to be capitalized to inventory. For example, a taxpayer using the section 471(c) NIMS inventory method does not capitalize direct labor costs or any indirect costs to inventory costs. See discussion of direct labor costs later in section 3.A.iii of this Summary of Comments and Explanation of Revisions. Simplification does not indicate that the nature of the property was changed by the TCJA, or that the intent of Congress was to provide immediate expensing of inventory costs. Thirdly, taxpayers, other than a tax shelter under section 448(a)(3), treating inventory as non-incidental materials and supplies under § 1.471-1(b)(5) are eligible to use the overall cash method of accounting for purchases and sales of merchandise, rather than being required to use an accrual method. *See* §1.446-1(a)(4)(i).

i. Definition of the Term “Used or Consumed”

The preamble to the proposed regulations provides that the Treasury Department and IRS interpret section 471(c)(1)(B)(i) as generally codifying the administrative guidance existing at the time of its enactment (that is, Revenue Procedure 2001-10 (2001-2 IRB 272) and Revenue Procedure 2002-28 (2002-18 IRB 815)) and making that method available to significantly more taxpayers. Accordingly, the proposed regulations provided that items of inventory treated as materials and supplies under section 471(c) are used or consumed in the taxable year in which the taxpayer provides the item to a customer, and the cost of such item is recovered in that taxable year or the taxable year in which the taxpayer pays for or incurs such cost, whichever is later.

Comments were received on the definition of “used or consumed” in proposed §1.471-1(b)(4)(i) as it relates to producers. A commenter asserted that the meaning of the term “used or consumed” for a producer using the section 471(c) NIMS inventory supplies method should be consistent with the meaning of the term “used or consumed” in §1.162-3. The commenter states that a producer’s raw materials

are “used or consumed” when the raw materials enter the taxpayer’s production process. The commenter states that under section 471(c)(1)(B)(i) and §1.162-3(a)(1), only section 263A would limit a producer’s ability to recover the cost of its raw materials when the raw materials are first used in the production process, and the final regulations should be modified to provide that a producer does not wait until the finished product is provided to a customer to recover the costs of its raw materials. In addition, the commenter states that the policy considerations underlying this provision were to provide small business taxpayers with simplification, and the definition of “used or consumed” for producers in proposed § 1.471-1(b)(4)(i) does not result in simplification.

The Treasury Department and IRS decline to change the definition of used or consumed for a producer in these final regulations. As discussed previously, the Treasury Department and the IRS interpret section 471(c)(1)(B)(i) as generally codifying the administrative guidance existing at the time of enactment of TCJA (that is, Revenue Procedure 2001-10 and Revenue Procedure 2002-28) and making it applicable to significantly more taxpayers, in addition to the other benefits discussed in section 3.A of this Summary of Comments and Explanation of Revisions. The commenter’s recommendation that the term “used or consumed” for a producer should be treated as occurring when the raw material is used or consumed in the taxpayer’s production process would allow a producer to recover production costs earlier than was previously allowed under the administrative guidance of Revenue Procedure 2001-10 and Revenue Procedure 2002-28. Additionally, the commenter’s recommendation suggests that the term “used or consumed” should be interpreted literally by looking to actual use or consumption by the taxpayer. However, under such an interpretation a reseller, unlike a producer, would not be able to recover any inventory costs as a reseller does not acquire raw materials for use in a production process nor does it use or consume finished inventory; rather a reseller acquires and resells finished inventory, unchanged, to customers. The Treasury Department and the IRS have determined that the statute and legislative history do not support a reading

of the provision that would provide such a disparity in the recovery of inventory costs between producers and resellers.

In addition, the commenter’s argument interprets the words “inventory treated as non-incidental materials and supplies” to mean that the components used to produce the finished goods inventory, rather than the finished goods inventory itself, are treated as materials and supplies. The interpretation advocated by the commenter would result in producers being permitted to recover the cost inputs of their units of inventory in the same manner as they recover the costs of their materials and supplies (that is, when the cost input is used or consumed in producing the unit of inventory). The Treasury Department and the IRS do not believe Congress intended to break down the traditional definition of the word “inventory,” particularly since that position benefits only a certain group of taxpayers (producers). The Treasury Department and the IRS determined that the definition for used or consumed should provide an equitable rule for the timing of the recovery of the inventory between producers and resellers. Accordingly, these final regulations adopt the proposed regulations without change.

ii. *De Minimis Safe Harbor under §1.263(a)-1(f)*

Several comments were received regarding the applicability of the *de minimis* safe harbor under § 1.263(a)-1(f) (*de minimis* safe harbor) to inventory treated as non-incidental materials and supplies. The commenters assert that the final regulations should permit a taxpayer that uses the section 471(c) NIMS inventory method to use the *de minimis* safe harbor for its inventory treated as non-incidental materials and supplies. The commenters point to footnote 465 of the Bluebook, which described the law, both before and after TCJA, as generally permitting deduction of the cost of non-incidental materials and supplies in the taxable year in which they are first used or are consumed in the taxpayer’s operations in accordance with §1.162-3(a)(1). Furthermore, under §1.162-3(a)(1), a taxpayer may also be able to elect to deduct such non-incidental materials and supplies in the taxable year

the amount is paid under the *de minimis* safe harbor election under §1.263(a)-1(f). General Explanation of Pub. Law 115-97, at 113 fn. 465.

The Treasury Department and the IRS were aware of footnote 465 in the Bluebook when drafting the proposed regulations, but have a different understanding of the rule for “inventory treated as non-incidental materials and supplies” under Section 471(c)(1)(B)(i) as explained in section 3.A.i of this Summary of Comments and Explanation of Revisions. The Treasury Department and the IRS interpret section 471(c)(1)(B)(i) as generally codifying the administrative procedures that established the non-incidental materials and supplies method for inventoriable items, and prior pronouncements of §§1.162-3 and 1.263(a)-1(f) that these regulations do not apply to inventory property, including inventory property treated as non-incidental materials and supplies. See, e.g., Tangible Property Regulations - Frequently Asked Questions, available at <https://www.irs.gov/businesses/small-businesses-self-employed/tangible-property-final-regulations#Ademinimis>.

A commenter states that the *de minimis* safe harbor was created after Revenue Procedure 2001-10 and Revenue Procedure 2002-28 were released, and therefore, did not address the issue of the applicability of the *de minimis* safe harbor. The Treasury Department and the IRS agree with the timeline described by the commenter. However, as discussed in the immediately preceding paragraph, the IRS’ position on the *de minimis* safe harbor has been addressed in a prior pronouncement. As described previously in section 3.A of this Summary of Comments and Explanation of Revisions, inventory treated as non-incidental materials and supplies retains its character as inventory property. The *de minimis* safe harbor, which is a regulatory election rather than a statutory one, does not apply to inventory. Section 1.263(a)-1(f)(2)(i).

Finally, the Treasury Department and the IRS note that for amounts paid to qualify for the *de minimis* safe harbor, the amounts must have been expensed on the taxpayer’s applicable financial statement or books and records, as applicable. Sections 1.263(a)-1(f)(1)(i)(B) and (ii)(B). This applicable financial statement or

books and records expensing requirement under §1.263(a)-1(f) would be an impediment to the application of the *de minimis* safe harbor under the section 471(c) NIMS inventory method for taxpayers who maintain records of their inventory in their applicable financial statement or books and records, even if the section 471(c) NIMS inventory method permitted the use of the *de minimis* safe harbor method. In addition, there is no need for the separate *de minimis* safe harbor because small business taxpayers may use the inventory method provided in section 471(c)(1)(B) which generally provides that a taxpayer who expenses inventory costs in its applicable financial statement or books and records may generally expense that cost for Federal income tax purposes. For example, a small business taxpayer that expenses the cost of “freight-in” in its books and records and wants to expense the item for Federal income tax purposes may generally do so using the non-AFS section 471(c) inventory method, as permitted by section 471(c)(1)(B)(ii) and discussed later in section 3.C.ii of this Summary of Comments and Explanation of Revisions.

iii. Direct Labor

Proposed §1.471-1(b)(4)(ii) provides that inventory costs includible in the section 471(c) NIMS inventory method are the direct costs of the property produced or property acquired for resale. However, an inventory cost does not include a cost for which a deduction would be disallowed or that is not otherwise recoverable, in whole or in part, but for §1.471-1(b)(4), under another provision of the Code.

Some comments were received on the types of direct costs required to be included as an inventory cost under the section 471(c) NIMS inventory method. These commenters recommended the final regulations exclude direct labor costs from the definition of an inventory cost under proposed §1.471-1(b)(4)(ii). The commenters reasoned that the preamble to the proposed regulation indicated that section 471(c)(1)(B)(i) was generally a codification of Revenue Procedure 2001-10 and Revenue Procedure 2002-28. However, the commenters point out that this administrative guidance did not provide for di-

rect labor or overhead costs to be included in the non-incidentals materials and supplies method.

One commenter asserted that inventory treated as non-incidentals materials and supplies are not inventory property but are to be characterized as a material and supply. The commenter discussed Example 1, in Section III.D of Notice 88-86 (1988-2 CB 401) to determine the treatment of non-incidentals materials and supplies prior to the enactment of section 263A. Example 1 involves an architect providing design services that include blueprints and drawings and deals with the provision of *de minimis* amounts of property by a service provider. This commenter cites to Notice 88-86 to provide, by analogy, that inventory treated as non-incidentals materials and supplies under section 471(c)(1)(B)(i) should not include direct labor costs.

The Treasury Department and the IRS disagree with the application by analogy to Example 1 in Section III.D of Notice 88-86. That example illustrates that an individual providing services, such as an architect, is not a producer despite providing a *de minimis* amount of property to the client as part of the provision of services. As discussed in section 3.A of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS believe that inventory property treated as non-incidentals materials and supplies retains its character as inventory property, and so Example 1 is inapposite.

The Treasury Department and the IRS acknowledge that there was uncertainty under Revenue Procedure 2001-10 and Revenue Procedure 2002-28 as to whether direct labor and overhead costs were required to be capitalized under the non-incidentals materials and supplies method permitted by those revenue procedures. The Treasury Department and the IRS are also aware that tracking of direct labor costs may be burdensome, and in some cases, difficult to do for many small businesses. The Treasury Department and the IRS agree with the commenters’ request that direct labor costs be excluded from the inventory costs required to be included in inventory treated as non-incidentals materials and supplies. As a result, these final

regulations provide that inventory costs includible in the section 471(c) NIMS inventory method are direct material costs of the property produced or the costs of property acquired for resale.

B. Treatment of Inventory by Taxpayers with an Applicable Financial Statement (AFS)

Under proposed §1.471-1(b)(5), a taxpayer other than a tax shelter, that has an AFS and that meets the Section 448(c) Gross Receipts Test is not required to take an inventory under section 471(a), and may choose to treat its inventory as reflected in its AFS. Proposed §1.471-1(b)(5)(ii) defines AFS by reference to section 451(b)(3) and the accompanying regulations, which included the additional AFS rules provided in proposed §1.451-3(h).

In section 4.C.i of the preamble to the proposed regulations, the Treasury Department and the IRS requested comments on a proposed consistency rule for a taxpayer with an AFS that has a financial accounting year that differs from the taxpayer’s taxable year, and on other issues related to the application of proposed §1.451-3(h) to the AFS section 471(c) inventory method. The Treasury Department and the IRS proposed to require a taxpayer with an AFS that uses the AFS section 471(c) inventory method to consistently apply the same mismatched reportable period method of accounting provided in proposed §1.451-3(h)(4) for its AFS section 471(c) inventory method of accounting that is used for section 451 purposes. No comments were received on the consistency rule or other issues related to the application of proposed §1.451-3(h) to the AFS section 471(c) inventory method.

These final regulations adopt this consistency rule. The Treasury Department and the IRS have determined that a taxpayer using an accrual method with an AFS that has a mismatched reporting period with its taxable year should apply the same mismatched reportable period method of accounting for revenue recognition purposes and inventory purposes because there is better matching of income and cost of goods sold by applying the same reportable period method.

C. Treatment of Inventory by Taxpayers Without an AFS

Under proposed §1.471-1(b)(6), a taxpayer, other than a tax shelter, that does not have an AFS and that meets the Section 448(c) Gross Receipts Test is not required to take an inventory under section 471(a), and may choose to use the non-AFS section 471(c) inventory method to account for its inventory. The non-AFS section 471(c) inventory method is the method of accounting for inventory reflected in the taxpayer's books and records that are prepared in accordance with the taxpayer's accounting procedures and that properly reflect the taxpayer's business activities for non-tax purposes. For example, a books and records method that determines ending inventory and cost of goods sold that properly reflects the taxpayer's business activities for non-Federal income tax purposes is to be used under the taxpayer's non-AFS section 471(c) inventory method.

(i) Definition of books and records

Some comments were received on the non-AFS section 471(c) inventory method and the standard used in proposed §1.471-1(b)(6) for "books and records." One commenter reasoned that the purpose of section 471(c)(1)(B)(ii) was to provide simplification, and the reliance on the definition of books and records used in case law is too complex, creates audit risks, and uncertainties as to what books and records means. The commenter recommended using a standard in which "books and records" is a flexible term and something the taxpayer and his accounting professional can agree on that is consistent from year to year. For example, the commenter suggests that any financial statement reporting of inventory that is consistently applied be acceptable as books and records.

Some comments discuss the issue of work papers and physical counts of inventory, and whether either should be used if a taxpayer is expensing these items for books and records purposes. The commenters asserted that even though a taxpayer takes a physical count of inventory, the taxpayer should be allowed to expense the inventory for Federal income tax pur-

poses if the inventory is expensed on its books and records.

The Treasury Department and the IRS decline to change the definition of the term "books and records" in these final regulations, and the rules continue to generally include both work papers and physical counts of inventory. The term books and records is used elsewhere in the Code and regulations, and there is no indication in the statute or legislative history to section 471(c)(1)(B)(ii) that a different definition is intended from the general usage of this term used elsewhere in the Code. Consequently, these final regulations use the well-established definition of books and records of a taxpayer, which includes the totality of the taxpayer's documents and electronically-stored data. See, for example, *United States v. Euge*, 444 U.S. 707 (1980). See also *Digby v. Commissioner*, 103 T.C. 441 (1994), and §1.6001-1(a).

Certain commenters requested that the final regulations provide additional clarification on the significance of the taking of a physical count of inventory under the non-AFS section 471(c) inventory method. For example, commenters requested that Example 1 in proposed §1.471-1(b)(6)(iii) be modified to provide that the physical count is ignored if the taxpayer does not provide inventory information to a creditor. These final regulations provide additional examples, including variations on Example 1, to clarify the relevance of a physical count of inventory under the non-AFS section 471(c) inventory method. For example, a taxpayer that takes a physical count of inventory for reordering purposes but does not allocate cost to such inventory is not required to use the physical count for the non-AFS section 471(c) inventory method, regardless of whether the information is otherwise used for an internal report purpose or provided to an external third party, such as a creditor. Alternatively, a taxpayer that takes an end-of-year physical count and uses this information in its accounting procedures to allocate costs to inventory is required to use this inventory information for the non-AFS section 471(c) inventory method regardless of whether the taxpayer makes reconciling entries to expense these costs in its financial statements. Thus, the examples in these final regulations clarify the principle that a taxpayer may not ignore its reg-

ular accounting procedures or portions of its books and records under the non-AFS section 471(c) inventory method.

(ii) Inventory costs

The proposed regulations defined "inventory costs" for the non-AFS section 471(c) inventory method generally as costs that the taxpayer capitalizes to property produced or property acquired for resale in its books and records. Certain commenters requested that the final regulations clarify how a taxpayer treats costs to acquire or produce tangible property that the taxpayer does not capitalize in its books and records because the proposed regulations did not specifically address these costs.

These final regulations clarify in § 1.471-1(b)(6)(i) that costs that are generally required to be capitalized to inventory under section 471(a) but that the taxpayer is not capitalizing in its books and records are not required to be capitalized to inventory. The Treasury Department and the IRS have also determined that, under this method, such costs are not treated as amounts paid to acquire or produce tangible property under § 1.263(a)-2, and therefore, are generally deductible when they are paid or incurred if such costs may be otherwise deducted or recovered notwithstanding § 1.471-1(b)(4) under another provision of the Code and Regulations. Additionally, these final regulations clarify that costs capitalized for the non-AFS section 471(c) inventory method are those costs that related to the production or resale of the inventory to which they are capitalized in the taxpayer's books and records. Similar clarifications have been made in § 1.471-1(b)(5) regarding the AFS section 471(c) inventory method.

APPLICABILITY DATES

These final regulations are applicable for taxable years beginning on or after January 5, 2021. However, a taxpayer may apply these regulations for a taxable year beginning after December 31, 2017, and before January 5, 2021, provided that if the taxpayer applies any aspect of these final regulations under a particular Code provision, the taxpayer must follow all the applicable rules contained in these regulations that relate to that Code

provision for such taxable year and all subsequent taxable years, and must follow the administrative procedures for filing a change in method of accounting in accordance with §1.446-1(e)(3)(ii). For example, a taxpayer that wants to apply §1.263A-1(j) to be exempt from capitalizing costs under section 263A must apply §1.448-2 to determine whether it is eligible for the exemption. The same taxpayer must apply §1.448-2 to determine whether it is eligible to apply §1.471-1(b) to be exempt from the general inventory rules under section 471(a). However, it may choose not to apply §1.471-1(b) even though it chooses to apply §1.263A-1(j) and §1.448-2.

Alternatively, a taxpayer may rely on the proposed regulations for a taxable year beginning after December 31, 2017 and before January 5, 2021, provided that if the taxpayer applies any aspect of the proposed regulations under a particular Code provision, the taxpayer must follow all of the applicable rules contained in the proposed regulations that relate to that Code provision for such taxable year, and follow the administrative procedures for filing a change in method of accounting in accordance with §1.446-1(e)(3)(ii).

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>.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

I. Paperwork Reduction Act

Section 1.448-2(b)(2)(iii)(B) imposes a collection of information for an election to

use prior year's allocated taxable income or loss to determine whether a partnership or other entity (other than a C corporation) is a "syndicate" for purposes of section 448(d)(3) for the current tax year. The election is made by attaching a statement to the taxpayer's original Federal income tax return (including extensions) for the taxable year that the election is made. The election is an annual election and, if made for a taxable year, cannot be revoked. The collection of information is voluntary for purposes of obtaining a benefit under the proposed regulations. The likely respondents are businesses or other for-profit institutions, and small businesses or organizations.

Estimated total annual reporting burden: 224,165 hours

Estimated average annual burden hours per respondent: 1 hour

Estimated number of respondents: 224,165

Estimated annual frequency of responses: once.

Other than the election statement, these regulations do not impose any additional information collection requirements in the form of reporting, recordkeeping requirements or third-party disclosure statements. However, because the exemptions in sections 263A, 448, 460 and 471 are methods of accounting under the statute, taxpayers are required to request the consent of the Commissioner for a change in method of accounting under section 446(e) to implement the statutory exemptions. The IRS expects that these taxpayers will request this consent by filing Form 3115, *Application for Change in Accounting Method*. Taxpayers may request these changes using reduced filing requirements by completing only certain parts of Form 3115. See Revenue Procedure 2018-40 (2018-34 IRB 320). Revenue Procedure 2018-40 provides procedures for a taxpayer to make a change in method of accounting using the automatic change procedures of Revenue Procedure 2015-13 (2015-5 IRB 419) in order to use the exemptions provided in sections 263A, 460 and/or 471. See also the revenue procedure accompanying these regulations for similar method change procedures to make a change in method of accounting to comply with these final regulations.

For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(c)) (PRA), the reporting burden associated with the collection of information for the election statement and Form 3115 will be reflected in the PRA submission associated with the income tax returns under the OMB control number 1545-0074 (in the case of individual filers of Form 3115) and 1545-0123 (in the case of business filers of Form 3115).

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 sections 263A, 448, 460 and 471.

As discussed earlier, the reporting burdens associated with 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 subject to Revenue Procedure 2019-43 and business filers that make the election under proposed §1.448-2(b)(2)(iii)(B)). The overall burden estimates associated with these OMB control numbers are aggregate amounts related to the entire package of forms associated with the applicable OMB control number and will 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 these regulations. These numbers are therefore not specific to the burden imposed by these regulations. The 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 TCJA. No burden estimates specific to the forms affected by the regulations are currently available. 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 TCJA and those that arise out of discretionary authority exercised in the final regulations and other regulations that affect the compliance burden for that form.

II. Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) (RFA) imposes certain requirements with respect to federal rules that are subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act (5 U.S.C. 551 *et seq.*) and that are likely to have a significant economic impact on a substantial number of small entities. Unless an agency determines that a proposal is not likely to have a significant economic impact on a substantial number of small entities, section 603 of the RFA requires the agency to present an initial regulatory flexibility analysis (IRFA) of the proposed rules. At the proposed rule stage, the Treasury Department and the IRS had not determined whether the proposed rules, when finalized, would likely have a significant economic impact on a substantial number of small entities. The determination of whether the voluntary exemptions under sections 263A, 448, 460, and 471, and the regulations providing guidance with respect to such exemptions, will have a significant economic impact on a substantial number of small entities requires further study. However, because there is a possibility of significant economic impact on a substantial number of small entities, an IRFA was provided at the proposed rule stage. In accordance with section 604 of the RFA, following is the final regulatory flexibility analysis.

1. Reasons for and Objectives of the Rule

As discussed earlier in the preamble, these regulations largely implement voluntary exemptions that relieve small business taxpayers from otherwise applicable restrictions and requirements under sections 263A, 448, 460, and 471.

Section 448 provides a general restriction for C corporations and partnerships with C corporation partners from

using the cash method of accounting, and sections 263A, 460 and 471 impose specific rules on uniform capitalization of direct and indirect production costs, the percentage of completion method for long-term contracts, and accounting for inventory costs, respectively. Section 13102 of TCJA provided new statutory exemptions from certain of these rules and expanded the scope of existing statutory exemptions from certain of these rules to reduce compliance burdens for small taxpayers. The regulations clarify the exemption qualification requirements and provide guidance with respect to the applicable methods of accounting should a taxpayer choose to apply one or more exemptions.

The objective of the regulations is to provide clarity and certainty for small business taxpayers implementing the exemptions. Under the Code, small business taxpayers were able to implement these provisions for taxable years beginning after December 31, 2017 (or, in the case of section 460, for contracts entered into after December 31, 2017) even in the absence of these regulations. Thus, the Treasury Department and the IRS expect that, at the time these regulations are published, many small business taxpayers may have already implemented some aspects of the regulations.

2. Significant Issues Raised by the Public Comments in Response to the IRFA and Comments Filed by the Chief Counsel for Advocacy of the Small Business Administration

No public comments were received in response to the IRFA. Additionally, no comments were filed by the Chief Counsel for Advocacy of the Small Business Administration in response to the proposed regulations.

3. Affected Small Entities

The voluntary exemptions under sections 263A, 448, 460 and 471 generally apply to taxpayers that meet the \$25 million (adjusted for inflation) gross receipts test in section 448(c) and are otherwise subject to general rules under sections 263A, 448, 460, or 471.

A. Section 263A

The Treasury Department and the IRS expect that the addition of section 263A(i) will expand the number of small business taxpayers exempted from the requirement to capitalize costs, including interest, under section 263A. Under section 263A(i), taxpayers (other than tax shelters) that meet the \$25 million (adjusted for inflation) gross receipts test in section 448(c) can choose to deduct certain costs that are otherwise required to be capitalized to the basis of property. Section 263A applies to taxpayers that are producers, resellers, and taxpayers with self-constructed assets. The Treasury Department and the IRS estimate that there are between 3,200,000 and 3,575,000 respondents with gross receipts of not more than \$25 million (adjusted for inflation) that have inventories. The Treasury Department and the IRS estimate that of these taxpayers there are between 28,900 and 38,900 respondents with gross receipts of not more than \$25 million (adjusted for inflation) that are eligible to change their method of accounting to no longer capitalize costs under section 263A. These estimates come from information collected on: Form 1125-A, *Cost of Goods Sold*, and attached to Form 1120, *U.S. Corporation Income Tax Return*, Form 1065, *U.S. Return of Partnership Income* or Form 1120-S, *U.S. Income Tax Return for an S Corporation*, on which the taxpayer also indicated it had additional section 263A costs. The Treasury Department and the IRS do not have readily available data to measure the prevalence of entities with self-constructed assets. In addition, these data also do not include other business entities, such as a business reported on Schedule C, *Profit or Loss Form Business*, of an individual's Form 1040, *U.S. Individual Income Tax Return*.

Under section 263A, as modified by the TCJA, small business entities that qualified for Section 263A small reseller exception will no longer be able to use this exception. The Treasury Department and the IRS estimate that nearly all taxpayers that qualified for the small reseller exception will qualify for the small business taxpayer exemption under section 263A(i) since the small reseller exception utilized a \$10 million gross receipts test. The Treas-

surey Department and the IRS estimate that there are between 28,900 and 38,900 respondents with gross receipts of not more than \$25 million that are eligible for the exemption under section 263A(i). These estimates come from information collected on: Form 1125-A, *Cost of Goods Sold*, and attached to Form 1120, *U.S. Corporation Income Tax Return*, Form 1065, *U.S. Return of Partnership Income* or Form 1120-S, *U.S. Income Tax Return for an S Corporation* on which the taxpayer also indicated it had additional section 263A costs. These data provide an upper bound for the number of taxpayers affected by the repeal of the small reseller exception and enactment of section 263A(i) because the data includes taxpayers that were not previously eligible for the small reseller exception, such as producers and taxpayers with gross receipts of more than \$10 million.

The regulations modify the \$50 million gross receipts test in §1.263A-1(d)(3)(ii)(B)(1) by using the Section 448 Gross Receipts Test. The \$50 million gross receipts amount is used by taxpayers to determine whether they are eligible to treat negative adjustments as additional section 263A costs for purposes of the simplified production method (SPM) under section 263A. The Treasury Department and the IRS do not have readily available data to measure the prevalence of entities using the SPM.

Section 1.263A-9 modifies the current regulation to increase the eligibility threshold to \$25 million for the election permitting taxpayers to use the highest applicable Federal rate as a substitute for the weighted average interest rate when tracing debt for purposes of capitalizing interest under section 263A(f). The Treasury Department and the IRS estimate that there are between 28,900 and 38,900 respondents with gross receipts of not more than \$25 million that are eligible to make this election. These estimates come from information collected on: Form 1125-A, *Cost of Goods Sold*, attached to Form 1120, *U.S. Corporation Income Tax Return*, Form 1065, *U.S. Return of Partnership Income* or Form 1120-S, *U.S. Income Tax Return for an S Corporation*, on which the taxpayer also indicated it had additional section 263A costs. The Treasury Department and the IRS expect that

many taxpayers eligible to make the election for purposes of section 263A(f) will instead elect the small business exemption under section 263A(i). Additionally, taxpayers who chose to apply section 263A even though they qualify for the small business exemption under section 263A(i) may not have interest expense required to be capitalized under section 263A(f). As a result, although these data do not include taxpayers with self-constructed assets that are eligible for the election, the Treasury Department and the IRS estimate that this data provides an upper bound for the number of eligible taxpayers.

B. Section 448

The Treasury Department and the IRS expect that the changes to section 448(c) by the TCJA will expand the number of taxpayers permitted to use the cash method. Section 448(a) provides that C corporations, partnerships with C corporations as partners, and tax shelters are not permitted to use the cash method of accounting; however section 448(c), as amended by the TCJA, provides that C corporations or partnerships with C corporations as partners, other than tax shelters, are not restricted from using the cash method if their average annual gross receipts are \$25 million (adjusted for inflation) or less. Prior to the amendments made by the TCJA, the applicable gross receipts threshold was \$5 million. Section 448 does not apply to S corporations, partnerships without a C corporation partner, or any other business entities (including sole proprietorships reported on an individual's Form 1040). The Treasury Department and the IRS estimate that there are between 587,000 and 605,000 respondents with gross receipts of not more than \$5 million presently using an accrual method, and between 70,000 and 76,500 respondents with gross receipts of more than \$5 million but not more than \$25 million that are permitted to use the cash method. These estimates come from information collected on Form 1120, *U.S. Corporation Income Tax Return*, Form 1065, *U.S. Return of Partnership Income* and Form 1120-S, *U.S. Income Tax Return for an S Corporation*.

Under the regulations, taxpayers that would meet the gross receipts test of section 448(c) and seem to be eligible to use

the cash method but for the definition of "syndicate" under section 448(d)(3), may elect to use the allocated taxable income or loss of the immediately preceding taxable year to determine whether the taxpayer is a "syndicate" for purposes of section 448(d)(3) for the current taxable year. The Treasury Department and IRS estimate that 224,165 respondents may potentially make this election. This estimate comes from information collected on the Form 1065, *U.S. Return of Partnership Income* and Form 1120-S, *U.S. Income Tax Return for an S Corporation*, and the Form 1125-A, *Cost of Goods Sold*, attached to the Forms 1065 and 1120-S. The Treasury Department and the IRS estimate that these data provide an upper bound for the number of eligible taxpayers because not all taxpayers eligible to make the election will choose to do so.

C. Section 460

The Treasury Department and the IRS expect that the modification of section 460(e)(1)(B) by the TCJA will expand the number of taxpayers exempted from the requirement to apply the percentage-of-completion method to long-term construction contracts. Under section 460(e)(1)(B), as modified by the TCJA, taxpayers (other than tax shelters) that meet the \$25 million (adjusted for inflation) gross receipts test in section 448(c) are not required to use PCM to account for income from a long-term construction contract expected to be completed in two years. Prior to the modification of section 460(e)(1)(B) by the TCJA, a separate \$10 million dollar gross receipts test applied. The Treasury Department and the IRS estimate that there are between 15,400 and 19,500 respondents with gross receipts of between \$10 million and \$25 million who are eligible to change their method of accounting to apply the modified exemption. This estimate comes from information collected on the Form 1120, *U.S. Corporation Income Tax Return*, Form 1065, *U.S. Return of Partnership Income* and Form 1120-S, *U.S. Income Tax Return for an S Corporation* in which the taxpayer indicated its principal business activity was construction (NAICS codes beginning with 23). These data available

do not distinguish between long-term contracts and other contracts, and also do not include other business entities that do not file Form 1120, *U.S. Corporation Income Tax Return*, Form 1065, *U.S. Return of Partnership Income*, and Form 1120-S, *U.S. Income Tax Return for an S Corporation*, such as a business reported on Schedule C, *Profit or Loss from Business*, of an individual's Form 1040, *U.S. Individual Income Tax Return*.

D. Section 471

The Treasury Department and the IRS expect that the addition of section 471(c) will expand the number of taxpayers exempted from the requirement to take inventories under section 471(a). Under section 471(c), taxpayers (other than tax shelters) that meet the \$25 million (adjusted for inflation) gross receipts test in section 448(c) can choose to apply certain simplified inventory methods rather than those otherwise required by section 471(a). The Treasury Department and the IRS estimate that there are between 3,200,000 and 3,575,000 respondents with gross receipts of not more than \$25 million that are exempted from the requirement to take inventories, and will treat their inventory either as non-incidentals and supplies, or conform their inventory method to the method reflected in their AFS, or if they do not have an AFS, in their books and records. This estimate comes from data collected on the Form 1125-A, *Cost of Goods Sold*. Within that set of taxpayers, the Treasury Department and the IRS estimate that there are between 10,500 and 11,500 respondents that may choose to conform their method of accounting for inventories to their method for inventory reflected in their AFS. This estimate comes from IRS-collected data on taxpayers that filed the Form 1125-A, *Cost of Goods Sold*, in addition to a Schedule M3, *Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More*, that indicated they had an AFS. These data provide a lower bound because they do not include other business entities, such as a business reported on Schedule C, *Profit or Loss from Business*, of an individual's Form 1040,

U.S. Individual Income Tax Return, that are not required to file the Form 1125-A, *Cost of Goods Sold*.

4. Projected Reporting, Recordkeeping, Other Compliance Requirements, and Costs

The Treasury Department and the IRS have not performed an analysis with respect to the projected reporting, recordkeeping, and other compliance requirements associated with the statutory exemptions under sections 263A, 448, 460, and 471 and the final regulations implementing these exemptions. The taxpayer may expend time to read and understand the final regulations. The cost to comply with these regulations are reflected in modest reporting activities. Taxpayers needing to make method changes pursuant to these regulations will be required to file a Form 3115. The Treasury Department and the IRS are minimizing the cost to comply with the regulations by providing administrative procedures that allow taxpayers to make multiple changes in method of accounting related to the statutory exemptions under sections 263A, 448, 460, and 471 for the same tax year on a single Form 3115, instead of filing a separate Form 3115 for each exemption. Although there is a nominal implementation cost, the Treasury Department and the IRS anticipate that the statutory exemptions and the final regulations implementing these exemptions will reduce overall the reporting, recordkeeping, and other compliance requirements of affected taxpayers relative to the requirements that exist under the general rules in sections 263A, 448, 460, and 471. For example, a taxpayer that applies section 471(c)(1)(B)(i) to treat inventory as non-incidentals and supplies will only need to capitalize the direct material cost of producing inventory instead of also having to capitalize the direct labor and indirect costs of producing inventory under the general rules of section 471(a). Additionally, a taxpayer that applies section 471(c)(1)(B)(ii) can follow the inventory method used in its applicable financial statement, or its books and records if it does not have an applicable financial statement, in lieu of keeping a separate inventory method under the general rules of section 471(a).

5. Steps Taken to Minimize the Economic Impact on Small Entities

As discussed earlier in the preamble, section 448 provides a general restriction for C corporations, partnerships with C corporation partners, and tax shelters from using the cash method of accounting, and sections 263A, 460 and 471 impose specific rules on uniform capitalization of direct and indirect production costs, the percentage of completion method for long-term contracts, and accounting for inventory costs, respectively. Section 13102 of TCJA provided new statutory exemptions and expanded the scope of existing statutory exemptions from these rules to reduce compliance burdens for small taxpayers (for example, reducing the burdens associated with applying complex accrual rules under section 451 and 461, maintaining inventories, identifying and tracking costs that are allocable to property produced or acquired for resale, identifying and tracking costs that are allocable to long-term contracts, applying the look-back method under section 460, etc.). For example, a small business taxpayer with average gross receipts of \$20 million may pay an accountant an annual fee of approximately \$2,375 to perform a 25 hour analysis to determine the section 263A costs that are capitalized to inventory produced during the year. If this taxpayer chooses to apply the exemption under section 263A and these regulations, it will no longer need to pay an accountant for the annual section 263A analysis.

The regulations implementing these exemptions are completely voluntary because small business taxpayers may continue using an accrual method of accounting, and applying the general rules under sections 263A, 460 and 471 if they so choose. Thus, the exemptions increase the flexibility small business taxpayers have regarding their accounting methods relative to other businesses. The regulations provide clarity and certainty for small business taxpayers implementing the exemptions.

As described in more detail earlier in the preamble, the Treasury Department and the IRS considered a number of alternatives under the final regulations. For example, in providing rules related

to inventory exemption in section 471(c)(1)(B)(i), which permits the taxpayer to treat its inventory as non-incidental materials and supplies, the Treasury Department and the IRS considered whether inventoriable costs should be recovered by (i) using an approach similar to the approach set forth under Revenue Procedure 2001-10 (2001-2 IRB 272) and Revenue Procedure 2002-28 (2002-28 IRB 815), which provided that inventory treated as non-incidental materials and supplies was “used and consumed,” and thus recovered through costs of goods sold by a cash basis taxpayer, when the inventory items were provided to a customer, or when the taxpayer paid for the items, whichever was later, or (ii) using an alternative approach that treated inventory as “used and consumed” and thus recovered through costs of goods sold by the taxpayer, in a taxable year prior to the year in which the inventory item is provided to the customer (for example, in the taxable year in which an inventory item is acquired or produced). The alternative approach described in (ii) would produce a savings equal the amount of the cost recovery multiplied by an applicable discount rate (determined based on the number of years the cost of goods sold recovery would be accelerated under this alternative). The Treasury Department and the IRS interpret section 471(c)(1)(B)(i) and its legislative history generally as codifying the rules provided in the administrative guidance existing at the time TCJA was enacted. Based on this interpretation, the Treasury Department and the IRS have determined that section 471(c) materials and supplies are “used and consumed” in the taxable year the taxpayer provides the goods to a customer, and are recovered through costs of goods sold in that year or the taxable year in which the cost of the goods is paid or incurred (in accordance with the taxpayer’s method of accounting), whichever is later. The Treasury Department and the IRS do not believe this approach creates or imposes undue burdens on taxpayers.

III. Section 7805(f)

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking

preceding this Treasury Decision was submitted to the Chief Counsel of the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

IV. 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 final 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.

Drafting Information

The principal author of these regulations is Anna Gleysteen, 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 record-keeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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 * * *

Par. 2. Section 1.263A-0 is amended by:

1. Revising the entry in the table of contents for §1.263A-1(b)(1).
2. Redesignating the entries in the table of contents for §1.263A-1(j), (k), and (l) as the entries for §1.263A-1(k), (l), and (m).

3. Adding a new entry in the table of contents for §1.263A-1(j).

4. Revising the newly designated entries for §1.263A-1(k), (l), and adding an entry for (m)(6).

5. Revising the entries in the table of contents for §1.263A-3(a)(2)(ii).

6. Adding entries for §1.263A-3(a)(5) and revising the entry for §1.263A-3(b).

7. Redesignating the entries in the table of contents for §1.263A-4(a)(3) and (4) as the entries for §1.263A-4(a)(4) and (5).

8. Adding in the table of contents a new entry for §1.263A-4(a)(3).

9. Revising the entry in the table of contents for §1.263A-4(d) introductory text.

10. Redesignating the entry in the table of contents for §1.263A-4(d)(5) as the entry for §1.263A-4(d)(7).

11. Adding in the table of contents a new entry for §1.263A-4(d)(5).

12. Adding an entry in the table of contents for §1.263A-4(d)(6).

13. Adding an entry in the table of contents for §1.263A-4(e)(5).

14. Revising the entry in the table of contents for §1.263A-4(f) introductory text.

15. Adding an entry in the table of contents for §1.263A-4(g).

16. Revising the entry in the table of contents for §1.263A-7(a)(4).

The revisions and additions read as follows:

§1.263A-0 Outline of regulations under section 263A.

* * * * *

§1.263A-1 Uniform Capitalization of Costs.

* * * * *

(b) * * *

(1) Small business taxpayers.

* * * * *

(j) Exemption for certain small business taxpayers.

(1) In general.

(2) Application of the section 448(c) gross receipts test.

(i) In general.

(ii) Gross receipts of individuals, etc.

(iii) Partners and S corporation shareholders.

- (iv) Examples.
 - (A) Example 1
 - (B) Example 2
- (3) Change in method of accounting.
 - (i) In general.
 - (ii) Prior section 263A method change.
- (k) Special rules
 - (1) Costs provided by a related person.
 - (i) In general
 - (ii) Exceptions
 - (2) Optional capitalization of period costs.
 - (i) In general.
 - (ii) Period costs eligible for capitalization.
 - (3) Trade or business application
 - (4) Transfers with a principal purpose of tax avoidance. [Reserved]
 - (1) Change in method of accounting.
 - (1) In general.
 - (2) Scope limitations.
 - (3) Audit protection.
 - (4) Section 481(a) adjustment.
 - (5) Time for requesting change.
- (m) * * *
- (6) Exemption for certain small business taxpayers.

§1.263A-3 Rules Relating to Property Acquired for Resale.

- (a) * * *
- (2) * * *
- (ii) Exemption for small business taxpayers. * * * *
- (5) *De minimis* production activities.
 - (i) In general.
 - (ii) Definition of gross receipts to determine *de minimis* production activities.
 - (iii) Example.
 - (b) [Reserved].

§1.263A-4 Rules for Property Produced in a Farming Business.

- (a) * * *
- (3) Exemption for certain small business taxpayers. * * * *
- (d) Election not to have section 263A apply under section 263A(d)(3). * * * *
- (5) Revocation of section 263A(d)(3) election to permit exemption under section 263A(i).

(6) Change from applying exemption under section 263A(i) to making a section 263A(d)(3) election.

- * * * *
- (e) * * *
- (5) Special temporary rule for citrus plants lost by reason of casualty.
- (f) Change in method of accounting. * * * *
- (g) Effective date.
 - (1) In general.
 - (2) Changes made by Tax Cuts and Jobs Act (Pub. L. No. 115-97).

§1.263A-7 Changing a method of accounting under section 263A.

- (a) * * *
- (4) Applicability dates.
 - (i) In general.
 - (ii) Changes made by Tax Cuts and Jobs Act (Pub. L. No. 115-97).

Par. 3. Section 1.263A-1 is amended by:

- 1. Revising paragraph (a)(2) subject heading.
- 2. In paragraph (a)(2)(i), revising the second sentence and adding a new third sentence.
- 3. Revising paragraph (b)(1).
- 4. In the second sentence of paragraph (d)(3)(ii)(B)(I), the language “§1.263A-3(b)” is removed and the language “§1.263A-1(j)” is added in its place.
- 5. Redesignating paragraphs (j) through (l) as paragraphs (k) through (m).
- 6. Adding a new paragraph (j).
- 7. In newly-redesignated paragraph (m), adding paragraph (m)(6).

The revisions and addition read as follows:

§1.263A-1 Uniform capitalization of costs.

- (a) * * *
- (2) *Applicability dates.* (i) * * * In the case of property that is inventory in the hands of the taxpayer, however, these sections are applicable for taxable years beginning after December 31, 1993. The small business taxpayer exception described in paragraph (b)(1) of this section and set forth in paragraph (j) of this section is applicable for taxable years beginning after December 31, 2017. * * *

* * * * *

(b) * * * (1) *Small business taxpayers.* For taxable years beginning after December 31, 2017, see section 263A(i) and paragraph (j) of this section for an exemption for certain small business taxpayers from the requirements of section 263A.

* * * * *

(j) *Exemption for certain small business taxpayers—*(1) *In general.* A taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), that meets the gross receipts test under section 448(c) and §1.448-2(c) (section 448(c) gross receipts test) for any taxable year (small business taxpayer) is not required to capitalize costs under section 263A to any real or tangible personal property produced, and any real or personal property described in section 1221(a) (1) acquired for resale, during that taxable year. This section 448(c) gross receipts test applies even if the taxpayer is not otherwise subject to section 448(a).

(2) *Application of the section 448(c) gross receipts test—*(i) *In general.* In the case of any taxpayer that is not a corporation or a partnership, and except as provided in paragraphs (j)(2)(ii) and (iii) of this section, the section 448(c) gross receipts test is applied in the same manner as if each trade or business of the taxpayer were a corporation or partnership.

(ii) *Gross receipts of individuals, etc.* Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer. Amounts not related to a trade or business are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer’s gross receipts do not include inherently personal amounts, such as personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W-2.

(iii) *Partners and S corporation shareholders.* Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of the partnership’s gross receipts in proportion to such partner’s distributive share, as deter-

mined under section 704, of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder of an S corporation includes such shareholder's *pro rata* share of S corporation gross receipts taken into account by the S corporation under section 1363(b).

(iv) *Examples.* The operation of this paragraph (j) is illustrated by the following examples:

(A) *Example 1.* Taxpayer A is an individual who operates two separate and distinct trades or business that are reported on Schedule C, *Profit or Loss from Business*, of A's Federal income tax return. For 2020, one trade or business has annual average gross receipts of \$5 million, and the other trade or business has average annual gross receipts of \$35 million. Under paragraph (j)(2)(ii) of this section, for 2020, neither of A's trades or businesses meets the gross receipts test of paragraph (j)(2) of this section (\$5 million + \$35 million = \$40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

(B) *Example 2.* Taxpayer B is an individual who operates three separate and distinct trades or business that are reported on Schedule C of B's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of \$15 million, Business Y is a dance studio with average annual gross receipts of \$6 million, and Business Z is a car repair shop with average annual gross receipts of \$12 million. Under paragraph (j)(2)(ii) of this section, B's gross receipts are the combined amount derived from all three of B's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (j)(2)(i) of this section (\$15 million + \$6 million + \$12 million = \$33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

(3) *Change in method of accounting—*
(i) *In general.* A change from applying the small business taxpayer exemption under paragraph (j) of this section to not applying the exemption under this paragraph (j), or *vice versa*, is a change in method of accounting under section 446(e) and §1.446-1(e). A taxpayer changing its method of accounting under paragraph (j) of this section may do so only with the consent of the Commissioner as required under section 446(e) and §1.446-1. In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and §1.446-1. The amount of the net section 481(a) adjustment and the adjustment period necessary to implement a change in method of accounting required under

this section are determined under §1.446-1(e) and the applicable administrative procedures to obtain the Commissioner's consent to change a method of accounting as published in the Internal Revenue Bulletin (see Revenue Procedure 2015-13 (2015-5 IRB 419) (or successor) (see also §601.601(d)(2) of this chapter).

(ii) *Automatic consent for certain method changes.* Certain changes in method of accounting made under paragraph (j) of this section may be made under the procedures to obtain the automatic consent of the Commissioner to change a method of accounting. See Revenue Procedure 2015-13 (2015-5 IRB 419) (or successor) (see also §601.601(d)(2) of this chapter)). In certain situations, special terms and conditions may apply.

* * * * *

(m) * * *.

(6) *Exemption for certain small business taxpayers.* The second and third sentence in paragraph (a)(2)(i), paragraphs (b)(1) and (j) of this section apply to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (m)(6), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

Par. 4. Section 1.263A-2 is amended by:

1. Adding a sentence at the end of paragraph (a) introductory text.
2. Revising paragraph (a)(1)(ii)(C).
3. Revising paragraph (g) subject heading.
4. Adding paragraph (g)(4).

The additions and revisions read as follows:

§1.263A-2 Rules relating to property produced by the taxpayer.

(a) * * * For taxable years beginning after December 31, 2017, see §1.263A-1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and §1.448-2(c).

(1) * * *

(ii) * * *

(C) Home construction contracts. Section 263A applies to a home construction

contract unless that contract will be completed within two years of the contract commencement date, and, for contracts entered into after December 31, 2017, in taxable years ending after December 31, 2017, the taxpayer meets the gross receipts test of section 448(c) and §1.448-2(c) for the taxable year in which such contract is entered into. Except as otherwise provided in this paragraph (a)(1)(ii)(C), section 263A applies to such a contract even if the contractor is not considered the owner of the property produced under the contract under Federal income tax principles.

* * * * *

(g) *Applicability dates.* * * *

(4) The rules set forth in the last sentence of the introductory text of paragraph (a) of this section and in paragraph (a)(1)(ii)(C) of this section apply for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (g)(4), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

Par. 5. Section 1.263A-3 is amended:

1. In paragraph (a)(1), by revising the second sentence.
2. By revising paragraphs (a)(2)(ii) and (iii).
4. In paragraph (a)(3), by removing the language "small reseller" and adding in its place the language "small business taxpayer".
5. In paragraph (a)(4)(ii), removing the language "(within the meaning of paragraph (a)(2)(iii) of this section)" and adding in its place the language "(within the meaning of paragraph (a)(5) of this section)".
6. By adding paragraph (a)(5).
7. By removing and reserving paragraph (b).
8. By revising paragraph (f).

The revisions and additions read as follows:

§1.263A-3 Rules relating to property acquired for resale.

(a) * * *(1) * * * However, for taxable years beginning after December 31, 2017, a small business taxpayer, as defined in

§1.263A-1(j), is not required to apply section 263A in that taxable year.***

(2)***

(ii) *Exemption for certain small business taxpayers.* For taxable years beginning after December 31, 2017, see §1.263A-1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and §1.448-2(c).

(iii) *De minimis production activities.* See paragraph (a)(5) of this section for rules relating to an exception for resellers with *de minimis* production activities.

(5) *De minimis production activities—*

(i) *In general.* In determining whether a taxpayer's production activities are *de minimis*, all facts and circumstances must be considered. For example, the taxpayer must consider the volume of the production activities in its trade or business. Production activities are presumed *de minimis* if—

(A) The gross receipts from the sale of the property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and

(B) The labor costs allocable to the trade or business's production activities are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

(ii) *Definition of gross receipts to determine de minimis production activities.* Gross receipts has the same definition as for purposes of the gross receipts test under §1.448-2(c), except that gross receipts are measured at the trade-or-business level rather than at the single-employer level.

(iii) *Example: Reseller with de minimis production activities.* Taxpayer N is in the retail grocery business. In 2019, N's average annual gross receipts for the three previous taxable years are greater than the gross receipts test of section 448(c). Thus, N is not exempt from the requirement to capitalize costs under section 263A. N's grocery stores typically contain bakeries where customers may purchase baked goods produced by N. N produces no other goods in its retail grocery business. N's gross receipts from its bakeries are 5 percent of the entire grocery business. N's labor costs from its bakeries are 3 percent of its total labor costs allocable to the entire grocery business. Because both ratios are less than 10 percent, N's production activities are *de minimis*. Further, because N's production activities are incident to its resale activities, N may use the simplified resale method, as provided in paragraph (a)(4)(ii) of this section.

(f) *Applicability dates.* (1) Paragraphs (d)(3)(i)(C)(3), (d)(3)(i)(D)(3), and (d)(3)

(i)(E)(3) of this section apply for taxable years ending on or after January 13, 2014.

(2) The rules set forth in the second sentence of paragraph (a)(1) of this section, paragraphs (a)(2)(ii) and (iii) of this section, the third sentence of paragraph (a)(3) of this section, and paragraphs (a)(4)(ii) and (a)(5) of this section apply for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (f)(2), provided the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

Par. 6. Section 1.263A-4 is amended:

1. In paragraph (a)(1), by revising the last sentence.

2. In paragraph (a)(2)(ii)(A)(1), by removing the language "section 464(c)" and adding in its place the language with "section 461(k)".

3. By redesignating paragraphs (a)(3) and (4) as paragraphs (a)(4) and (5) respectively.

4. By adding new paragraph (a)(3).

5. By revising the paragraph (d) subject heading.

6. In paragraph (d)(1), by revising the last sentence and adding a new sentence at the end of the paragraph.

7. In paragraph (d)(3)(i), by removing the last sentence.

8. By revising paragraph (d)(3)(ii).

9. By redesignating paragraph (d)(5) as paragraph (d)(7).

10. By adding new paragraphs (d)(5) and (6).

11. By adding paragraph (e)(5).

12. By redesignating paragraph (f) as paragraph (g).

13. By adding new paragraph (f).

14. By revising the subject headings of newly-redesignated paragraphs (g) and (g)(1), and by revising newly-designated paragraph (g)(2).

The revisions and additions read as follows:

§1.263A-4 Rules for property produced in a farming business.

(a)***(1)***Except as provided in paragraphs (a)(2), (a)(3), and (e) of

this section, taxpayers must capitalize the costs of producing all plants and animals unless the election described in paragraph (d) of this section is made.

(3) *Exemption for certain small business taxpayers.* For taxable years beginning after December 31, 2017, see §1.263A-1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and §1.448-2(c).

(d) *Election not to have section 263A apply under section 263A(d)(3)—(1)**** Except as provided in paragraph (d)(5) and (6) of this section, the election is a method of accounting under section 446. An election made under section 263A(d)(3) and this paragraph (d) is revocable only with the consent of the Commissioner.

(3)***

(ii) *Nonautomatic election.* Except as provided in paragraphs (d)(5) and (6) of this section, a taxpayer that does not make the election under this paragraph (d) as provided in paragraph (d)(3)(i) of this section must obtain the consent of the Commissioner to make the election by filing a Form 3115, *Application for Change in Method of Accounting*, in accordance with §1.446-1(e)(3).

(5) *Revocation of section 263A(d)(3) election to permit exemption under section 263A(i).* A taxpayer that elected under section 263A(d)(3) and paragraph (d)(3) of this section not to have section 263A apply to any plant produced in a farming business that wants to revoke its section 263A(d)(3) election, and in the same taxable year, apply the small business taxpayer exemption under section 263A(i) and §1.263A-1(j) may revoke the election in accordance with the applicable administrative guidance as published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter). A revocation of the taxpayer's section 263A(d)(3) election under this paragraph (d)(5) is not a change in method of accounting under sections 446 and 481 and §§1.446-1 and 1.481-1 through 1.481-5.

(6) *Change from applying exemption under section 263A(i) to making a section 263A(d)(3) election.* A taxpayer whose

method of accounting is to not capitalize costs under section 263A based on the exemption under section 263A(i), that becomes ineligible to use the exemption under section 263A(i), and is eligible and wants to elect under section 263A(d)(3) for this same taxable year to not capitalize costs under section 263A for any plant produced in the taxpayer's farming business, must make the election in accordance with the applicable administrative guidance as published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter). An election under section 263A(d)(3) made in accordance with this paragraph (d)(6) is not a change in method of accounting under sections 446 and 481 and §§1.446-1 and 1.481-1 through 1.481-5.

(e)***

(5) *Special temporary rule for citrus plants lost by reason of casualty.* Section 263A(d)(2)(A) provides that if plants bearing an edible crop for human consumption were lost or damaged while in the hands of the taxpayer by reason of freezing temperatures, disease, drought, pests, or casualty, section 263A does not apply to any costs of the taxpayer of replanting plants bearing the same type of crop (whether on the same parcel of land on which such lost or damaged plants were located or any other parcel of land of the same acreage in the United States). The rules of this paragraph (e)(5) apply to certain costs that are paid or incurred after December 22, 2017, and on or before December 22, 2027, to replant citrus plants after the loss or damage of citrus plants. Notwithstanding paragraph (e)(2) of this section, in the case of replanting citrus plants after the loss or damage of citrus plants by reason of freezing temperatures, disease, drought, pests, or casualty, section 263A does not apply to replanting costs paid or incurred by a taxpayer other than the owner described in section 263A(d)(2)(A) if—

(i) The owner described in section 263A(d)(2)(A) has an equity interest of not less than 50 percent in the replanted citrus plants at all times during the taxable year in which such amounts were paid or incurred and the taxpayer holds any part of the remaining equity interest; or

(ii) The taxpayer acquired the entirety of the equity interest in the land of that

owner described in section 263A(d)(2)(A) and on which land the lost or damaged citrus plants were located at the time of such loss or damage, and the replanting is on such land.

(f) *Change in method of accounting.* Except as provided in paragraphs (d)(5) and (6) of this section, any change in a taxpayer's method of accounting necessary to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and §1.446-1 through 1.446-7 and §1.481-1 through §1.481-3 apply.

(g) *Applicability dates—(1) In general.****

(2) *Changes made by Tax Cuts and Jobs Act (Pub. L. No. 115-97).* Paragraphs (a)(3), (d)(5), (d)(6), and (e)(5) of this section apply for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (g)(2), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

Par. 7. §1.263A-7 is amended:

1. By revising paragraph (a)(3)(i).
2. By redesignating paragraph (a)(4) as paragraph (a)(4)(i).
3. By adding a paragraph (a)(4) subject heading.
4. By revising the newly-designated paragraph (a)(4)(i) subject heading.
5. By adding paragraph (a)(4)(ii).
6. In paragraph (b)(1), by removing the language “Rev. Proc. 97-27 (1997-21 I.R.B.10)” and adding in its place the language “Revenue Procedure 2015-13 (2015-5 IRB 419)”.
7. In paragraph (b)(2)(ii), by removing the language “Rev. Proc. 2002-9 (2002-1 C.B. 327) and Rev. Proc. 97-27 (1991-1 C.B. 680)” and adding the language “Revenue Procedure 2015-13, 2015-5 IRB 419 (or successor)” in its place.

The revisions and additions read as follows:

§1.263A-7 *Changing a method of accounting under section 263A.*

§1.263A-7 *Changing a method of accounting under section 263A.*

(a)***

(3)***

(i) For taxable years beginning after December 31, 2017, resellers of real or personal property or producers of real or tangible personal property whose average annual gross receipts for the immediately preceding 3-taxable-year period, or lesser period if the taxpayer was not in existence for the three preceding taxable years, annualized as required, exceed the gross receipts test of section 448(c) and the accompanying regulations where the taxpayer was not subject to section 263A in the prior taxable year;

(4) *Applicability dates—(i) In general.****

(ii) *Changes made by Tax Cuts and Jobs Act (Pub. L. No. 115-97).* Paragraph (a)(3)(i) of this section applies to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraph described in the first sentence of this paragraph (a)(4)(ii), provided that the taxpayer follows all the applicable rules contained in the regulations under section 263A for such taxable year and all subsequent taxable years.

Par. 8. Section 1.263A-8 is amended by adding a sentence to the end of paragraph (a)(1) to read as follows:

§1.263A-8 *Requirement to capitalize interest.*

(a)***However, a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), that meets the gross receipts test of section 448(c) for the taxable year is not required to capitalize costs, including interest, under section 263A. See §1.263A-1(j).

Par. 9. Section 1.263A-9 is amended by adding a sentence to the end of paragraph (e)(2) to read as follows:

§1.263A-9 *The avoided cost method.*

(e)***

(2)***A taxpayer is an eligible taxpayer for a taxable year for purposes of this paragraph (e) if the taxpayer is a

small business taxpayer, as defined in §1.263A-1(j).

Par. 10. Section 1.263A-15 is amended by adding paragraph (a)(4) to read as follows:

§1.263A-15 Effective dates, transitional rules, and anti-abuse rule.

(a)*****

Old Paragraphs	New Paragraphs
(a)(6)(i)(i) and (ii)	(a)(6)(i)(A) and (B)
(a)(6)(ii)(i) and (ii)	(a)(6)(ii)(A) and (B)

3. In newly designated paragraphs (a)(6)(ii)(A) and (B), by removing the language “small reseller” and adding in its place the language “small business taxpayer” everywhere it appears.

4. By adding a sentence to the end of paragraph (f).

The addition reads as follows:

§1.381(c)(5)-1 Inventory method.

(f)*** The designations of paragraphs (a)(6)(ii)(A) and (B) of this section and removal of the term “small reseller” and replacement with the term “small business taxpayer” apply to taxable years beginning on or after January 5, 2021.

Par. 12. §1.446-1 is amended:

1. In paragraph (a)(4)(i), by revising the first sentence.

2. By revising paragraph (c)(2)(i).

3. By adding paragraph (c)(3).

The revisions and additions read as follows:

§1.446-1 General rule for methods of accounting.

(a)***

(4)***

(i) Except in the case of a taxpayer qualifying as a small business taxpayer for the taxable year under section 471(c), in all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in progress, raw materials, and supplies) at the beginning and end of the year

(4) The last sentence of each of §1.263A-8(a)(1) and §1.263A-9(e)(2) apply to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the last sentence of each of §1.263A-8(a)(1) and §1.263A-9(e)(2), provided that the taxpayer follows all the applicable rules contained in the regulations under sec-

tion 471(c) shall be taken into account in computing the taxable income of the year.***

(c)***

(2)***

(i) In any case in which it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales unless:

(A) The taxpayer qualifies as a small business taxpayer for the taxable year under section 471(c), or

(B) Otherwise authorized under paragraph (c)(2)(ii) of this section.

(3) *Applicability date.* The first sentence of paragraph (a)(4)(i) of this section and paragraph (c)(2)(i) of this section apply to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the rules provided in the first sentence of this paragraph (c)(3), provided that the taxpayer follows all the applicable rules contained in the regulations under section 446 for such taxable year and all subsequent taxable years.

Par. 13. Section 1.448-1 is amended by adding new first and second sentences to paragraphs (g)(1) and (h)(1) to read as follows:

§1.448-1 Limitation on the use of the cash receipts and disbursements method of accounting.

tion 263A for such taxable year and all subsequent taxable years.

Par. 11. Section 1.381(c)(5)-1 is amended:

1. In paragraph (a)(6), by designating *Examples 1* and *2* as paragraphs (a)(6)(i) and (ii), respectively.

2. In newly-designated paragraphs (a)(6)(i) and (ii), by redesignating the paragraphs in the first column as the paragraphs in the second column:

(g)*** (1)*** The rules provided in paragraph (g) of this section apply to taxable years beginning before January 1, 2018. See §1.448-2 for rules relating to taxable years beginning after December 31, 2017.***

(h)*** (1)*** The rules provided in paragraph (h) of this section apply to taxable years beginning before January 1, 2018. See §1.448-2 for rules relating to taxable years beginning after December 31, 2017.***

§1.448-2 [Redesignated as §1.448-3]

Par. 14. Section 1.448-2 is redesignated as §1.448-3.

Par. 15. A new §1.448-2 is added to read as follows:

§1.448-2 Limitation on the use of the cash receipts and disbursements method of accounting for taxable years beginning after December 31, 2017.

(a) *Limitation on method of accounting—(1) In general.* The rules of this section relate to the limitation on the use of the cash receipts and disbursements method of accounting (cash method) by certain taxpayers applicable for taxable years beginning after December 31, 2017. For rules applicable to taxable years beginning before January 1, 2018, see §§1.448-1 and 1.448-1T.

(2) *Limitation rule.* Except as otherwise provided in this section, the computation of taxable income using the cash method is prohibited in the case of a:

(i) C corporation;

(ii) Partnership with a C corporation as a partner, or a partnership that had a C corporation as a partner at any time during the partnership's taxable year beginning after December 31, 1986; or

(iii) Tax shelter.

(3) *Treatment of combination methods*—(i) *In general.* For purposes of this section, the use of a method of accounting that records some, but not all, items on the cash method is considered the use of the cash method. Thus, a C corporation that uses a combination of accounting methods including the use of the cash method is subject to this section.

(ii) *Example.* The following example illustrates the operation of this paragraph (a)(3). In 2020, A is a C corporation with average annual gross receipts for the prior three taxable years of greater than \$30 million, is not a tax shelter under section 448(a)(3) and does not qualify as a qualified personal service corporation, as defined in paragraph (e) of this section. For the last 20 years, A used an accrual method for items of income and expenses related to purchases and sales of inventory, and the cash method for items related to its provision of services. A is using a combination of accounting methods that include the cash method. Thus, A is subject to section 448. A is prohibited from using the cash method for any item for 2020 and is required to change to a permissible method.

(b) *Definitions.* For purposes of this section—

(1) *C corporation*—(i) *In general.* The term *C corporation* means any corporation that is not an S corporation (as defined in section 1361(a)(1)). For example, a regulated investment company (as defined in section 851) or a real estate investment trust (as defined in section 856) is a C corporation for purposes of this section. In addition, a trust subject to tax under section 511(b) is treated, for purposes of this section, as a C corporation, but only with respect to the portion of its activities that constitute an unrelated trade or business. Similarly, for purposes of this section, a corporation that is exempt from Federal income taxes under section 501(a) is treated as a C corporation only with respect to the portion of its activities that constitute an unrelated trade or business. Moreover, for purposes of determining whether a partnership has a C corporation as a partner, any partnership described in paragraph (a)(2)(ii) of this section is treated as a C corporation. Thus, if partnership ABC has a partner that is a partnership with a C corporation, then, for purposes of this section, part-

nership ABC is treated as a partnership with a C corporation partner.

(ii) [Reserved]

(2) *Tax shelter*—(i) *In general.* The term *tax shelter* means any—

(A) Enterprise, other than a C corporation, if at any time, including taxable years beginning before January 1, 1987, interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or state agency having the authority to regulate the offering of securities for sale;

(B) Syndicate, within the meaning of paragraph (b)(2)(iii) of this section; or

(C) Tax shelter, within the meaning of section 6662(d)(2)(C).

(ii) *Requirement of registration.* For purposes of paragraph (b)(2)(i)(A) of this section, an offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to register the offering would result in a violation of the applicable Federal or state law. This rule applies regardless of whether the offering is in fact registered. In addition, an offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable Federal or state law, regardless of whether the notice is in fact filed. However, an S corporation is not treated as a tax shelter for purposes of section 448(d)(3) or this section merely by reason of being required to file a notice of exemption from registration with a state agency described in section 461(i)(3)(A), but only if all corporations offering securities for sale in the state must file such a notice in order to be exempt from such registration.

(iii) *Syndicate*—(A) *In general.* For purposes of paragraph (b)(2)(i)(B) of this section, the term *syndicate* means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs. For purposes of this paragraph (b)(2)(iii), the term *limited entrepreneur* has the same meaning given such term in section 461(k)(4). In addition, in determining whether an interest in a partnership is

held by a limited partner, or an interest in an entity or enterprise is held by a limited entrepreneur, section 461(k)(2) applies in the case of the trade or business of farming (as defined in paragraph (d)(2) of this section), and section 1256(e)(3)(C) applies in all other cases. Moreover, for purposes of paragraph (b)(2) of this section, the losses of a partnership, entity, or enterprise (entities) means the excess of the deductions allowable to the entities over the amount of income recognized by such entities under the entities' method of accounting used for Federal income tax purposes (determined without regard to this section). For this purpose, gains or losses from the sale of capital assets or assets described in section 1221(a)(2) are not taken into account.

(B) *Irrevocable annual election to test the allocation of losses from prior taxable year*—(1) *In general.* For purposes of paragraph (b)(2)(iii)(A) of this section, to determine if more than 35 percent of the losses of a venture are allocated to limited partners or limited entrepreneurs, entities may elect to use the allocations made in the immediately preceding taxable year instead of using the current taxable year's allocation. An election under this paragraph (b)(2)(iii)(B) applies only to the taxable year for which the election is made. Except as otherwise provided in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), a taxpayer that makes an election under this paragraph (b)(2)(iii)(B) must apply this election for other provisions of the Code that specifically apply the definition of tax shelter in section 448(a)(3).

(2) *Time and manner of making election.* A taxpayer makes this election for the taxable year by attaching a statement to its timely filed original Federal income tax return (including extensions) for such taxable year. The statement must state that the taxpayer is making the election under §1.448-2(b)(2)(iii)(B). In the case of an S corporation or partnership, the election is made by the S corporation or the partnership and not by the shareholders or partners. An election under this paragraph (b)(2)(iii)(B) may not be made by the taxpayer in any other manner. For example, the election cannot be made through a request under section 446(e) to change the taxpayer's method of accounting. A taxpay-

er may not revoke an election under this paragraph (b)(2)(iii)(B).

(3) *Administrative guidance.* The IRS may publish procedural guidance in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) that provides alternative procedures for complying with paragraph (b)(2)(iii)(B)(2) of this section.

(C) *Examples.* The following examples illustrate the rules of paragraph (b)(2)(iii) of this section. For purposes of the examples, the term “losses” has the meaning stated in paragraph (b)(2)(iii)(A) of this section.

(1) *Example 1.* Taxpayer B is a calendar year limited partnership, with no active management from its limited partner. For 2019, B is profitable and has no losses to allocate to its limited partner. For 2020, B is not profitable and allocates 60 percent of its losses to its general partner and 40 percent of its losses to its limited partner. For 2021, B is not profitable and allocates 50 percent of its losses to its general partner and 50 percent of its losses to its limited partner. For taxable year 2020, B makes an election under paragraph (b)(2)(iii)(B) of this section to use its prior year allocated amounts. Accordingly, for 2020, B is not a syndicate because B was profitable for 2019 and did not allocate any losses to its limited partner in 2019. For 2021, B is a syndicate because B allocated 50 percent of its 2021 losses to its limited partner under paragraph (b)(2)(ii)(3)(A) of this section. Even if B made an election under paragraph (b)(2)(iii)(B) of this section to use prior year allocated amounts, B is a syndicate for 2021 because B allocated 40 percent of its 2020 losses to its limited partner in 2020. Because B is a syndicate under paragraph (b)(2)(iii)(A) of this section for 2021, B is a tax shelter prohibited from using the cash method for taxable year 2021 under paragraph (b)(2)(i)(B) of this section.

(2) *Example (2).* Same facts as Example (1) in paragraph (b)(2)(iii)(C)(1) of this section, except for 2021, B is profitable and has no losses to allocate to its limited partner. For 2020, B makes an election under paragraph (b)(2)(iii)(B) of this section to use its prior year allocated amounts. Accordingly, for 2020, B is not a syndicate because it did not allocate any losses to its limited partner in 2019. For 2021, B chooses not to make the election under paragraph (b)(2)(iii)(B) of this section. For 2021, B is not a syndicate because it does not have any 2021 losses to allocate to a limited partner. For taxable years 2019, 2020 and 2021, B is not a syndicate under paragraph (b)(2)(iii)(A) of this section and is not prohibited from using the cash method for taxable years 2019, 2020 or 2021 under paragraph (b)(2)(i)(B) of this section.

(iv) *Presumed tax avoidance.* For purposes of (b)(2)(i)(C) of this section, marketed arrangements in which persons carrying on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons use borrowed funds

to prepay a substantial portion of their farming expenses. Payments for farm supplies that will not be used or consumed until a taxable year subsequent to the taxable year of payment are an example of one type of such prepayment.

(v) *Taxable year tax shelter must change accounting method.* A tax shelter must change from the cash method for the taxable year that it becomes a tax shelter, as determined under paragraph (b)(2) of this section.

(vi) *Determination of loss amount.* For purposes of section 448(d)(3), the amount of losses to be allocated under section 1256(e)(3)(B) is calculated without regard to section 163(j).

(c) *Exception for entities with gross receipts not in excess of the amount provided in section 448(c)—(1) In general.* Except in the case of a tax shelter, this section does not apply to any C corporation or partnership with a C corporation as a partner for any taxable year if such corporation or partnership (or any predecessor thereof) meets the gross receipts test of paragraph (c)(2) of this section.

(2) *Gross receipts test—(i) In general.* A corporation meets the gross receipts test of this paragraph (c)(2) if the average annual gross receipts of such corporation for the 3 taxable years (or, if shorter, the taxable years during which such corporation was in existence, annualized as required) ending with such prior taxable year does not exceed the gross receipts test amount provided in paragraph (c)(2)(v) of this section (section 448(c) gross receipts test). In the case of a C corporation exempt from Federal income taxes under section 501(a), or a trust subject to tax under section 511(b) that is treated as a C corporation under paragraph (b)(1) of this section, only gross receipts from the activities of such corporation or trust that constitute unrelated trades or businesses are taken into account in determining whether the gross receipts test is satisfied. A partnership with a C corporation as a partner meets the gross receipts test of paragraph (c)(2) of this section if the average annual gross receipts of such partnership for the 3 taxable years (or, if shorter, the taxable years during which such partnership was in existence annualized as required) ending with such prior year does not exceed the gross receipts test amount of para-

graph (c)(2)(v) of this section. Except as provided in paragraph (c)(2)(ii) of this section, the gross receipts of the corporate partner are not taken into account in determining whether a partnership meets the gross receipts test of paragraph (c)(2) of this section.

(ii) *Aggregation of gross receipts.* The aggregation rules in §1.448-1T(f)(2)(ii) apply for purposes of aggregating gross receipts for purposes of this section.

(iii) *Treatment of short taxable year.* The short taxable year rules in §1.448-1T(f)(2)(iii) apply for purposes of this section.

(iv) *Determination of gross receipts.* The determination of gross receipts rules in §1.448-1T(f)(2)(iv) apply for purposes of this section.

(v) *Gross receipts test amount—(A) In general.* For purposes of paragraph (c) of this section, the term *gross receipts test amount* means \$25,000,000, adjusted annually for inflation in the manner provided in section 448(c)(4). The inflation adjusted gross receipts test amount is published annually in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter).

(B) *Example.* Taxpayer A, a C corporation, is a plumbing contractor that installs plumbing fixtures in customers' homes or businesses. A's gross receipts for the 2017-2019 taxable years are \$20 million, \$16 million, and \$30 million, respectively. A's average annual gross receipts for the three taxable-year period preceding the 2020 taxable year is \$22 million $(\$20 \text{ million} + \$16 \text{ million} + \$30 \text{ million}) / 3 = \22 million . A may use the cash method for its trade or business for the 2020 taxable year because its average annual gross receipts for the preceding three taxable years is not more than the gross receipts test amount of paragraph (c)(2)(vi) of this section, which is \$26 million for 2020.

(d) *Exception for farming businesses—(1) In general.* Except in the case of a tax shelter, this section does not apply to any farming business. A taxpayer engaged in a farming business and a separate non-farming business is not prohibited by this section from using the cash method with respect to the farming business, even though the taxpayer may be prohibited by this section from using the cash method with respect to the non-farming business.

(2) *Farming business—(i) In general.* For purposes of paragraph (d) of this section, the term *farming business* means—

(A) The trade or business of farming as defined in section 263A(e)(4) (including

the operation of a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts or other crops, or ornamental trees),

(B) The raising, harvesting, or growing of trees described in section 263A(c) (5) (relating to trees raised, harvested, or grown by the taxpayer other than trees described in paragraph (d)(2)(i)(A) of this section),

(C) The raising of timber, or

(D) Processing activities which are normally incident to the growing, raising, or harvesting of agricultural products.

(ii) *Example.* Assume a taxpayer is in the business of growing fruits and vegetables. When the fruits and vegetables are ready to be harvested, the taxpayer picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the business of farming with respect to the growing of fruits and vegetables, and the processing activities incident to the harvest.

(iii) *Processing activities excluded from farming businesses—(A) In general.* For purposes of this section, a farming business does not include the processing of commodities or products beyond those activities normally incident to the growing, raising, or harvesting of such products.

(B) *Examples. (1) Example 1.* Assume that a C corporation taxpayer is in the business of growing and harvesting wheat and other grains. The taxpayer processes the harvested grains to produce breads, cereals, and similar food products which it sells to customers in the course of its business. Although the taxpayer is in the farming business with respect to the growing and harvesting of grain, the taxpayer is not in the farming business with respect to the processing of such grains to produce breads, cereals, and similar food products which the taxpayer sells to customers.

(2) *Example 2.* Assume that a taxpayer is in the business of raising livestock. The taxpayer uses the livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged or canned for sale to customers. Although the taxpayer is in the farming business with respect to the raising of livestock, the taxpayer is not in the farming business with respect to the meat processing operation.

(e) *Exception for qualified personal service corporation.* The rules in §1.448-1T(e) relating to the exception for qualified personal service corporations apply for taxable years beginning after December 31, 2017.

(f) *Effect of section 448 on other provisions.* Except as provided in paragraph

(b)(2)(iii)(B) of this section, nothing in section 448 shall have any effect on the application of any other provision of law that would otherwise limit the use of the cash method, and no inference shall be drawn from section 448 with respect to the application of any such provision. For example, nothing in section 448 affects the requirement of section 447 that certain corporations must use an accrual method of accounting in computing taxable income from farming, or the requirement of §1.446-1(c)(2) that, in general, an accrual method be used with regard to purchases and sales of inventory. Similarly, nothing in section 448 affects the authority of the Commissioner under section 446(b) to require the use of an accounting method that clearly reflects income, or the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. For example, a taxpayer using the cash method may be required to change to an accrual method of accounting under section 446(b) because such method clearly reflects the taxpayer's income, even though the taxpayer is not prohibited by section 448 from using the cash method. Similarly, a taxpayer using an accrual method of accounting that is not prohibited by section 448 from using the cash method may not change to the cash method unless the taxpayer secures the consent of the Commissioner under section 446(e).

(g) *Treatment of accounting method change and rules for section 481(a) adjustment—(1) In general.* Any taxpayer to whom section 448 applies must change its method of accounting in accordance with the provisions of this paragraph (g). In the case of any taxpayer required by this section to change its method of accounting, the change shall be treated as a change initiated by the taxpayer to compute the adjustment required under section 481. A taxpayer must change to an overall accrual method of accounting for the first taxable year the taxpayer is subject to this section or a subsequent taxable year in which the taxpayer is newly subject to this section after previously making a change in method of accounting that complies with section 448 (mandatory section 448 year). A taxpayer may have more than one manda-

tory section 448 year. For example, a taxpayer may exceed the gross receipts test of section 448(c) in non-consecutive taxable years. If the taxpayer complies with the provisions of paragraph (g)(3) of this section for its mandatory section 448 year, the change shall be treated as made with the consent of the Commissioner. The change shall be implemented pursuant to the applicable administrative procedures to obtain the automatic consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (see Revenue Procedure 2015-13 (2015-5 IRB 419) (or successor) (see also §601.601(d)(2) of this chapter)). This paragraph (g) applies only to a taxpayer who changes from the cash method as required by this section. This paragraph (g) does not apply to a change in method of accounting required by any Code section (or applicable regulation) other than this section.

(2) *Section 481(a) adjustment.* The amount of the net section 481(a) adjustment and the adjustment period necessary to implement a change in method of accounting required under this section are determined under §1.446-1(e) and the applicable administrative procedures to obtain the Commissioner's consent to change a method of accounting as published in the Internal Revenue Bulletin (see Revenue Procedure 2015-13 (2015-5 IRB 419) (or successor) (see also §601.601(d)(2) of this chapter)).

(h) *Applicability dates.* The rules of this section apply for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the rules provided in this section provided that the taxpayer follows all the applicable rules contained in the regulations under section 448 for such taxable year and all subsequent taxable years.

Par. 16. Newly-redesignated § 1.448-3 is amended by revising paragraphs (a)(2) and (h) to read as follows:

§1.448-3 Nonaccrual of certain amounts by service providers.

(a) * * *

(2) The taxpayer meets the gross receipts test of section 448(c) and §1.448-1T(f)(2) (in the case of taxable years beginning before January 1, 2018), or §1.448-2(c) (in the case of taxable years beginning after December 31, 2017) for all prior taxable years.

(h) *Applicability dates.* (1) Except as provided in paragraph (h)(2) of this section, this section is applicable for taxable years ending on or after August 31, 2006.

(2) The rules of paragraph (a)(2) of this section apply for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraph described in the first sentence of this paragraph (h) (2), provided that the taxpayer follows all the applicable rules contained in the regulations under section 448 for such taxable year and all subsequent taxable years.

Par. 17. Section 1.460-0 is amended by:

- 1. Adding an entry for §1.460-1(h)(3).
- 2. Revising the entries for §1.460-3(b) (3), §1.460-3(b)(3)(i) and (ii), and adding entries for §1.460-3(b)(3)(ii)(A), (B), (C) and (D).

3. Removing the entry for §1.460-3(b) (3)(iii).

4. Adding entries for §1.460-3(d), §1.460-4(i), and §1.460-6(k).

The additions and revisions read as follows:

§1.460-0 Outline of regulations under section 460.

§1.460-1 Long-term contracts.

(h) ***

(3) Changes made by Tax Cuts and Jobs Act (Pub. L. 115-97).

§1.460-3 Long-term construction contracts.

(b) ***

(3) Gross receipts test of section 448(c)

(i) In general

(ii) Application of gross receipts test

(A) In general

(B) Gross receipts of individuals, etc.

(C) Partners and S corporation shareholders

(D) Examples

(1) Example 1.

(2) Example 2.

(iii) Method of accounting.

(d) Applicability dates.

§1.460-4 Methods of Accounting for long-term contracts.

(i) Applicability date.

§1.460-6 Look-back method.

(k) Applicability date.

Par. 18. Section 1.460-1 is amended by adding three sentences to the end of paragraph (f)(3) and adding paragraph (h)(3) to read as follows:

§1.460-1 Long-term contracts.

(f) ***

(3) *** A taxpayer may adopt any permissible method of accounting for each classification of contract. Such adoption is not a change in method of accounting under section 446 and the accompanying regulations. For example, a taxpayer that has had only contracts classified as non-exempt long-term contracts and has used the PCM for these contracts may adopt an exempt contract method in the taxable year it first enters into an exempt long-term contract.

(h) ***

(3) *Changes made by Tax Cuts and Jobs Act (Pub. L. 115-97).* Paragraph (f) (3) of this section, and §1.460-5(d)(1) and (d)(3), apply for contracts entered into in taxable years beginning on or after January 5, 2021. However, for contracts entered into after December 31, 2017, in a taxable year ending after December 31, 2017, and before January 5, 2021, a taxpayer may apply paragraph (f)(3) of this section, and §1.460-5(d)(1) and (d)(3), provided that the taxpayer also applies the

applicable rules contained in the regulations under section 460 for such taxable year and all subsequent taxable years.

Par. 19. Section 1.460-3 is amended by revising paragraphs (b)(1)(ii) and (b) (3), and adding paragraph (d) to read as follows:

§1.460-3 Long-term construction contracts.

(b) ***

(1) ***

(ii) Other construction contract, entered into after December 31, 2017, in a taxable year ending after December 31, 2017, by a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting (cash method) under section 448(a)(3), who estimates at the time such contract is entered into that such contract will be completed within the 2-year period beginning on the contract commencement date, and who meets the gross receipts test described in paragraph (b)(3) of this section for the taxable year in which such contract is entered into.

(3) *Gross receipts test*—(i) *In general.* A taxpayer, other than a tax shelter prohibited from using the cash method under section 448(a)(3), meets the gross receipts test of this paragraph (b)(3) if it meets the gross receipts test of section 448(c) and §1.448-2(c)(2). This gross receipts test applies even if the taxpayer is not otherwise subject to section 448(a).

(ii) *Application of gross receipts test*—(A) *In general.* In the case of any taxpayer that is not a corporation or a partnership, and except as provided in paragraphs (b) (3)(ii)(B) and (C) of this section, the gross receipts test of section 448(c) and the accompanying regulations are applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership.

(B) *Gross receipts of individuals, etc.* Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer. Amounts not related to a trade or business

are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W-2.

(C) *Partners and S corporation shareholders.* Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of partnership gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder includes the pro rata share of S corporation gross receipts taken into account by the S corporation under section 1363(b).

(D) *Example.* The operation of this paragraph (b)(3) is illustrated by the following examples:

(1) *Example 1.* Taxpayer A is an individual who operates two separate and distinct trades or business that are reported on Schedule C, *Profit or Loss from Business*, of A's Federal income tax return. For 2020, one trade or business has annual average gross receipts of \$5 million, and the other trade or business has average annual gross receipts of \$35 million. Under paragraph (b)(3)(ii)(B) of this section, for 2020, neither of A's trades or businesses meets the gross receipts test of paragraph (b)(3) of this section (\$5 million + \$35 million = \$40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

(2) *Example 2.* Taxpayer B is an individual who operates three separate and distinct trades or business that are reported on Schedule C of B's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of \$15 million, Business Y is a dance studio with average annual gross receipts of \$6 million, and Business Z is a car repair shop with average annual gross receipts of \$12 million. Under paragraph (b)(3)(ii)(B) of this section, B's gross receipts are the combined amount derived from all three of B's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (b)(3)(i) of this section (\$15 million + \$6 million + \$12 million = \$33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

(iii) *Method of accounting.* A change in the method of accounting used for exempt construction contracts described in paragraph (b)(1)(ii) of this section is a change in method of accounting under section 446 and the accompanying regulations.

For rules distinguishing a change in method from adoption of a method, see §1.460-1(f)(3). A taxpayer changing its method of accounting must obtain the consent of the Commissioner in accordance with §1.446-1(e)(3). For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and §1.446-1. A change in method of accounting shall be implemented pursuant to the applicable administrative procedures to obtain the consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (IRB) (see Revenue Procedure 2015-13 (2015-5 IRB 419) (or successor) (see §601.601(d)(2) of this chapter)). A taxpayer that uses the percentage of completion method for exempt contracts described in paragraph (b)(1)(ii) of this section that wants to change to another exempt contract method is to use the applicable administrative procedures to obtain the automatic consent of the Commissioner to change such method under section 446(e) as published in the IRB. A taxpayer-initiated change in method of accounting will be permitted only on a cut-off basis, and thus, a section 481(a) adjustment will not be permitted or required. See § 1.460-4(g).

(d) *Applicability Dates.* Paragraphs (b)(1)(ii) and (b)(3) of this section apply, for contracts entered into in taxable years beginning on or after January 5, 2021. However, for contracts entered into after December 31, 2017, in a taxable year ending after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (d), provided that the taxpayer follows all the applicable rules contained in the regulations under section 460 for such taxable year and all subsequent taxable years.

Par. 20. Section 1.460-4 is amended by revising the first sentence of paragraph (f)(1) and adding paragraph (i) to read as follows:

§1.460-4 Methods of Accounting for long-term contracts.

(f) * * *(1) * * *Under section 56(a)(3), a taxpayer subject to the AMT must

use the PCM to determine its AMTI from any long-term contract entered into on or after March 1, 1986, that is not a home construction contract, as defined in §1.460-3(b)(2). * * *

(i) *Applicability date.* Paragraph (f)(1) of this section applies to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraph described in the first sentence of this paragraph (i), provided that the taxpayer follows all the applicable rules contained in the regulations under section 460 for such taxable year and all subsequent taxable years.

Par. 21. Section 1.460-5 is amended:

1. In paragraph (d)(1), by removing the language “(concerning contracts of homebuilders that do not satisfy the \$10,000,000 gross receipts test described in §1.460-3(b)(3) or will not be completed within two years of the contract commencement date)”.

2. By revising paragraph (d)(3).

The revision reads as follows:

§1.460-5 Cost allocation rules.

(d) * * *

(3) *Large homebuilders.* A taxpayer must capitalize the costs of home construction contracts under section 263A, unless the taxpayer estimates, when entering into the contract, that it will be completed within two years of the contract commencement date, and the taxpayer satisfies the gross receipts test of section 448(c) described in §1.460-3(b)(3) for the taxable year in which the contract is entered into.

Par. 22. Section 1.460-6 is amended:

1. In paragraph (b)(2) introductory text, by removing the language “section 460(e)(4)” and adding in its place the language “section 460(e)(3)”.

2. By revising the first and last sentences of paragraph (b)(2)(ii).

3. By designating the undesignated text after paragraph (b)(3)(ii) as paragraph (b)(3)(iii).

4. In newly designated paragraph (b)(3)(iii), by adding a sentence to the end of the paragraph.

5. In paragraph (c)(1)(i), by revising the fifth sentence.

6. In paragraph (c)(2)(i), by revising the third sentence.

7. In paragraph (c)(2)(iv), by revising the first sentence.

8. In paragraph (c)(3)(ii), by revising the first sentence.

9. In paragraph (c)(3)(vi), by revising the first sentence.

10. In paragraph (d)(2)(i), by removing the language “whether or not the taxpayer would have been subject to the alternative minimum tax” and adding in its place the language “for taxpayers subject to the alternative minimum tax without regard to whether tentative minimum tax exceeds regular tax for the redetermination year”.

11. By revising paragraph (d)(4)(i)(A).

12. By designating paragraph (h)(8)(ii) *Example 7* as paragraph (h)(8)(iii).

13. By revising newly designated paragraph (h)(8)(iii).

14. By adding paragraph (k).

The revisions and additions read as follows:

§1.460-6 *Look-back method.*

(b)***

(2)***

(ii) is not a home construction contract but is estimated to be completed within a 2-year period by a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), who meets the gross receipts test of section 448(c) and §1.460-3(b)(3) for the taxable year in which such contract is entered into. ***The look-back method, however, applies to the alternative minimum taxable income from a contract of this type, for those taxpayers subject to the AMT in taxable years prior to the filing taxable year in which the look-back method is required, unless the contract is exempt from required use of the percentage of completion method under section 56(a)(3).

(3)***

(iii) ***For contracts entered into after December 31, 2017, in a taxable year ending after December 31, 2017, a taxpayer’s gross receipts are determined in the manner required by regulations under section 448(c).

(c)***

(1)***

(i)*** Based on this reapplication, the taxpayer determines the amount of taxable income (and, when applicable, alternative minimum taxable income and modified taxable income under section 59A(c)) that would have been reported for each year prior to the filing year that is affected by contracts completed or adjusted in the filing year if the actual, rather than estimated, total contract price and costs had been used in applying the percentage of completion method to these contracts, and to any other contracts completed or adjusted in a year preceding the filing year. ***

(2)***(i)***The taxpayer then must determine the amount of taxable income (and, when applicable, alternative minimum taxable income and modified taxable income under section 59A(c)) that would have been reported for each affected tax year preceding the filing year if the percentage of completion method had been applied on the basis of actual contract price and contract costs in reporting income from all contracts completed or adjusted in the filing year and in any preceding year. ***

(iv)*** In general, because income under the percentage of completion method is generally reported as costs are incurred, the taxable income and, when applicable, alternative minimum taxable income and modified taxable income under section 59A(c), are recomputed only for each year in which allocable contract costs were incurred. ***

(3)***

(ii)*** Under the method described in this paragraph (c)(3) (actual method), a taxpayer first must determine what its regular and, when applicable, its alternative minimum tax and base erosion minimum tax liability would have been for each redetermination year if the amounts of contract income allocated in Step One for all contracts completed or adjusted in the filing year and in any prior year were substituted for the amounts of contract income reported under the percentage of completion method on the taxpayer’s original

return (or as subsequently adjusted on examination, or by amended return). ***

(vi)***For purposes of Step Two, the income tax liability must be redetermined by taking into account all applicable additions to tax, credits, and net operating loss carrybacks and carryovers. Thus, the taxes, if any, imposed under sections 55 and 59A (relating to alternative and base erosion minimum tax, respectively) must be taken into account. ***

(d)***

(4)***(i)***(A) *General rule.* The simplified marginal method is required to be used with respect to income reported from domestic contracts by a pass-through entity that is either a partnership, an S corporation, or a trust, and that is not closely held. With respect to contracts described in the preceding sentence, the simplified marginal impact method is applied by the pass-through entity at the entity level. The pass-through entity determines the amount of any hypothetical underpayment or overpayment for a redetermination year using the highest rate of tax in effect for corporations under section 11. However, for redetermination years beginning before January 1, 2018, the pass-through entity uses the highest rates of tax in effect for corporations under section 11 and section 55(b)(1). Further, the pass-through entity uses the highest rates of tax imposed on individuals under section 1 and section 55(b)(1) if, at all times during the redetermination year involved (that is, the year in which the hypothetical increase or decrease in income arises), more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass-through entities.

(h)***

(8)***

(iii) *Example 7.* X, a calendar year C corporation, is engaged in the construction of real property under contracts that are completed within a 24-month period. Its average annual gross receipts for the prior 3-taxable-year period does not exceed \$25,000,000. As permitted by section 460(e)(1)(B), X uses the completed contract method (CCM) for regular tax purposes. However, X is engaged in the construction of commercial real property and, for years beginning before January 1, 2018, is required to use the percentage of completion method (PCM) for alternative minimum tax (AMT) purposes. Assume that for 2017, 2018, and 2019, X has only one long-term

contract, which is entered into in 2017 and completed in 2019 and that in 2017 X's average annual gross receipts for the prior 3-taxable-years do not exceed \$10,000,000. Assume further that X estimates gross income from the contract to be \$2,000, total contract costs to be \$1,000, and that the contract is 25 percent complete in 2017 and 70 percent complete in 2018, and 5 percent complete in 2019. In 2019, the year of completion, gross income from the contract is actually \$3,000, instead of \$2,000, and costs are actually \$1,000. Because X was required to use the PCM for 2017 for AMT purposes, X must apply the look-back method to its AMT reporting for that year. X has elected to use the simplified marginal impact method. For 2017, X's income using estimated contract price and costs is as follows:

Table 1 to paragraph (h)(8)(iii)

Estimates	2017
Gross Income	\$500 = (\$2,000 x 25%)
Deductions	\$(250) = (\$1,000 x 25%)
Contract Income-PCM	\$250

(A) When X files its federal income tax return for 2019, the contract completion year, X applies the look-back method. For 2017, X's income using actual contract price and costs is as follows:

Table 2 to paragraph (h)(8)(iii)(A)

Actual	2017
Gross Income	\$750 = (\$3,000 x 25%)
Deductions	\$(250) = (\$1,000 x 25%)
Contract Income-PCM	\$500

(B) Accordingly, the reallocation of contract income under the look-back method results in an increase of income for AMT purposes for 2017 of \$250 (\$500-\$250). Under the simplified marginal impact method, X applies the highest rate of tax under section 55(b)(1) to this increase, which produces a hypothetical underpayment for 2017 of \$50 (.20 x \$250). Interest is charged to X on this \$50 underpayment from the due date of X's 2017 return until the due date of X's 2019 return. X, a C corporation, is not subject to the AMT in 2018. X does not compute alternative minimum taxable income or use the PCM in that year. Accordingly, look-back does not apply to 2018.

* * * * *

(k) *Applicability date.* Paragraphs (b) (2), (b)(2)(ii), (b)(3)(iii), (c)(1)(i), (c)(2)(i), (c)(2)(iv), (c)(3)(ii), (c)(3)(vi), (d)(2)(i), (d)(4)(i)(A), and (h)(8)(iii) of this section apply to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the paragraphs described in the first sentence of this paragraph (k), provided that the taxpayer follows all the applicable rules contained in the regulations under section 460 for such taxable year and all subsequent taxable years. Further, a taxpayer may apply those por-

tions of paragraphs (b)(2)(ii) and (b)(3)(iii) of this section that relate to section 460(e)(1)(B) for contracts entered into after December 31, 2017, in a taxable year ending after December 31, 2017, provided that the taxpayer follows all the applicable rules contained in the regulations under section 460 for such taxable year and all subsequent taxable years.

Par. 23. §1.471-1 is amended by:

1. Designating the undesignated paragraph as paragraph (a).

2. Adding a heading to newly designated paragraph (a) and revising the first sentence.

3. Adding paragraphs (b) and (c).

The revision and addition read as follows:

§1.471-1 Need for inventories.

(a) *In general.* Except as provided in paragraph (b) of this section, in order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. * * *

(b) *Exemption for certain small business taxpayers—(1) In general.* Paragraph (a) of this section shall not apply to a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting (cash method) under section 448(a)(3), in any taxable year if the taxpayer meets the gross receipts test described in paragraph (b) (2) of this section, and uses as a method of accounting for its inventory a method that is described in paragraph (b)(3) of this section.

(2) *Gross receipts test—(i) In general.* A taxpayer, other than a tax shelter prohibited from using the cash method under section 448(a)(3), meets the gross receipts test of this paragraph (b)(2) if it meets the gross receipts test of section 448(c) and §1.448-2(c). This gross receipts test applies even if the taxpayer is not otherwise subject to section 448(a).

(ii) *Application of the gross receipts test—(A) In general.* In the case of any taxpayer that is not a corporation or partnership, and except as otherwise provided in paragraphs (b)(2)(ii)(B) and (C) of this section, the gross receipts test of section

448(c) and the accompanying regulations are applied in the same manner as each trade or business of the taxpayer were a corporation or partnership.

(B) *Gross receipts of individuals, etc.* Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer. Amounts not related to a trade or business are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as: personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W-2.

(C) *Partners and S corporation shareholders—(1) In general.* Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of the partnership's gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder includes the *pro rata* share of S corporation gross receipts taken into account by the S corporation under section 1363(b).

(2) [Reserved]

(D) *Examples.* The operation of this paragraph (b)(2) is illustrated by the following examples:

(1) *Example 1.* Taxpayer A, a calendar year S corporation, is a reseller and maintains inventories. In 2017, 2018, and 2019, A's gross receipts were \$10 million, \$11 million, and \$13 million respectively. A is not prohibited from using the cash method under section 448(a)(3). For 2020, A meets the gross receipts test of paragraph (b)(2) of this section.

(2) *Example 2.* Taxpayer B operates two separate and distinct trades or businesses that are reported on Schedule C, *Profit or Loss from Business*, of B's Federal income tax return. For 2020, one trade or business has annual average gross receipts of \$5 million, and the other trade or business has average annual gross receipts of \$35 million. Under paragraph (b)(2)(ii)(B) of this section, for 2020, neither of B's trades or businesses meets the gross receipts test of paragraph (b)(2) of this section (\$5 million + \$35 million = \$40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

(3) *Example 3.* Taxpayer C is an individual who operates three separate and distinct trades or businesses that are reported on Schedule C of C's Federal income

tax return. For 2020, Business X is a retail store with average annual gross receipts of \$15 million, Business Y is a dance studio with average annual gross receipts of \$6 million, and Business Z is a car repair shop with average annual gross receipts of \$12 million. Under paragraph (b)(2)(ii)(B) of this section, C's gross receipts are the combined amount derived from all three of C's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (b)(2)(i) of this section (\$15 million + \$6 million + \$12 million = \$33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

(3) *Methods of accounting under the small business taxpayer exemption.* A taxpayer eligible to use, and that chooses to use, the exemption described in paragraph (b) of this section may account for its inventory by either:

(i) Using a method that treats its inventory as non-incidental materials and supplies (section 471(c) NIMS inventory method), as described in paragraph (b)(4) of this section; or

(ii) Using the method for each item that is reflected in the taxpayer's applicable financial statement (AFS) (AFS section 471(c) inventory method); or, if the taxpayer does not have an AFS for the taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures, as defined in paragraph (b)(6)(ii) of this section (non-AFS section 471(c) inventory method).

(4) *Inventory treated as non-incidental materials and supplies—(i) In general.* The costs of inventory treated as non-incidental materials and supplies are recovered through cost of goods sold only in the taxable year in which the inventory is used or consumed in the taxpayer's business, or in the taxable year in which the taxpayer pays for or incurs the cost of the inventory, whichever is later. Inventory treated as non-incidental materials and supplies is used or consumed in the taxpayer's business in the taxable year in which the taxpayer provides the inventory to its customer. The costs of inventory are treated as non-incidental materials and supplies under this paragraph (b)(4) are not eligible for the *de minimis* safe harbor election under §1.263(a)-1(f)(2).

(ii) *Identification and valuation of inventory treated as non-incidental materials and supplies.* A taxpayer may determine the amount of the costs of its inventory treated as non-incidental ma-

terials and supplies that are recoverable through costs of goods sold by using either a specific identification method, a first-in, first-out (FIFO) method, or an average cost method, provided that method is used consistently. See §1.471-2(d). A taxpayer that uses the section 471(c) NIMS inventory method may not use any other method described in the regulations under section 471, or the last-in, first-out (LIFO) method described in section 472 and the accompanying regulations, to either identify inventory treated as non-incidental materials and supplies, or to value that inventory treated as non-incidental materials and supplies. The inventory costs includible in the section 471(c) NIMS inventory method are the direct material costs of the property produced or the costs of property acquired for resale. However, an inventory cost does not include a cost for which a deduction would be disallowed, or that is not otherwise recoverable but for paragraph (b) (4) of this section, in whole or in part, under a provision of the Internal Revenue Code.

(iii) *Allocation methods.* A taxpayer treating its inventory as non-incidental materials and supplies under this paragraph (b)(4) may allocate the costs of such inventory by using specific identification or any other reasonable method.

(iv) *Example.* Taxpayer D is a baker that reports its baking trade or business on Schedule C, *Profit or Loss From Business*, of the Form 1040, *Individual Tax Return*, and D's baking business has average annual gross receipts for the 3-taxable years prior to 2019 of less than \$100,000. D meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under section 448(a)(3) in 2019. Therefore, D qualifies as a small business taxpayer under paragraph (b)(2) of this section. D uses the overall cash method, and the section 471(c) NIMS inventory method. D purchases \$50 of peanut butter in November 2019. In December 2019, D uses all of the peanut butter to bake cookies available for immediate sale. D sells those peanut butter cookies to customers in January 2020. The peanut butter cookies are used or consumed under paragraph (b) (4)(i) of this section in January 2020 when the cookies are sold to customers, and D may recover the cost of the peanut butter in 2020.

(5) *AFS section 471(c) inventory method—(i) In general.* A taxpayer that meets the gross receipts test described in paragraph (b)(2) of this section and that has an AFS for such taxable year may use the AFS section 471(c) inventory method described in this paragraph to account for its

inventory costs for the taxable year. For purposes of the AFS section 471(c) inventory method, an inventory cost is a cost of production or resale that a taxpayer capitalizes to inventory property produced or property acquired for resale in its AFS. For purposes of the AFS section 471(c) inventory method, costs that are generally required to be capitalized to inventory under section 471(a) but that the taxpayer does not capitalize to inventory on its AFS are not required to be capitalized to inventory. However, an inventory cost does not include a cost that is neither deductible nor otherwise recoverable but for paragraph (b)(5) of this section, in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g), or 274). In lieu of the inventory method described in section 471(a), a taxpayer using the AFS section 471(c) inventory method recovers its inventory costs in accordance with the inventory method used in its AFS.

(ii) *Definition of Applicable Financial Statement (AFS).* The term applicable financial statement (AFS) is defined in section 451(b)(3) and the accompanying regulations. See §1.451-3(a)(5). The rules relating to additional AFS issues provided in §1.451-3(h) apply to the AFS section 471(c) inventory method. In the case of a taxpayer with a financial accounting year that differs from the taxpayer's taxable year, the taxpayer must consistently use the same method of accounting described in §1.451-3(h)(4)(i)(A) through (C) that is used for section 451(b) purposes to also determine its inventory for the taxable year under this paragraph (b)(5)(ii). A taxpayer has an AFS for the taxable year if all of the taxpayer's taxable year is covered by an AFS.

(iii) *Timing of inventory costs.* Notwithstanding the timing rules used in the taxpayer's AFS, the amount of any inventoriable cost may not be capitalized or otherwise taken into account for Federal income tax purposes any earlier than the taxable year during which the amount is paid or incurred under the taxpayer's overall method of accounting, as described in §1.446-1(c)(1). For example, in the case of an accrual method taxpayer, inventoriable costs must satisfy the all events test, including economic performance, of section 461. See §1.446-1(c)(1)

(ii) and section 461 and the accompanying regulations.

(iv) *Example.* H is a calendar year C corporation that is engaged in the trade or business of selling office supplies and providing copier repair services. H meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under section 448(a)(3) for 2019 or 2020. For Federal income tax purposes, H chooses to account for purchases and sales of inventory using an accrual method of accounting and for all other items using the cash method. For AFS purposes, H uses an overall accrual method of accounting. H uses the AFS section 471(c) inventory method of accounting. In H's 2019 AFS, H incurred \$2 million in purchases of office supplies held for resale and recovered the \$2 million as cost of goods sold. On January 5, 2020, H makes payment on \$1.5 million of these office supplies. For purposes of the AFS section 471(c) inventory method of accounting, H can recover the \$2 million of office supplies in 2019 because the amount has been included in cost of goods sold in its AFS inventory method and section 461 has been satisfied.

(6) *Non-AFS section 471(c) inventory method*—(i) *In general.* A taxpayer that meets the gross receipts test described in paragraph (b)(2) of this section for a taxable year and that does not have an AFS, as defined in paragraph (b)(5)(ii) of this section, for such taxable year may use the non-AFS section 471(c) inventory method to account for its inventories for the taxable year in accordance with this paragraph (b)(6). The non-AFS section 471(c) inventory method is the method of accounting used for inventory in the taxpayer's books and records that properly reflect its business activities for non-tax purposes and are prepared in accordance with the taxpayer's accounting procedures. For purposes of the non-AFS section 471(c) inventory method, an inventory cost is a cost of production or resale that the taxpayer capitalizes to inventory property produced or property acquired for resale in its books and records, except as provided in paragraph (b)(6)(ii) of this section. Costs that are generally required to be capitalized to inventory under section 471(a), but that the taxpayer does not capitalize in its books and records are not required to be capitalized to inventory. However, an inventory cost does not include a cost that is neither deductible nor otherwise recoverable but for paragraph (b)(5) of this section, in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g), or 274). In lieu of the inventory method described in section 471(a), a tax-

payer using the non-AFS section 471(c) inventory method recovers its applicable costs through its book inventory method of accounting. A taxpayer that has an AFS for such taxable year may not use the non-AFS section 471(c) inventory method.

(ii) *Timing and amounts of costs.* Notwithstanding the timing of costs reflected in the taxpayer's books and records, a taxpayer may not recover any costs that have not been paid or incurred under the taxpayer's overall method of accounting, as described in §1.446-1(c)(1). For example, in the case of an accrual method taxpayer or a taxpayer using an accrual method for purchases and sales, inventory costs must satisfy the all events test, including economic performance, under section 461(h). See §1.446-1(c)(1)(ii), and section 461 and the accompanying regulations.

(iii) *Examples.* The following examples illustrate the rules of paragraph (b)(6) of this section.

(A) *Example 1.* Taxpayer E is a C corporation that is engaged in the retail trade or business of selling beer, wine, and liquor. In 2019, E has average annual gross receipts for the prior 3-taxable-years of \$15 million and is not otherwise prohibited from using the cash method under section 448(a)(3). E does not have an AFS for the 2019 taxable year. E is eligible to use the non-AFS section 471(c) inventory method of accounting. E uses the overall cash method, and the non-AFS section 471(c) inventory method of accounting for Federal income tax purposes. In E's electronic bookkeeping software, E treats all costs paid during the taxable year as presently deductible. As part of its regular business practice, E's employees take a physical count of inventory on E's selling floor and its warehouse on December 31, 2019, and E uses this physical count as part of its books and records for purposes of capitalizing and allocating costs to inventory. E also makes representations to its creditor of the cost of inventory on hand for specific categories of product it sells. E may not expense all of its costs paid during the 2019 taxable year because its books and records do not accurately reflect the inventory records used for non-tax purposes in its regular business activity. Instead, E must use the physical inventory count taken at the end of 2019 to determine how its capitalized costs are allocated and recovered.

(B) *Example 2.* Same facts as Example (1) in paragraph (b)(6)(iii)(A) of this section but E does not use the physical count to capitalize and allocate costs to inventory and does not make any representations about inventory on hand to any creditors. Although E pays or incurs costs that are generally required to be capitalized to inventory under section 471(a), because such costs are not capitalized to inventory in E's books and records, they are not required to be capitalized to inventory under paragraph (b)(6)(i) of this section.

(C) *Example 3.* Same facts as Example (1) in paragraph (b)(6)(iii)(A) of this section but E does

not use the physical count to capitalize and allocate costs to inventory in its electronic bookkeeping software and does not make any representations about inventory on hand to any external parties. E does use the physical count to value inventory on hand for internal reports to its shareholders. The internal reports to its shareholders are part of E's books and records and must be taken into account for E's non-AFS section 471(c) inventory method. E recovers its inventory costs consistent with its non-AFS section 471(c) inventory method.

(D) *Example 4.* Taxpayer F is a C corporation that is engaged in the manufacture of baseball bats. In 2019, F has average annual gross receipts for the prior 3-taxable-years of less than \$25 million and is not otherwise prohibited from using the cash method under section 448(a)(3). F does not have an AFS for the 2019 taxable year. For Federal income tax purposes, F uses the overall cash method of accounting, and the non-AFS section 471(c) inventory method of accounting. For its books and records, F uses an overall accrual method and maintains inventories. In December 2019, F's financial statements show \$500,000 of direct and indirect material costs. F pays its supplier in January 2020. Under paragraph (b)(6)(ii) of this section, F recovers its direct and indirect material costs in 2020.

(E) *Example 5.* Taxpayer G is a baker that reports its baking trade or business on Schedule C, Profit or Loss From Business, of the Form 1040, Individual Tax Return. In 2020, G's baking business has average annual gross receipts for the prior 3-taxable years of less than \$100,000 and is not otherwise prohibited from using the cash method under section 448(a)(3). G does not have an AFS for the 2020 taxable year. For Federal income tax purposes, G uses the overall cash method of accounting and the non-AFS section 471(c) inventory method. In G's books and records for 2020 that properly reflects its business activities for non-tax purposes, G capitalizes the cost of its cookie ingredients to inventory but immediately expends the cost of labor for G's employee who bakes the cookies. Under paragraphs (b)(6)(i) and (ii) of this section, G treats as an inventory cost the cost of its cookie ingredients and recovers such costs in accordance with the accounting procedures used to prepare its books and records, or, if later, when paid. Additionally, although the cost of direct labor is generally required to be capitalized to inventory under section 471(a), because such cost is not capitalized to inventory in G's books and records, it is not required to be capitalized to inventory under paragraph (b)(6)(i) of this section. Further, because such direct labor cost is generally deductible under section 162, and not otherwise required to be capitalized under section 263(a), G may deduct the cost of labor in the year G pays that expense.

(F) *Example 6.* Taxpayer H is a partnership engaged in the resale of beer, wine, and liquor. In 2020, H has average annual gross receipts for the prior 3-taxable-years of less than \$25 million and is not otherwise prohibited from using the cash method under section 448(a)(3). H does not have an AFS for the 2020 taxable year. For Federal income tax purposes, H uses the overall cash method of accounting, and the non-AFS section 471(c) inventory method of accounting. For its books and records, H uses the overall cash method. As part of its regular business prac-

tice, H's employees take regular physical counts of the inventory on the shop floor and in the storeroom, however H's method of accounting for inventory for its books and records does not allocate costs between ending inventory and cost of goods sold, and instead expenses the cost of the inventory in the year it was paid for. Prior to December 2020, H acquires and pays for \$500,000 of beer, wine, and liquor. In addition, on December 1, 2020, H acquires \$50,000 in beer and wine, and pays for this beer and wine on December 20, 2020. H may recover as deductions in 2020 the \$550,000 of inventory costs.

(G) *Example 7.* Taxpayer J is a partnership engaged in the resale of beer, wine, and liquor. In 2020, J has average annual gross receipts for the prior 3-taxable-years of less than \$25 million and is not otherwise prohibited from using the cash method under section 448(a)(3). J does not have an AFS for the 2020 taxable year. For Federal income tax purposes, J uses the overall cash method of accounting, and the non-AFS section 471(c) inventory method of accounting. For its books and records, J uses the overall cash method. J maintains a point-of-sale computer system that tracks acquisition costs and inventory levels of the beer, wine, and liquor. The ledger is periodically reconciled with physical counts performed by J's employees. J must use the physical inventory count and ledger to determine its ending inventory. J includes in cost of goods sold for 2020 those inventory costs that are not properly allocated to ending inventory.

(7) *Effect of section 471(c) on other provisions.* Nothing in section 471(c) shall have any effect on the application of any other provision of law that would otherwise apply, and no inference shall be drawn from section 471(c) with respect to the application of any such provision. For example, an accrual method taxpayer that includes inventory costs in its AFS is required to satisfy section 461 before such cost can be included in cost of goods sold for the taxable year. Similarly, nothing in section 471(c) affects the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. If an item of income or expense is not treated consistently

from year to year, that treatment may not clearly reflect income, notwithstanding the application of this section. Finally, nothing in section 471(c) permits the deduction or recovery of any cost that a taxpayer is otherwise precluded from deducting or recovering under any other provision in the Code or Regulations.

(8) *Method of accounting—(i) In general.* A change in the method of treating inventory under this paragraph (b) is a change in method of accounting under sections 446 and 481 and the accompanying regulations. A taxpayer changing its method of accounting under paragraph (b) of this section may do so only with the consent of the Commissioner as required under section 446(e) and §1.446-1. For example, a taxpayer using the AFS section 471(c) inventory method or non-AFS section 471(c) inventory method that wants to change its method of accounting for inventory in its AFS, or its books and records, respectively, is required to secure the consent of the Commissioner before using this new method for Federal income tax purposes. However, a change from having an AFS to not having an AFS, or vice versa, without a change in the underlying method for inventory for financial reporting purposes that affects Federal income tax is not a change in method of accounting for such inventory under section 446(e). In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and §1.446-1. The amount of the net section 481(a) adjustment and the adjustment period necessary to implement a

change in method of accounting required under this section are determined under §1.446-1(e) and the applicable administrative procedures to obtain the Commissioner's consent to change a method of accounting as published in the Internal Revenue Bulletin (see Revenue Procedure 2015-13 (2015-5 IRB 419) (or successor) (see also §601.601(d)(2) of this chapter).

(ii) *Automatic consent for certain method changes.* Certain changes in method of accounting made under paragraph (b) of this section may be made under the procedures to obtain the automatic consent of the Commissioner to change a method of accounting. See Revenue Procedure 2015-13 (2015-5 IRB 419) (or successor) (see §601.601(d)(2) of this chapter)). In certain situations, special terms and conditions may apply.

(c) *Applicability dates.* This section applies for taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply this section provided that the taxpayer follows all the applicable rules contained in this section for such taxable year and all subsequent taxable years.

Douglas W. O'Donnell,
Acting Deputy Commissioner for
Services and Enforcement.

Approved: December 18, 2020.

David J. Kautter,
Assistant Secretary of the Treasury
(Tax Policy).

(Filed by the Office of the Federal Register on 12/31/2020, 8:45 a.m., and published in the issue of the Federal Register for 01/05/2021)

Part III

2021 Standard Mileage Rates

Notice 2021-2

SECTION 1. PURPOSE

This notice provides the optional 2021 standard mileage rates for taxpayers to use in computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes. This notice also provides the amount taxpayers must use in calculating reductions to basis for depreciation taken under the business standard mileage rate, and the maximum standard automobile cost that may be used in computing the allowance under a fixed and variable rate (FAVR) plan. Additionally, this notice provides the maximum fair market value (FMV) of employer-provided automobiles first made available to employees for personal use in calendar year 2021 for which employers may use the fleet-average valuation rule in § 1.61-21(d)(5)(v) of the Income Tax Regulations or the vehicle cents-per-mile valuation rule in § 1.61-21(e).

SECTION 2. BACKGROUND

Rev. Proc. 2019-46, 2019-49 I.R.B. 1301, provides rules for computing the deductible costs of operating an automobile for business, charitable, medical, or moving expense purposes, and for substantiating, under § 274(d) of the Internal Revenue Code and § 1.274-5, the amount of ordinary and necessary business expenses of local transportation or travel away from home. Taxpayers using the standard mileage rates must comply with Rev. Proc. 2019-46. However, a taxpayer is not required to use the substantiation methods described in Rev. Proc. 2019-46, but instead may substantiate using actual allowable expense amounts if the taxpayer maintains adequate records or other sufficient evidence.

An independent contractor conducts an annual study for the Internal Revenue Service of the fixed and variable costs of operating an automobile to determine the

standard mileage rates for business, medical, and moving use reflected in this notice. The standard mileage rate for charitable use is set by § 170(i).

Longstanding regulations under § 61 provide special valuation rules for employer-provided automobiles. The amount that must be included in the employee's income and wages for the personal use of an employer-provided automobile generally is determined by reference to the automobile's FMV. If an employer chooses to use a special valuation rule, the special value is treated as the FMV of the benefit for income tax and employment tax purposes. Section 1.61-21(b)(4). Two such special valuation rules, the fleet-average valuation rule and the vehicle cents-per-mile valuation rule, are set forth in § 1.61-21(d)(5)(v) and § 1.61-21(e), respectively. These two special valuation rules are subject to limitations, including that they may be used only in connection with automobiles having values that do not exceed a maximum amount set forth in the regulations.

SECTION 3. STANDARD MILEAGE RATES

The standard mileage rate for transportation or travel expenses is 56 cents per mile for all miles of business use (business standard mileage rate). See section 4 of Rev. Proc. 2019-46. However, § 11045 of the Tax Cuts and Jobs Act, Public Law 115-97, 131. Stat. 2054 (December 22, 2017) (the "TCJA") suspends all miscellaneous itemized deductions that are subject to the two-percent of adjusted gross income floor under § 67, including unreimbursed employee travel expenses, for taxable years beginning after December 31, 2017, and before January 1, 2026. Thus, the business standard mileage rate provided in this notice cannot be used to claim an itemized deduction for unreimbursed employee travel expenses during the suspension. Notwithstanding the foregoing suspension of miscellaneous itemized deductions, deductions for expenses that are deductible in determining adjusted gross income are not suspended. For example, members of a reserve component

of the Armed Forces of the United States (Armed Forces), state or local government officials paid on a fee basis, and certain performing artists are entitled to deduct unreimbursed employee travel expenses as an adjustment to total income on line 11 of Schedule 1 of Form 1040 (2020), not as an itemized deduction on Schedule A of Form 1040 (2020), and therefore may continue to use the business standard mileage rate.

The standard mileage rate is 14 cents per mile for use of an automobile in rendering gratuitous services to a charitable organization under § 170. See section 5 of Rev. Proc. 2019-46.

The standard mileage rate is 16 cents per mile for use of an automobile: (1) for medical care described in § 213; or (2) as part of a move for which the expenses are deductible under § 217(g). See section 5 of Rev. Proc. 2019-46. Section 11049 of the TCJA suspends the deduction for moving expenses for taxable years beginning after December 31, 2017, and before January 1, 2026. However, the suspension does not apply to members of the Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station. Thus, except for taxpayers to whom § 217(g) applies, the standard mileage rate provided in this notice is not applicable for the use of an automobile as part of a move occurring during the suspension.

SECTION 4. BASIS REDUCTION AMOUNT

For automobiles a taxpayer uses for business purposes, the portion of the business standard mileage rate treated as depreciation is 25 cents per mile for 2017, 25 cents per mile for 2018, 26 cents per mile for 2019, 27 cents per mile for 2020, and 26 cents per mile for 2021. See section 4.04 of Rev. Proc. 2019-46.

SECTION 5. MAXIMUM STANDARD AUTOMOBILE COST

For purposes of computing the allowance under a FAVR plan, the standard automobile cost may not exceed \$51,100 for

automobiles (including trucks and vans). See section 6.02(6) of Rev. Proc. 2019-46.

SECTION 6. MAXIMUM VALUE OF EMPLOYER-PROVIDED AUTOMOBILES

For purposes of the fleet-average valuation rule in § 1.61-21(d)(5)(v) and the vehicle cents-per-mile valuation rule in § 1.61-21(e), the maximum FMV of automobiles (including trucks and vans) first made available to employees in calendar year 2021 is \$51,100.

SECTION 7. EFFECTIVE DATE

This notice is effective for: (1) deductible transportation expenses paid or incurred on or after January 1, 2021; (2) mileage allowances or reimbursements paid to a charitable volunteer or a member of the Armed Forces to whom § 217(g) applies: (a) on or after January 1, 2021, and (b) for transportation expenses the charitable volunteer or such member of the Armed Forces pays or incurs on or after January 1, 2021; and (3) for purposes of the maximum FMV of employer-provided automobiles for which employers may use the fleet-average valuation rule in § 1.61-21(d)(5)(v) or the vehicle cents-per-mile rule in § 1.61-21(e), automobiles first made available to employees for personal use on or after January 1, 2021.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Notice 2020-05 is superseded.

DRAFTING INFORMATION

The principal author of this notice is Anna Gleysteen of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information on this notice regarding the use of an employee-provided automobile, contact Ms. Gleysteen at (202) 317-7007 (not a toll-free number). For further information on this notice regarding the use of an employer-provided automobile, contact Stephanie Caden of the Office of Associate Chief Counsel

(Employee Benefits, Exempt Organizations, and Employment Taxes), at (202) 317-4774 (not a toll-free number).

Beginning of Construction for Sections 45 and 48; Extension of Continuity Safe Harbor for Offshore Projects and Federal Land Projects

Notice 2021-5

SECTION 1. PURPOSE

This notice clarifies and modifies the prior notices¹ published by the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) that address the beginning of construction requirement for qualified facility and energy property projects under §§ 45 and 48, respectively, of the Internal Revenue Code (Code). Specifically, section 4.01 of this notice provides that a qualified facility or energy property construction project that is an Offshore Project or a Federal Land Project (each as defined in section 4.02 of this notice) satisfies the Continuity Safe Harbor (as defined in section 2.04(3) of this notice) if a taxpayer places the qualified facility or energy property that is the subject of the project into service within 10 calendar years after the calendar year during which construction of the project began.

SECTION 2. BACKGROUND

.01 *Renewable Electricity Production and Investment Tax Credits.* Section 38 of the Code allows certain business credits against the tax imposed by chapter 1 of subtitle A of the Code. Among the credits allowed by § 38 are (i) the renewable electricity production tax credit under § 45 of the Code (PTC), and (ii) the investment tax credit determined under § 46 of the Code (ITC). The ITC includes the energy credit under § 48. See § 46(2).

.02 *Qualification and Calculation of PTC and ITC.* To qualify for the PTC, electricity must, among other things, be produced by the taxpayer at a qualified facility described in § 45(d). See § 45(a)(2)(A)(ii). The PTC for any taxable year is calculated by multiplying an inflation-adjusted credit rate by kilowatt hours of electricity produced and sold by the taxpayer to an unrelated person. See § 45(a). The ITC is calculated as a percentage of the basis of energy property (as defined in § 48(a)(3)) placed in service during the taxable year. See § 48(a)(1). Additionally, under § 48(a)(5), a taxpayer may elect to claim the ITC in lieu of the PTC with respect to qualified property that is part of certain qualified facilities. Both the PTC and the ITC have beginning of construction requirements.

.03 *Recent amendments to PTC and ITC statutes.* The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Act), enacted as Division EE of the Consolidated Appropriations Act, 2021, Public Law 116-260 (Dec. 27, 2020), amended §§ 45 and 48 with regard to the PTC and the ITC. Section 131(a) of the Act extended the deadlines for the beginning of construction requirements for certain qualified facilities to December 31, 2021 (in other words, before January 1, 2022). Section 131(b) of the Act extended the beginning of construction deadline applicable to the election to claim the ITC in lieu of the PTC by one year with respect to certain qualified facilities if construction of such facilities begins before January 1, 2022. Section 132(a) of the Act extended the deadlines for the beginning of construction requirements for certain ITC energy property to December 31, 2023 (in other words, before January 1, 2024). In addition, sections 131(c) and 132(b) of the Act extended beginning of construction deadlines for the phaseout provisions applicable to the PTC and the ITC. Finally, section 204 of the Act amends § 48(a)(5) of the Code to provide special rules for “qualified offshore wind facilities.”

.04 *Physical Work Test, Five Percent Safe Harbor, and Continuity Requirement for Qualified Facilities.* Notice 2013-29 provides two methods to establish the

¹ Notice 2013-29, 2013-20 I.R.B. 1085; Notice 2013-60, 2013-44 I.R.B. 431; Notice 2014-46, 2014-36 I.R.B. 520; Notice 2015-25, 2015-13 I.R.B. 814; Notice 2016-31, 2016-23 I.R.B. 1025; Notice 2017-04, 2017-4 I.R.B. 541; Notice 2018-59, 2018-28 I.R.B. 196; Notice 2019-43, 2019-31 I.R.B. 487; and Notice 2020-41, 2020-25 I.R.B. 954 (collectively, the prior notices).

beginning of construction for a qualified facility: (i) the “Physical Work Test” and (ii) the “Five Percent Safe Harbor.” Each method requires a taxpayer to make continuous progress towards completion once construction of the qualified facility project has begun (Continuity Requirement).

(1) *Physical Work Test.* Section 4 of Notice 2013-29 sets forth the Physical Work Test. Section 4.01 of the notice provides the following, which requires a facts-and-circumstances analysis:

Construction of a qualified facility begins when physical work of a significant nature begins. . . . Whether a taxpayer has begun construction of a facility before [the statutory deadline], will depend on the relevant facts and circumstances. The [IRS] will closely scrutinize a facility, and may determine that construction has not begun on a facility before [the statutory deadline], if a taxpayer does not maintain a *continuous program of construction* as determined under section 4.06 [(Continuous Construction Test)]. (Emphasis added.)

Section 4.06(1) of Notice 2013-29 provides that a “continuous program of construction” involves continuing physical work of a significant nature. Further, section 4.06(1) provides that whether the taxpayer has maintained a continuous program of construction (and thus satisfied the Continuous Construction Test) will be determined by the relevant facts and circumstances.

(2) *Five Percent Safe Harbor.* Section 5 of Notice 2013-29 sets forth the Five Percent Safe Harbor. Section 5.01 of the notice provides the following general rule, which also requires a facts-and-circumstances analysis:

Construction of a facility will be considered as having begun before [the statutory deadline], if (1) a taxpayer pays or incurs (within the meaning of Treas. Reg. § 1.461-1(a)(1) and (2)) five percent or more of the total cost of the facility, except as provided in section 5.01(2), before [the statutory deadline], and (2) thereafter, the taxpayer makes *continuous efforts to advance towards completion of the facility* (as determined under section 5.02 [(Continuous Efforts Test)]). (Emphasis added.)

Section 5.02(1) of Notice 2013-29 provides that whether a taxpayer makes continuous efforts to advance towards completion of the facility (and thus satisfies the Continuous Efforts Test) will be determined by the relevant facts and circumstances. Further, section 5.02(1) provides that facts and circumstances indicating continuous efforts to advance towards completion of the facility may include, but are not limited to: (i) paying or incurring additional amounts included in the total cost of the facility; (ii) entering into binding written contracts for components or future work on construction of the facility; (iii) obtaining necessary permits; and (iv) performing physical work of a significant nature (as described in section 4.02 of Notice 2013-29). *See* section 5.02(1)(a) through (d).

(3) *Continuity Safe Harbor for determining satisfaction of the Continuity Requirement.* Notice 2013-60 provides clarifications for determining whether a taxpayer satisfies the Physical Work Test or the Five Percent Safe Harbor with regard to a qualified facility. In particular, section 3.02 of Notice 2013-60 provides a “Continuity Safe Harbor” that allows a facility to be deemed to have satisfied the Continuity Requirement. Under the Continuity Safe Harbor, if a facility is placed in service before January 1, 2016, the facility will be considered to satisfy (i) the Continuous Construction Test, for purposes of satisfying the Physical Work Test, or (ii) the Continuous Efforts Test, for purposes of satisfying the Five Percent Safe Harbor. Section 3.02 of the notice also provides that, if a facility is not placed in service before January 1, 2016, whether the facility satisfies the Continuous Construction Test or Continuous Efforts Test will be determined by the relevant facts and circumstances, as described in sections 4.06 and 5.02 of Notice 2013-29, respectively.

.05 *Additional notices further extending and modifying the Continuity Safe Harbor.* The Treasury Department and the IRS have published several notices to extend and otherwise modify the Continuity Safe Harbor, which include the following:

(1) *Notice 2015-25*, which extends the Continuity Safe Harbor for one year.

(2) *Notice 2016-31*, which modifies the Continuity Safe Harbor (as originally

provided in section 3.02 of Notice 2013-60 and extended by Notice 2015-25) by providing that, if a taxpayer places a facility in service by the later of (i) a calendar year that is no more than four calendar years after the calendar year during which construction of the facility began, or (ii) December 31, 2016, the facility will be considered to satisfy the Continuity Safe Harbor.

(3) *Notice 2017-04*, which further extends and modifies the Continuity Safe Harbor by providing that, if a taxpayer places a facility in service by the later of (i) a calendar year that is no more than four calendar years after the calendar year during which construction of the facility began, or (ii) December 31, 2018, the facility will be considered to satisfy the Continuity Safe Harbor.

(4) *Notice 2018-59*, which provides methods to establish the beginning of construction of an energy property (that is, the Physical Work Test and Five Percent Safe Harbor), a Continuity Requirement for both methods, rules for transferring energy property, and additional rules applicable to the beginning of construction requirement for energy property projects for purposes of the ITC. Section 6.05 of Notice 2018-59 provides a Continuity Safe Harbor that mirrors the safe harbor provided for qualified facilities in the prior notices:

Except as provided in this section, if a taxpayer places an energy property in service by the end of a calendar year that is no more than four calendar years after the calendar year during which construction of the energy property began (the Continuity Safe Harbor Deadline), the energy property will be considered to satisfy the Continuity Safe Harbor. The excusable disruption rules in section 6.03 do not apply for purposes of applying the Continuity Safe Harbor. However, if an energy property is not placed in service before the end of the fourth calendar year after the calendar year during which construction of the energy property began, whether the energy property satisfies the Continuity Requirement under either the Physical Work Test or the Five Percent Safe Harbor will be determined by the relevant facts and circumstances.

(5) *Notice 2019-43*, which provides that the Continuity Safe Harbor may be tolled and extended in certain limited circumstances involving significant national security concerns.

(6) *Notice 2020-41*, which, in response to development delays caused by the Coronavirus Disease 2019 (COVID-19) pandemic, extended the Continuity Safe Harbor from four years to five years for qualified facilities or energy property that began construction under the Physical Work Test or the Five Percent Safe Harbor in either calendar year 2016 or 2017.

.06 *Relief provided to qualified offshore wind facilities by the Taxpayer Certainty and Disaster Tax Relief Act of 2020* — (1) *Qualified offshore wind facilities.* Section 204 of the Act amends § 48(a)(5) of the Code to provide special rules for “qualified offshore wind facilities.” Under amended § 48(a)(5)(F)(ii), a “qualified offshore wind facility” means a qualified facility described in § 45(d)(1) (determined without regard to any date by which the construction of the facility is required to begin) that is located in the inland navigable waters of the United States or in the coastal waters of the United States.

(2) *Summary of relief.* Solely with regard to qualified offshore wind facilities, amended § 48(a)(5)(F)(i) provides the following relief. First, for purposes of qualifying as a qualified investment credit facility (as defined by § 48(a)(5)(C)), the beginning of construction deadline under § 48(a)(5)(C)(ii) is extended to December 31, 2025. See § 48(a)(5)(F)(i)(I). In addition, the phaseout of credit for wind facilities under § 48(a)(5)(E) does not apply. See § 48(a)(5)(F)(i)(II). Lastly, for purposes of qualifying as a qualified facility (as defined by § 45(d)(1)) for which a taxpayer can elect to claim the ITC in lieu of the PTC under § 48(a)(5), the beginning of construction deadline provided in § 45(d)(1) is extended to December 31, 2025. See § 48(a)(5)(F)(i)(III).

(3) *Applicability of relief.* Amended § 48(a)(5)(F) applies to periods after December 31, 2016, under rules similar to the rules of § 48(m) of the Code before the amendment of § 48 by the Revenue Reconciliation Act of 1990. This citation makes applicable certain transitional rules regarding the ability of a taxpayer to claim qualified progress expenditures to the ex-

tent of their qualified investment. See section 204(b) of the Act.

SECTION 3. RECOGNITION OF GREATER DELAYS FOR CONSTRUCTION OF PROJECTS OFFSHORE AND ON FEDERAL LAND

.01 *Overview.* The Treasury Department and the IRS are aware of certain qualified facilities and energy property that are being constructed Offshore or on Federal Land (each as defined in section 4.02 of this notice). Based on comments received from Congress and project stakeholders, the Treasury Department and the IRS have determined that such projects ordinarily are subject to significantly greater delays than projects not constructed Offshore or on Federal Land, and therefore are at a significantly higher risk of failing the Continuity Safe Harbor.

.02 *Description of typical project delays.* The ordinary-course delays for the qualified facility and energy property projects described in section 3.01 of this notice result from various complicating factors, including (i) the applicability of significantly more stringent permitting requirements, (ii) lengthier engineering and construction timelines due to, for example, the difficulty of installing equipment Offshore, (iii) heightened environmental regulation (including, for example, the environmental analysis process carried out by the Director of the Bureau of Land Management), and (iv) the need to construct new transmission lines to connect these projects to the electrical grid system of the United States (Grid). In addition, such delays ordinarily are outside the control of the project developers and can result in project completion times of up to twice as long as those experienced by qualified facility and energy property projects that are not constructed Offshore or on Federal Land.

.03 *Additional certainty to investors provided by this notice.* The Treasury Department and the IRS are providing this relief to complement previous relief provided through the list of excusable disruptions under section 4.02(2) of Notice 2016-31 and section 6.03 of Notice 2018-59, which potentially would cover the complicating factors described in section

3.02 of this notice (and therefore would disregard them, and the delays resulting therefrom, for purposes of determining whether a taxpayer satisfied the Continuous Construction Test or Continuous Efforts Test with regard to a qualified facility or energy property).

SECTION 4. EXTENSION OF THE CONTINUITY SAFE HARBOR FOR SECTIONS 45 AND 48

.01 *Qualification for Continuity Safe Harbor Extension.* A qualified facility or an energy property construction project that is an Offshore Project or a Federal Land Project (each as defined in section 4.02 of this notice) satisfies the Continuity Safe Harbor if a taxpayer places the qualified facility or energy property that is the subject of the project into service by the end of a calendar year that is no more than 10 calendar years after the calendar year during which construction of the project began.

.02 *Definitions.* For purposes of qualifying for the Continuity Safe Harbor extension under section 4.01 of this notice, the following definitions apply:

(1) *Federal Land.* The term “Federal Land” means any land owned or controlled by the United States.

(2) *Federal Land Project.* The term “Federal Land Project” means a qualified facility or an energy property construction project—

(a) more than 50 percent of which will be placed in service on Federal Land, as determined by relative value or relative area; and

(b) that will require the construction of one or more high-voltage transmission lines to connect the qualified facility or energy property to the Grid.

(3) *Offshore.* The term “Offshore” means any inland navigable waters of the United States or any coastal waters of the United States.

(4) *Offshore Project.* The term “Offshore Project” means a qualified facility or an energy property construction project that will be placed in service Offshore.

SECTION 5. NO RULE

The IRS will not issue private letter rulings or determination letters to a tax-

payer regarding the application of this notice, the prior IRS notices, or the beginning of construction requirements under §§ 45 and 48.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Each of Notice 2013-29, Notice 2013-60, Notice 2014-46, Notice 2015-25, Notice 2016-31, Notice 2017-04, Notice 2018-59, Notice 2019-43, and Notice 2020-41 is clarified and modified.

SECTION 7. DRAFTING INFORMATION

The principal author of this notice is Jennifer Bernardini of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice contact Jennifer Bernardini on (202) 317-6853 (not a toll-free number).

COVID-19 Relief for Employers Using the Automobile Lease Valuation Rule

Notice 2021-7

I. PURPOSE

In response to the ongoing Coronavirus Disease 2019 (COVID-19) pandemic, this notice provides temporary relief for employers and employees using the automobile lease valuation rule to determine the value of an employee's personal use of an employer-provided automobile for purposes of income inclusion, employment tax, and reporting. Due solely to the COVID-19 pandemic, if certain requirements are satisfied, employers and employees that are using the automobile lease valuation rule may instead use the vehicle cents-per-mile valuation rule to

determine the value of an employee's personal use of an employer-provided automobile beginning as of March 13, 2020. For 2021, employers and employees may revert to the automobile lease valuation rule or continue using the vehicle cents-per-mile valuation rule provided certain requirements are met.

II. BACKGROUND

If an employer provides an employee with an automobile that is available to the employee for personal use, the value of the personal use must be included in the employee's gross income. Treas. Reg. section 1.61-21(b)(1) states that an employee must include in gross income the amount by which the fair market value of a fringe benefit exceeds the sum of: (1) the amount, if any, paid for the benefit by or on behalf of the recipient; and (2) the amount, if any, specifically excluded from gross income by some other section of subtitle A of the Internal Revenue Code of 1986. The value of an employee's personal use of an employer-provided automobile may be determined under the automobile lease valuation rule to the extent the employer meets the requirements under section 1.61-21(d). Alternatively, an employer may determine the value of the personal use by using the vehicle cents-per-mile valuation rule to the extent the employer meets the requirements under section 1.61-21(e)(1) or the commuting valuation rule to the extent the employer meets the requirements under section 1.61-21(f).¹ The rules set forth in sections 1.61-21(d)(7) and 1.61-21(e)(5) (the "consistency rules") provide that the employer and the employee must use the chosen valuation methodology consistently, except that the employer and the employee may use the commuting valuation rule if the requirements for it are satisfied.

Section 132(a)(3) of the Internal Revenue Code provides that gross income does not include any fringe benefit that qualifies as a working condition fringe. A working condition fringe means any ben-

efit provided to an employee of the employer to the extent that, if the employee paid for the benefit, the payment would be allowable as a deduction under section 162 or 167. Employers that provide vehicles for their employees' use can exclude as a working condition fringe the amount that would be allowable as a deductible business expense if the employee paid for its use. If the employee uses the vehicle for both business and personal use, the value of the working condition fringe is the part determined to be for business use of the vehicle. Amounts that are excluded from gross income under section 132 are also excluded from Federal Insurance Contributions Act (FICA) taxes (social security and Medicare, including Additional Medicare Tax), Federal Unemployment Tax Act (FUTA) tax, and Federal Income tax withholding. Sections 3121(a)(20), 3306(b)(16), and 3401(a)(19).

On March 13, 2020, the President of the United States issued an emergency declaration under the Robert T. Stafford Disaster Relief and Emergency Assistance Act in response to the ongoing COVID-19 pandemic. As a result of the pandemic, many employers suspended business operations or implemented telework arrangements for employees. Consequently, employers have indicated that business and personal use of employer-provided automobiles has been reduced for employees. However, due to the way in which the value of an employee's personal use of an employer-provided automobile is computed using the automobile lease valuation rule under section 1.61-21(d), employers have noted a resulting increase in the lease value required to be included in an employee's income for 2020 compared to prior years. In contrast, determining the value of an employee's personal use of an employer-provided automobile using the vehicle cents-per-mile valuation rule results in income inclusion of only the value that relates to actual personal use, thereby providing a more accurate reflection of the employee's income in these circumstances.

¹ Employers that qualify for use of the commuting valuation rule under section 1.61-21(f) determine the value of a vehicle they provide to an employee for commuting use by multiplying the number of one-way commutes by \$1.50. Use of this rule is subject to stringent requirements, such as having a written policy limiting the employee's use to commuting and de minimis personal use.

A. AUTOMOBILE LEASE VALUATION RULE

Under the automobile lease valuation rule, the employer determines the fair market value of the automobile when it was first made available to any employee and applies the corresponding “Annual Lease Value” from the table provided in section 1.61-21(d)(2)(iii). “Automobile” is defined in section 1.61-21(d)(1)(ii) as any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways. Section 1.61-21(d)(1)(i) specifies that absent any statutory exclusions relating to the employer-provided automobile, such as the exclusion for working condition fringe benefits under section 132(a)(3), the amount of the Annual Lease Value is included in the gross income of the employee. If the automobile is used by the employee in the employer’s business, the employer generally reduces the Annual Lease Value by the amount that is excluded from the employee’s wages as a working condition fringe.

Section 1.61-21(d)(4) provides that, for periods of continuous availability of at least thirty days, but less than an entire calendar year, an employer may pro-rate the Annual Lease Value in certain circumstances by multiplying the applicable Annual Lease Value by a fraction, the numerator of which is the number of days of availability and the denominator of which is 365.

An employer with a fleet of 20 or more automobiles may use a fleet-average value for purposes of calculating the Annual Lease Values of the automobiles in the employer’s fleet, provided the requirements of section 1.61-21(d)(5)(v) are met. The fleet-average value is the average of the fair market value of each automobile in the fleet.

Section 1.61-21(d)(7) provides various consistency rules. Section 1.61-21(d)(7)(i) states that an employer may adopt the automobile lease valuation rule only if it is adopted by the later of: (1) January 1, 1989; or (2) the first day on which the automobile is made available to an employee of the employer for personal use (or, if the commuting valuation rule is used when

the automobile is first made available to an employee for personal use, the first day on which the commuting valuation rule is not used). Section 1.61-21(d)(7)(ii) provides that an employer must continue to use the automobile lease valuation rule for all subsequent years that the employer makes the automobile available for use by any employee, except the employer may use the commuting valuation rule in any year that the requirements for that rule are met.

Section 1.61-21(d)(7)(iii) provides that an employee may adopt the automobile lease valuation rule only if the employer adopts the rule. Further, the employee may adopt the automobile lease valuation rule as of the first day that the automobile is made available for personal use or, if the commuting valuation rule is used when the automobile is first made available to the employee for personal use, the first day on which the commuting valuation rule is not used. Section 1.61-21(d)(7)(iv) further specifies that an employee is required to use the automobile lease valuation rule for all subsequent years after the rule has been adopted and the automobile is available to the employee, unless the employer uses the commuting valuation rule.

B. VEHICLE CENTS-PER-MILE VALUATION RULE

Under the vehicle cents-per-mile valuation rule, the value of the benefit provided in the calendar year equals the standard mileage rate (cents-per-mile rate) multiplied by the total number of miles the vehicle is driven by the employee for personal purposes (personal miles). Section 1.61-21(e)(4) defines “personal miles” as all miles for which the employee used the automobile except miles driven in the employee’s trade or business of being an employee of the employer. Notice 2020-05, 2020-4 I.R.B. 380, provides that the standard mileage rate is 57.5 cents per mile for 2020. For purposes of the vehicle cents-per-mile valuation rule, “vehicle” is defined to include “automobiles” under section 1.61-21(d)(1)(ii).²

Section 1.61-21(e)(1)(iii)(A) provides that the vehicle cents-per-mile valuation

rule may not be used for a calendar year if the fair market value of the vehicle (determined pursuant to section 1.61-21(d)(5)(i) through (iv)) on the first day the vehicle is made available to the employee exceeds a base value of \$50,000, as adjusted annually for inflation under section 280F(d)(7). For 2020, the vehicle cents-per-mile valuation rule may not be used for vehicles with a fair market value in excess of \$50,400. Notice 2020-05.

Section 1.61-21(e) provides that employers may use the vehicle cents-per-mile valuation rule if the employer provides an employee with the use of a vehicle that: (1) the employer reasonably expects will be regularly used in the employer’s trade or business throughout the calendar year (or such shorter period as the vehicle may be owned or leased by the employer), or (2) satisfies the requirements of the mileage rule (described in section 1.61-21(e)(1)(ii)). Section 1.61-21(e)(1)(iv) provides that the vehicle is considered to be regularly used in an employer’s trade or business if either of the following safe harbor conditions are satisfied: (1) at least 50 percent of the vehicle’s total annual mileage is for the employer’s business, or (2) the vehicle is generally used each workday to transport at least three employees of the employer to and from work in an employer-sponsored commuting vehicle pool.

Section 1.61-21(e)(5) provides various consistency rules. Section 1.61-21(e)(5)(i) provides that an employer must adopt the vehicle cents-per-mile valuation rule by the first day on which the employer-provided vehicle is used by an employee for personal use (or, if the commuting valuation rule is used when the vehicle is first used by an employee for personal use, the first day on which the commuting valuation rule is not used). Further, section 1.61-21(e)(5)(ii) requires the employer to use the vehicle cents-per-mile valuation rule for all subsequent years in which the vehicle qualifies, except that the employer may use the commuting valuation rule with respect to a particular vehicle to the extent the requirements for the rule are satisfied.

Section 1.61-21(e)(5)(iii) provides that the employer may adopt the vehicle cents-

² Vehicle is defined in section 1.61-21(e)(2) for purposes of the vehicle cents-per-mile valuation rule to mean “any motorized wheeled vehicle manufactured primarily for use on public streets, roads, and highways”, including an “automobile” as defined for purposes of the automobile lease valuation rule.

per-mile valuation rule only if the rule is adopted by the employer and beginning as of the first day on which the vehicle for which the employer adopted the rule is available to that employee for personal use (or, if the commuting valuation rule is used when the vehicle is first used by an employee for personal use, the first day on which the commuting valuation rule is not used). Further, the employee must use the vehicle cents-per-mile valuation rule for all subsequent years of personal use of the vehicle under section 1.61-21(e)(5)(iv) unless the employer uses the commuting valuation rule.

C. ANNOUNCEMENT 85-113

Employer-provided automobiles are noncash fringe benefits. Employment taxes imposed on noncash fringe benefits are collected (or paid) by an employer at the time and in the manner prescribed by the Secretary in regulations.³ Announcement 85-113, 1985-31 I.R.B. 31, provides guidelines for withholding, paying, and reporting employment tax on taxable noncash fringe benefits. Announcement 85-113 provides generally that taxpayers may rely on the guidelines in the announcement until the issuance of regulations that supersede the temporary and proposed regulations under section 3501(b).⁴ Announcement 85-113 generally is applicable to current payments of noncash fringe benefits, including automobiles.

Section 1 of Announcement 85-113 allows payors of certain noncash fringe benefits to treat the benefits as paid on any day(s) during the year so long as they treat benefits provided in a calendar year as paid not later than December 31 of the calendar year. Section 5 of the announcement allows employers to treat certain benefits paid during the last two months of the year (or any shorter period) as paid during the subsequent calendar year.

III. GRANT OF RELIEF

Due to the suddenness and unexpected onset of the COVID-19 pandemic, the Department of the Treasury and the Internal

Revenue Service are providing relief from the consistency rules in sections 1.61-21(d)(7) and 1.61-21(e)(5). Accordingly, an employer using the automobile lease valuation rule for the 2020 calendar year may instead use the vehicle cents-per-mile valuation rule beginning on March 13, 2020, notwithstanding the consistency rules in section 1.61-21(d)(7), if, at the beginning of the 2020 calendar year, the employer reasonably expected that an automobile with a fair market value not exceeding \$50,400 would be regularly used in the employer's trade or business throughout the year, but due to the COVID-19 pandemic the automobile was not regularly used in the employer's trade or business throughout the year. For this purpose, the COVID-19 pandemic is considered to have commenced on March 13, 2020, the date of the President's emergency declaration. Therefore, employers that choose to switch from the automobile lease valuation rule to the vehicle cents-per-mile valuation rule in the 2020 calendar year must prorate the value of the vehicle using the automobile lease valuation rule for January 1, 2020, through March 12, 2020. Employers should multiply the applicable Annual Lease Value by a fraction, the numerator of which is the number of days during the period beginning on January 1, 2020, and ending on March 12, 2020 (72 days), and the denominator of which is 365. As of March 13, 2020, employers may begin using the vehicle-cents-per-mile valuation rule. Employees using the automobile lease valuation rule whose employers switch from the automobile lease valuation rule to the vehicle cents-per-mile valuation rule under this notice must also switch to the vehicle cents-per-mile valuation rule.

Further, notwithstanding the consistency rules in section 1.61-21(e)(5), employers that choose to switch from the automobile lease valuation rule to the vehicle cents-per-mile valuation rule during 2020 may revert to the automobile lease valuation rule for 2021, provided they meet the requirements of section 1.61-21(d), other than the consistency rules in section 1.61-21(d)(7). Alternatively, employers that choose to switch to the vehicle cents-per-mile valuation rule during 2020 may continue using that rule

for 2021, provided they meet the requirements of section 1.61-21(e), other than the consistency rules in section 1.61-21(e)(5). Employees that use one of the special valuation rules for vehicles must use the same special valuation rule for vehicles that is used by their employer. The consistency rules in section 1.61-21(e)(5) will apply as of January 1, 2021, as if January 1, 2021, were the first day the vehicle was used by the employee for personal use, and the consistency rules in section 1.61-21(d)(7) will apply as of January 1, 2021, as if January 1, 2021, were the first day the vehicle was made available to the employee for personal use. Accordingly, the special valuation rule used for 2021 must continue to be used by the employer and the employee for all subsequent years, except to the extent the employer uses the commuting valuation rule.

Employers that originally used the automobile lease valuation rule to calculate the value of the personal use of an employer-provided automobile during 2020 and that want to instead begin using the vehicle cents-per-mile valuation rule during 2020 based on the relief provided in this notice may use the rules in Announcement 85-113 for reporting and withholding on taxable noncash fringe benefits, or the adjustment process under section 6413 or the refund claim process under section 6402 to correct any overpayment of federal employment taxes on these benefits (for information on these adjustment and refund claim processes, see the regulations under these sections, Rev. Rul. 2009-39, 2009-52 I.R.B. 951, section 13 of Publication 15 (Circular E), Employer's Tax Guide, and the Instructions for Form 941-X, Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund).

IV. DRAFTING INFORMATION

The principal author of this notice is Andrew Trujillo. For further information regarding this notice contact Andrew Trujillo on (202) 317-4826 (not a toll-free number).

³Section 3501(b).

⁴As of the date of publication of this notice, no regulations have been issued that supersede the temporary and proposed regulations under section 3501(b).

Rev. Proc. 2021-9

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor that allows a trade or business that manages or operates a qualified residential living facility, as defined in section 3.01 of this revenue procedure, to be treated as a real property trade or business, solely for purposes of qualifying to make the election under section 163(j)(7)(B) of the Internal Revenue Code (Code) to be an electing real property trade or business.

SECTION 2. BACKGROUND

.01 On December 22, 2017, section 163(j) was amended by § 13301 of Public Law No. 115-97, 131 Stat. 2054, commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 163(j), as amended by the TCJA, provides rules limiting the amount of business interest expense that can be deducted for taxable years beginning after December 31, 2017. *See* TCJA § 13301(a).

.02 On March 27, 2020, section 163(j) was further amended by § 2306 of the Coronavirus Aid, Relief, and Economic Security Act, Public Law No. 116-136, 13 Stat. 281 (CARES Act), to provide special rules for applying section 163(j) to taxable years beginning in 2019 or 2020.

.03 Under section 163(j)(1), the amount allowed as a deduction for business interest expense is limited to the sum of: (1) the taxpayer's business interest income, as defined in section 163(j)(6), for the taxable year; (2) 30 percent of the taxpayer's adjusted taxable income, as defined in section 163(j)(8), for such taxable year, or 50 percent of the taxpayer's adjusted taxable income (if applicable, as provided in section 163(j)(10)); and (3) the taxpayer's floor plan financing interest, as defined in section 163(j)(9), for such taxable year.

.04 The limitation under section 163(j) on the deductibility of business interest expense applies to all taxpayers with business interest, as defined in section 163(j)(5), except for taxpayers, other than tax

shelters under section 448(a)(3), that meet the gross receipts test in section 448(c).

.05 Section 163(j)(5) generally provides that the term "business interest" means any interest expense properly allocable to a trade or business. Section 163(j)(7)(A)(ii) provides that, for purposes of the limitation on the deduction for business interest, the term "trade or business" does not include an "electing real property trade or business." Thus, interest expense properly allocable to an electing real property trade or business is not properly allocable to a trade or business for purposes of section 163(j), and is not business interest expense that is subject to section 163(j)(1).

.06 The term "electing real property trade or business" under section 163(j)(7)(B) means "any trade or business which is described in section 469(c)(7)(C) and which makes an election" to be an electing real property trade or business.

.07 Section 168(g)(1)(F) provides that an electing real property trade or business within the meaning of section 163(j)(7)(B) must use the alternative depreciation system for property described in section 168(g)(8). *See* section 163(j)(11)(A).

.08 The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) published (1) proposed regulations under section 163(j) in a notice of proposed rulemaking (REG-106089-18) in the Federal Register (83 FR 67490) on December 28, 2018 (2018 proposed regulations), (2) final regulations under section 163(j) (TD 9905) in the Federal Register (85 FR 56686) on September 14, 2020 (final regulations), and (3) concurrently with the publication of the final regulations, additional proposed regulations under section 163(j) in a notice of proposed rulemaking (REG-107911-18) in the Federal Register (85 FR 56846).

.09 Section 1.163(j)-1(b)(14) of the final regulations defines an electing real property trade or business as one that makes an election under § 1.163(j)-9 or other published guidance that is (1) a real property trade or business described in section 469(c)(7)(C) of the Code and § 1.469-9(b)(2) of the final regulations, (2) a REIT that qualifies for the safe harbor described in § 1.163(j)-9(h), or (3) a trade or business specifically designated by the Secretary of the Treasury or his delegate

in guidance published in the Federal Register or the Internal Revenue Bulletin as a real property trade or business for section 163(j).

.10 Section 1.163(j)-9 provides rules and procedures for making an election under section 163(j)(7)(B) to be an electing real property trade or business. The Treasury Department and the IRS released Rev. Proc. 2020-22, 2020-18 I.R.B. 745, (April 27, 2020) to provide the time and manner of making a late election, or withdrawing an election under section 163(j)(7)(B) to be an electing real property trade or business for taxable years beginning in 2018, 2019, or 2020. Rev. Proc. 2020-22 also provides the time and manner of making or revoking elections provided by the CARES Act under section 163(j)(10) for taxable years beginning in 2019 or 2020. *See* Rev. Proc. 2020-22 for more information regarding the time and manner of making, revoking, or withdrawing elections under section 163(j)(7) and (10).

.11 Section 469(c)(7)(C) defines a real property trade or business as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. *See also* § 1.469-9(b)(2).

.12 In response to the 2018 proposed regulations, commenters expressed concern as to whether a trade or business that manages or operates a residential living facility and also provides supplemental assistive, nursing, or routine medical services to its customers or patients is eligible to make the election under section 163(j)(7)(B) to be an electing real property trade or business.

.13 On September 28, 2020, the Treasury Department and the IRS published Notice 2020-59, 2020-40 I.R.B. 782, which contained a proposed revenue procedure providing a safe harbor for a trade or business that manages or operates a qualified residential living facility, as defined in section 3.01 of the proposed revenue procedure, to be treated as a real property trade or business solely for purposes of qualifying to make the election under section 163(j)(7)(B) to be treated as an electing real property trade or business. Notice 2020-59 requested comments on the proposed revenue procedure.

.14 In response to the proposed revenue procedure in Notice 2020-59, commenters presented three distinct concerns:

(1) First, commenters requested that the definition of a qualified residential living facility be modified to reduce the minimum threshold for the average period of customer or patient use of individual dwelling units requirement from 90 days to less than 90 days, and that the determination of the average period of customer or patient use take into account that some customers or patients may reside at the facility without a rental contract or other formal written lease agreement. Because Medicare and Medicaid plans generally pay for stays that are substantially less than 90 days, commenters noted that the 90-day average period of customer or patient use requirement would unfairly penalize taxpayers with large numbers of Medicare and Medicaid patients and potentially exclude taxpayers that Congress intended to be eligible to make a real property trade or business election under section 163(j)(7)(B). Commenters also explicitly mentioned that certain facilities that are wholly or partially licensed to receive Medicare and Medicaid payments provide care outside of a rental contract or other formal written lease agreement. The Treasury Department and the IRS agree with this comment, and accordingly, this revenue procedure reduces the average period for customer or patient use requirement from 90 days to 30 days, and allows taxpayers to determine the average period by reference to either the number of days paid for by Medicare or Medicaid or the number of days under a rental contract or other formal written lease agreement.

(2) Second, commenters requested that the revenue procedure provide an alternative test to meet certain requirements of the definition of a qualified residential living facility. Commenters specifically proposed using the definition of “residential rental property” under section 168(e)(2)(A) of the Code as an alternative to the requirements in section 3.01(1) (primary residence requirement) and 3.01(3) (average period of customer or patient use requirement) of the proposed revenue procedure, in part because the legislative history of the TCJA confirms that the trade or business of operating or managing “residential rental property” housing

the elderly is eligible to be a real property trade or business despite the provision of necessary supplemental assistive services to the residents of the residential rental property. Moreover, commenters pointed out the linkage between section 168 and section 163(j) because section 168(g)(1)(F) provides that an electing real property trade or business within the meaning of section 163(j)(7)(B) must use the alternative depreciation system for property described in section 168(g)(8), which includes residential rental property, and because the IRS has previously concluded that various types of retirement care facilities, including independent living, assisted living, and skilled nursing facilities, for example, may qualify as residential rental property for purposes of section 168(e)(2)(A). Commenters also noted that taxpayers have to determine whether their facilities qualify as residential rental property under section 168(e)(2)(A) for purposes of calculating depreciation. They indicated that allowing the section 168(e)(2)(A) test to be used as an alternative to the primary residence requirement and the average period of customer or patient use requirement would reduce taxpayer burden. The Treasury Department and the IRS agree with this comment and this revenue procedure includes an alternative test providing that if a taxpayer operates or manages residential living facilities that qualify as residential rental property under section 168(e)(2)(A), then the facility also meets the requirements set forth in section 3.01(1) and (3) of this revenue procedure.

(3) Third, commenters requested clarification on whether a taxpayer’s reliance on the residential living facility safe harbor to make an election under section 163(j)(7)(B) to be an electing real property trade or business must be determined on an annual basis or remains in effect for taxable years after the taxable year in which an initial election is made. Generally, taxpayers may make an irrevocable one-time election under section 163(j)(7)(B) and § 1.163(j)-9(c) to be an electing real property trade or business. This election, once made, applies to the taxable year in which the election is made and to all subsequent taxable years, and automatically terminates under § 1.163(j)-9(e)(1) if the taxpayer ceases to engage in the electing trade or business. Thus, com-

menters requested that the proposed revenue procedure be amended to clarify that the same rules apply to a taxpayer relying on the safe harbor to make the election such that a trade or business may make a one-time determination as to whether it qualifies for the safe harbor. The Treasury Department and the IRS decline to adopt this comment. An annual test is necessary under the safe harbor because, unlike most trades or businesses that are subject to the electing real property trade or business provisions in § 1.163(j)-9, taxpayers relying solely on the safe harbor provided in this revenue procedure must perform a mathematical calculation to determine their eligibility to make the real property trade or business election under section 163(j)(7)(B), and eligibility is conditioned upon continuing to meet the eligibility requirements for each taxable year. This revenue procedure clarifies that, if the taxpayer fails to satisfy the requirements to be a qualified residential living facility in section 3.01 of this revenue procedure in a subsequent taxable year, the residential living facility safe harbor no longer applies and the taxpayer is deemed to have ceased the electing trade or business. This deemed cessation of the electing trade or business does not apply to taxpayers that otherwise continue to qualify as an electing real property trade or business without the use of the safe harbor. If, in a taxable year subsequent to the taxable year in which the taxpayer is deemed to have ceased the electing trade or business the taxpayer again satisfies the requirements in section 3.01 of this revenue procedure, the taxpayer’s initial election pursuant to the residential living facility safe harbor will be automatically reinstated. See § 1.168(i)-4(d) and section 4.02 of Rev. Proc. 2019-08, 2019-03 I.R.B. 347 (January 14, 2019) for guidance on how to change the computation of depreciation for certain property held by an electing real property trade or business.

.15 In light of the comments received in response to the 2018 proposed regulations and to Notice 2020-59, this revenue procedure provides a safe harbor that allows a taxpayer engaged in a trade or business that manages or operates a qualified residential living facility, as defined in section 3.01 of this revenue procedure, to treat the trade or business as a real property trade or

business solely for purposes of qualifying to make an election under section 163(j)(7)(B) to be an electing real property trade or business (residential living facility safe harbor).

SECTION 3. DEFINITIONS FOR RESIDENTIAL LIVING FACILITY SAFE HARBOR

The following definitions apply for purposes of this revenue procedure:

.01 *Qualified Residential Living Facility.* Except as provided in sections 3.02 and 4.04 of this revenue procedure, a “qualified residential living facility” is a residential living facility that:

(1) Consists of multiple rental dwelling units within one or more buildings or structures that generally serve as primary residences on a permanent or semi-permanent basis to individual customers or patients;

(2) Provides supplemental assistive, nursing, or other routine medical services; and

(3) Has an average period of customer or patient use of individual rental dwelling units of 30 days or more.

.02 *Section 168(e)(2)(A) test.* A residential living facility that qualifies as residential rental property under section 168(e)(2)(A) satisfies the requirements in section 3.01(1) and (3) of this revenue procedure.

.03 *Average period of customer or patient use.*

(1) *In general.* The “average period of customer or patient use” is determined by dividing: (i) the sum of the total number of days in the taxable year that each customer or patient resides in a rental dwelling unit of the residential living facility, which may be determined by reference to a rental contract or other formal written lease agreement, or by the number of days paid for by Medicare or Medicaid; by (ii) the total number of individual residential customers or patients that reside in all of the rental dwelling units of the facility for the taxable year. For this purpose, a married couple residing in a single rental dwelling unit of the residential living facility will be counted as one individual customer or patient, unless each spouse is separately properly treated as an individual customer or patient of the residential living facility

that receives supplemental assistive, nursing, or other routine medical services from or on behalf of the residential living facility. Days in which a rental dwelling unit of a residential living facility are not occupied are not included in the calculation of the average period of customer or patient use.

(2) *Example.* Facility has 100 rental dwelling units. Of the 100 units, 60 units are occupied by the same customer or patient for the entire year, 25 other units are occupied for 360 days of the year with each customer or patient occupying a unit for 90 days, and the remaining 15 units are occupied for a total of 10 months (March through December = 306 days) of the year. Of the 15 units occupied for 10 months of the year, 10 units are occupied by customers or patients during the entire months of March through July (153 days) and by different customers or patients during the entire months of August through December (153 days), for a total of 20 customers for the 10-month period. For the remaining 5 of the 15 units that are occupied for 10 months of the year, 5 customers or patients occupy the units for 8 months (May through December = 245 days) of the year, and 5 other customers or patients occupy the units for 2 months (September and October = 61 days) of the year. The average period of customer or patient use is determined by dividing the sum of the total number of days in the taxable year that each customer resides in a rental dwelling unit, by the total number of individual residential customers or patients that reside in all of the rental dwelling units for the taxable year. The total number of days in the taxable year that the customers or patients reside in the rental dwelling unit is 35,490 days [21,900 days (60 units that are occupied for the entire year x 365 days per year) + 9,000 days (25 units that are occupied for 90 days each x 90 days x 4 90-day periods) + 4,590 days (15 units that are occupied for 10 months x 306 days)]. The total number of individual residential customers or patients is 190 [60 customers or patients occupying a unit for the entire year + 100 (25 customers or patients occupying units for 90 days each x 4 90-day periods in a year) + 20 customers or patients that occupy a unit for a 5-month period + 5

customers or patients that occupy a unit for a 8-month period + 5 customers or patients that occupy a unit for a 2-month period]. Accordingly, the average period of customer or patient use is approximately 187 days (35,490/190).

.04 *Supplemental assistive, nursing, or other routine medical services.* “Supplemental assistive, nursing, or other routine medical services” are personal and professional services that are customarily and routinely provided to individual residential customers or patients of nursing homes, assisted living facilities, memory care residences, continuing care retirement communities, skilled nursing facilities, or similar facilities, as needed, on a day-to-day basis. Such services generally do not include surgical, radiological, or other intensive or specialized medical services that are usually provided only in emergency or short-term in-patient or out-patient hospital or surgical settings.

.05 *Permanent or semi-permanent basis.* The rental dwelling units of a residential living facility serve as primary residences on a “permanent or semi-permanent basis” to customers or patients whose use of the units is generally long-term (30 days or more) in nature, even though some customers or patients may arrive at the residential living facility with significantly shortened life expectancies due to advanced age or terminal medical conditions, and some customers or patients otherwise may be expected to periodically reside away from the residential living facility, such as at the primary residence of a spouse or other relative, for short periods of time.

SECTION 4. RESIDENTIAL LIVING FACILITY SAFE HARBOR

.01 *Safe harbor for residential living facility trades or businesses.* A taxpayer engaged in a trade or business that manages or operates a qualified residential living facility, as defined in section 3.01 of this revenue procedure, may treat such trade or business as a real property trade or business solely for purposes of the election under section 163(j)(7)(B) to be an electing real property trade or business. Satisfying the requirements of this safe harbor is not a determination that the taxpayer is en-

gaged in a real property trade or business under section 469.

.02 *Effect of election and how to make the election.* If a taxpayer relies on this safe harbor in section 4.01 this revenue procedure to make the election under section 163(j)(7)(B) to be an electing real property trade or business, the provisions in § 1.163(j)-9 apply, and the taxpayer must use the alternative depreciation system of section 168(g) to depreciate the property described in section 168(g)(8). The taxpayer makes the election under section 163(j)(7)(B) at the time, and in the manner prescribed by § 1.163(j)-9(d). *See also* Rev. Proc. 2020-22.

.03 *Substantiation.* A trade or business that manages or operates a residential living facility to which this revenue procedure applies must retain books and records to substantiate that all the requirements of this section 4 have been met in accordance with section 6001.

.04 *Annual test; reinstated election.* For any taxable year, subsequent to the taxable year in which a taxpayer relies on the safe harbor in section 4.01 of this revenue procedure to make the election under section 163(j)(7)(B) to be treated as a real property trade or business, in which a taxpayer does not satisfy the requirements in section 3.01 of this revenue procedure, the taxpayer is deemed to have ceased to engage in the electing trade or business, as provided in § 1.163(j)-9(e) for such subsequent taxable year. For any subsequent taxable year in which a taxpayer satisfies the requirements in section 3.01 of this revenue procedure after a deemed cessation of the electing trade or business, the taxpayer's initial election under section 163(j)(7)(B) will be automatically reinstated.

.05 *Anti-abuse.* Taxpayers are not eligible to rely on the safe harbor in this revenue procedure if a principal purpose of an arrangement or transaction is to avoid section 163(j) and its regulations

and in a manner that is contrary to the purpose of this revenue procedure. *See* § 1.163(j)-2(j).

SECTION 5. APPLICABILITY

Taxpayers may apply the rules of this revenue procedure to taxable years beginning after December 31, 2017.

SECTION 6. PAPERWORK REDUCTION ACT

.01 This revenue procedure does not impose any additional information collection requirements in the form of reporting, recordkeeping requirements, or third-party disclosure requirements to the burden that is accounted for in the final regulations. However, this revenue procedure provides that qualified residential living facilities, as defined in section 3.01 of this revenue procedure, may be treated as real property trades or businesses, within the meaning of section 469(c)(7)(C), solely for purposes of making the election under section 163(j)(7)(B) to qualify as an electing real property trade or business. Taxpayers relying on the safe harbor in section 4.01 of this revenue procedure must file a statement with their return under the procedures set forth in, and containing the information required by, § 1.163(j)-9 and Rev. Proc. 2020-22, if applicable. That collection of information 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 1545-0123.

.02 This information is required to be collected and retained for compliance purposes, namely, to determine whether the taxpayer has made an election for one of its trades or businesses to be an electing real property trade or business.

.03 The Treasury Department and the IRS estimate that approximately 30,210 respondents are likely. This number was determined by examining, for the 2017 tax year, Form 1120, Form 1120-S, Form 1065, and Form 1120-REIT filers with NAICS codes of 623110 (nursing care facilities (skilled nursing facilities)), 623311 (continuing care retirement communities), 623312 (assisted living facilities for the elderly) and 623990 (other residential care facilities) with gross receipts of at least \$10 million.

.04 The estimated number of respondents is 30,210. The estimated annual burden per respondent/recordkeeper varies from 0 to 30 minutes, depending on individual circumstances, with an estimated average of 15 minutes. The estimated total annual reporting and/or recordkeeping burden is 7,552.5 hours (30,210 respondents x 15 minutes). The estimated annual cost burden to respondents is \$95 per hour. Accordingly, we expect the total annual cost burden for the election statements to be \$717,487.50 (30,210 * .25 * \$95). The estimated annual frequency of responses is once because the statements only have to be filed once.

SECTION 7. DRAFTING INFORMATION

The principal authors of this revenue procedure are Susie Bird, Charles Gorham, Justin Grill, Bernard Harvey and Jaime Park of the Office of Associate Chief Counsel (Income Tax & Accounting) and Adrienne Mikolashek and William Kostak of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact Mr. Grill at (202) 317-7003 (not a toll-free number).

Part IV

26 CFR Part 300

Notice of Proposed Rulemaking

User Fee for Estate Tax Closing Letter

REG-114615-16

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations establishing a new user fee for authorized persons who wish to request the issuance of IRS Letter 627, also referred to as an estate tax closing letter. The Independent Offices Appropriations Act of 1952 authorizes charging user fees in appropriate circumstances. The proposed regulations affect persons who request an estate tax closing letter.

DATES: Written or electronic comments and requests for a public hearing must be received by March 1, 2021. Requests for a public hearing must be submitted as prescribed in the “**Comments and Requests for a Public Hearing**” section.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at <http://www.regulations.gov> (indicate IRS and REG-114615-16) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket. Send paper submissions to: CC:PA:LPD:PR (REG-114615-16), Room 5203, Internal

Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044.

FOR FURTHER INFORMATION CONTACT: Concerning submissions of comments and/or requests for a public hearing, Regina Johnson, at (202) 317-5177; concerning cost methodology, Michael Weber, at (202) 803-9738; concerning the proposed regulations, Juli Ro Kim, at (202) 317-6859 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

A. Overview

This document contains proposed amendments to the User Fee Regulations (26 CFR part 300) to establish a user fee applicable to requests for estate tax closing letters provided by the IRS to an authorized person. (The term “authorized person” is used herein to refer to a decedent’s estate or other person properly authorized under section 6103 of the Internal Revenue Code (Code) to receive, and therefore, to request, an estate tax closing letter with respect to the estate.) The IRS issues estate tax closing letters upon request of an authorized person only after an estate tax return (generally, Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return) has been accepted by the IRS (1) as filed, (2) after an adjustment to which the estate has agreed, or (3) after an adjustment in the deceased spousal unused exclusion (DSUE) amount. An estate tax closing letter informs an authorized person of the acceptance of the estate tax return and certain other return information, including the amount of the net estate tax, the State death tax credit or deduction, and any generation-skipping transfer tax for which the estate is liable.¹

¹ In the context of a Form 706 (a “return” as defined in section 6103(b)(1)), the term “return information” is broadly defined in section 6103(b)(2) to include not only information appearing on the Form 706, but also whether the estate’s return was, is being, or will be examined or subject to other investigation or processing, or any other data, received by, recorded by, prepared by, furnished to, or collected by the Secretary of the Treasury or his delegate (Secretary) with respect to the Form 706 or with respect to the determination of the existence, or possible existence, of liability (or the amount thereof) of any person under the Code for any tax, penalty, interest, fine, forfeiture, or other imposition, or offense.

The IRS understands that knowledge of the acceptance by the IRS of the estate tax return - including the amount of the gross estate and the estate tax liability - is important to executors or other persons administering estates because of the unique nexus between an estate’s Federal estate tax obligations and State and local law obligations to administer and close a probate estate. This knowledge aids an executor’s ability to make the final division and distribution of estate assets and to avoid potential personal liability for unpaid estate tax in making such distribution. Personal liability can be imposed on an executor when the executor makes preferential payments to creditors or distributions to beneficiaries, leaving insufficient funds for the full payment of the tax owed to the government. See 31 U.S.C. 3713(b). On the other hand, an estate tax closing letter does not indicate whether any of the estate tax has been paid or the amount of estate tax that has been paid.

The estate tax closing letter also includes relevant procedural and substantive explanations. Addressing the potential for conflating an estate tax closing letter with a formal closing agreement, the letter confirms that it is not a formal closing agreement with the IRS that is described under section 7121 of the Code. Additionally, the estate tax closing letter explains that, consistent with Rev. Proc. 2005-32, 2005-1 C.B. 1206, the IRS will not reopen or examine the estate tax return to determine the estate tax liability of a decedent’s estate unless the estate notifies the IRS of changes to the estate tax return or if there is (1) evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact, (2) a clearly defined substantial error based upon an established IRS position, or (3) a serious administrative omission. However, the estate tax closing letter does not limit or foreclose future adjustments to the DSUE amount shown on the estate tax return, so the estate tax closing letter further explains that the IRS has authority to examine returns of a decedent in the context of determining the DSUE amount for portability purposes. (See part C of this section for a discussion of portability of the DSUE amount.) Finally, the estate tax closing

letter includes explanations related to the potential application of sections 6166 and 6324A (installment payments and special extended lien), 2204 (discharge of personal liability), and 6324 (estate tax lien). Currently, the IRS does not charge for providing an estate tax closing letter to authorized persons.

B. June 2015 Change to IRS Practice in Issuing Estate Tax Closing Letters

The practice of issuing estate tax closing letters to authorized persons is not mandated by any provision of the Code or other statutory requirement. Instead, the practice is fundamentally a customer service convenience offered to authorized persons in view of the unique nature of estate tax return filings and the bearing of an estate's Federal estate tax obligations on the obligation to administer and close a probate estate under applicable State and local law. Essentially, the practice takes into account estates' and stakeholders' need for information regarding the status of an estate's Federal tax obligations in administering and closing a probate estate. Prior to June 2015, the IRS generally issued an estate tax closing letter for every estate tax return filed. However, for estate tax returns filed on or after June 1, 2015, the IRS changed its practice and now offers an estate tax closing letter only upon the request of an authorized person.

The IRS changed its practice of issuing estate tax closing letters for every filed Form 706 for two primary reasons. First, the volume of estate tax return filings increased at the same time that the IRS experienced additional budget and resource constraints. In particular, the number of estate tax filings increased dramatically due to the enactment in December 2010 of portability of a deceased spouse's unused applicable exclusion amount (DSUE amount) for the benefit of a surviving spouse. (See part C for a discussion of the impact of portability of the DSUE amount on estate tax filings.) Second, the IRS recognized that an account transcript with a transaction code and explanation of "421 - Closed examination of tax return" is an available alternative to the estate tax closing letter. See Notice 2017-12, I.R.B. 2017-

5 (describing the utility of the account transcript in lieu of the estate tax closing letter and its availability at no charge). Notwithstanding these considerations, the IRS was aware that executors, local probate courts, State tax departments, and others had come to rely on the convenience of estate tax closing letters and the return information and procedural and substantive explanations such letters provided for confirmation that the examination of the estate tax return by the IRS had been completed and the IRS file had been closed. Accordingly, in 2015 the IRS decided to continue providing the service of issuing estate tax closing letters, still at no charge, but only upon the request of an authorized person.

Until restrictions were added due to the ongoing Coronavirus Disease 2019 (COVID-19) pandemic, an authorized person was able to request an estate tax closing letter by telephone or fax. Now, due to the COVID-19 pandemic, an authorized person may request an estate tax closing letter only by fax (current procedure and details available at <http://www.irs.gov>).

C. The Continuing Impact of Portability on Estate Tax Return Filings

Portability of the DSUE amount became effective for estates of decedents dying after December 31, 2010, upon enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. 111-312, 124 Stat. 3296, 3302 (Dec. 17, 2010), and became permanent upon enactment of the American Taxpayer Relief Act of 2012, Pub. L. 112-240, 126 Stat. 2313 (January 2, 2013). In order to elect portability of the DSUE amount for the benefit of the surviving spouse, the estate of the deceased spouse must timely file an estate tax return, even if the sum of the value of the gross estate and the amount of adjusted taxable gifts is insufficient to trigger a filing requirement under section 6018(a). In calendar year 2016, the number of estate tax returns filed solely to elect portability of the DSUE amount was approximately 20,000, compared to approximately 12,000 estate tax returns filed because of a filing requirement under section 6018(a).

D. Establishment of User Fee for Estate Tax Closing Letters

The IRS continues to experience significant budget and resource constraints that require the IRS to allocate its existing resources as efficiently as possible. The volume of estate tax return filings remains high (approximately 30,500 estate tax returns filed in 2018), in large part attributable to estate tax returns that are filed for estates having no tax liability or filing requirement under section 6018 and that are filed solely to elect portability of the DSUE amount for the benefit of the surviving spouse of a decedent.

While the practice of issuing estate tax closing letters is intended as a customer service convenience to authorized persons based on an understanding of the unique nexus between an estate's Federal estate tax obligations and the estate's obligations under applicable local law for State and local estate and inheritance taxes and to administer and close a probate estate, the Treasury Department and the IRS received feedback from taxpayers and practitioners that the procedure for requesting an estate tax closing letter can be inconvenient and burdensome. When requests had been accepted by telephone, a request could not be made until the IRS's examination of the estate tax return had been completed. Taxpayer representatives, therefore, often needed to repeat the telephone request, sometimes multiple times, before the request could be accepted by the IRS. Currently, the instructions on <http://www.irs.gov> advise that, prior to faxing a request, an account transcript should be requested and reviewed to ensure the transaction code and explanation of "421 - Closed examination of tax return" are present. Account transcripts are available online to registered tax professionals using the IRS's Transcript Delivery System (TDS) or to authorized persons making requests using Form 4506-T.

In view of the resource constraints and purpose of issuing estate tax closing letters as a convenience to authorized persons, the IRS has identified the provision of estate tax closing letters as an appropriate service for which to establish a user fee to recover the costs that the government incurs in providing such letters. Accordingly, the Treasury Department

and the IRS propose establishing a user fee for estate tax closing letter requests (see parts E and F for explanation of the authority to establish the user fee). As currently determined, the user fee is \$67, as detailed in part H.

Guidance on the procedure for requesting an estate tax closing letter and paying the associated user fee is not provided in these proposed regulations. The Treasury Department and the IRS expect to implement a procedure that will improve convenience and reduce burden for authorized persons requesting estate tax closing letters by initiating a one-step, web-based procedure to accomplish the request of the estate tax closing letter as well as the payment of the user fee. As presently contemplated, a Federal payment website, such as <http://www.pay.gov>, will be used and multiple requests will not be necessary. The Treasury Department and the IRS believe implementing such a one-step procedure will reduce the current administrative burden on authorized persons in requesting estate tax closing letters and will limit the burden associated with the establishment of a user fee for providing such service.

E. User Fee Authority

The Independent Offices Appropriations Act of 1952 (IOAA) (31 U.S.C. 9701) authorizes each agency to promulgate regulations establishing the charge for services provided by the agency (user fees). The IOAA provides that these user fee regulations are subject to policies prescribed by the President and shall be as uniform as practicable. Those policies are currently set forth in the Office of Management and Budget (OMB) Circular A-25, 58 FR 38142 (July 15, 1993; OMB Circular).

The IOAA states that the services provided by an agency should be self-sustaining to the extent possible. 31 U.S.C. 9701(a). The OMB Circular states that agencies providing services that confer special benefits on identifiable recipients beyond those accruing to the general public must identify those services, determine whether user fees should be assessed for those services, and, if so, establish user fees that recover the full cost of providing those services.

As required by the IOAA and the OMB Circular, agencies are to review user fees biennially and update them as necessary to reflect changes in the cost of providing the underlying services. During these biennial reviews, an agency must calculate the full cost of providing each service, taking into account all direct and indirect costs to any part of the U.S. Government. The full cost of providing a service includes, but is not limited to, salaries, retirement benefits, rents, utilities, travel, and management costs, as well as an appropriate allocation of overhead and other support costs associated with providing the service.

An agency should set the user fee at an amount that recovers the full cost of providing the service unless the agency requests, and the OMB grants, an exception to the full cost requirement. The OMB may grant exceptions only where the cost of collecting the fees would represent an unduly large part of the fee for the activity, or where any other condition exists that, in the opinion of the agency head, justifies an exception. When the OMB grants an exception, the agency does not collect the full cost of providing the service and therefore must fund the remaining cost of providing the service from other available funding sources. When the OMB grants an exception, the agency, and by extension all taxpayers, subsidize the cost of the service to the recipients who otherwise would be required to pay the full cost of providing the service, as the IOAA and the OMB Circular directs.

F. Special Benefits Conferred by Issuance of Estate Tax Closing Letters

The issuance of an estate tax closing letter, and the return information and procedural and substantive explanations such letters provide, constitutes the provision of a service and confers special benefits on identifiable recipients beyond those accruing to the general public. Upon receipt of an estate tax closing letter, authorized persons can make use of the return information and procedural and substantive explanations provided in the letter for non-Federal tax purposes, for example, to facilitate the executor's ability to make the final distribution of estate assets and to

respond as needed to non-Federal tax authorities and entities, such as local probate courts, State tax departments, and private stakeholders. Further, executors of such estates can make use of the return information pertaining to the estate's Federal tax liability to avoid potential personal liability for payment of the tax under 31 U.S.C. 3713.

Moreover, letters comparable to estate tax closing letters are not universally available or provided to taxpayers filing Federal tax returns other than estate tax returns, upon request by authorized persons or otherwise. By comparison, account transcripts are universally provided by the IRS upon request to all taxpayers. After issuing Notice 2017-12 to publicize the availability and utility of an account transcript as an alternative in lieu of an estate tax closing letter, the feedback the IRS received from stakeholders reflects a definite preference for the return information and procedural and substantive explanations provided by the IRS in an estate tax closing letter. While the IRS will continue to offer transcripts as an alternative in lieu of estate tax closing letters at no charge, an authorized person may choose which service best supports their needs based upon the specific circumstances of the decedent's estate. Estate tax closing letters are uniquely available for authorized persons that have need of such special benefits.

For these reasons, the issuance of an estate tax closing letter constitutes the provision of a service and confers special benefits to authorized persons requesting such letters beyond those accruing to the general public. Accordingly, the IRS is authorized, pursuant to the IOAA and the OMB Circular, to charge a user fee for the issuance of an estate tax closing letter that reflects the full cost of providing this service. See also section 6103(p)(2)(B) (allowing for a reasonable fee for furnishing return information to any person).

G. Calculation of User Fees Generally

User fee calculations begin by first determining the full cost for the service. The IRS follows the guidance provided by the OMB Circular to compute the full cost of the service, which includes all indirect and direct costs to any part of the

U.S. Government including but not limited to direct and indirect personnel costs, physical overhead, rents, utilities, travel, and management costs. The IRS's cost methodology is described later in this part G.

Once the total amount of direct and indirect costs associated with a service is determined, the IRS follows the guidance in the OMB Circular to determine the costs associated with providing the service to each recipient, which represents the average per unit cost of that service. This average per unit cost is the amount of the user fee that will recover the full cost of the service.

The IRS follows generally accepted accounting principles (GAAP), as established by the Federal Accounting Standards Advisory Board (FASAB), in calculating the full cost of providing services. The FASAB Handbook of Accounting Standards and Other Pronouncements, as amended, which is available at http://files.fasab.gov/pdf/2019_fasab-handbook.pdf, includes the Statement of Federal Financial Accounting Standards 4: Managerial Cost Accounting Standards and Concepts (SFFAS No. 4) for the Federal Government. SFFAS No. 4 establishes internal costing standards under GAAP to accurately measure and manage the full cost of Federal programs. The methodology described in the remainder of this part G is in accordance with SFFAS No. 4.

1. Cost center allocation

The IRS determines the cost of its services and the activities involved in producing them through a cost accounting system that tracks costs to organizational units. The lowest organizational unit in the IRS's cost accounting system is called a cost center. Cost centers are usually separate offices that are distinguished by subject-matter area of responsibility or geographic region. All costs of operating a cost center are recorded in the IRS's cost accounting system and are allocated to that cost center. The costs allocated to a cost center are the direct costs for the cost center's activities as well as all indirect costs, including overhead, associated with

that cost center. Each cost is recorded in only one cost center.

2. Determining the per unit cost

To establish the per unit cost, the total cost of providing the service is divided by the volume of services provided. The volume of services provided includes both services for which a fee is charged as well as subsidized services. The subsidized services are those where OMB has approved an exception to the full cost requirement, for example, to charge a reduced fee to low-income taxpayers. The volume of subsidized services is included in the total volume of services provided to ensure that the IRS, and not those who are paying full cost, subsidizes the cost of the reduced-cost services.

3. Cost estimation of direct labor and benefits

Not all cost centers are fully devoted to only one service for which the IRS charges a user fee. Some cost centers work on a number of different services. In these cases, the IRS estimates the cost incurred in those cost centers attributable to the service for which a user fee is being calculated by measuring the time required to accomplish activities related to the service, and estimating the average time required to accomplish these activities. The average time required to accomplish these activities is multiplied by the relevant organizational unit's average labor and benefits cost per unit of time to determine the labor and benefits cost incurred to provide the service. To determine the full cost, the IRS then adds an appropriate overhead charge, as discussed in part G.4.

4. Calculating overhead

Overhead is an indirect cost of operating an organization that cannot be immediately associated with an activity that the organization performs. Overhead includes costs of resources that are jointly or commonly consumed by one or more organizational unit's activities but are not specifically identifiable to a single activity.

These costs can include:

- General management and administrative services of sustaining and support organizations;
- Facilities management and ground maintenance services (security, rent, utilities, and building maintenance);
- Procurement and contracting services;
- Financial management and accounting services;
- Information technology services;
- Services to acquire and operate property, plants, and equipment;
- Publication, reproduction, and graphics and video services;
- Research, analytical, and statistical services;
- Human resources/personnel services; and
- Library and legal services.

To calculate the overhead allocable to a service, the IRS multiplies a corporate overhead rate (Corporate Overhead rate) by the direct labor and benefits costs determined as discussed above in part G.3. The Corporate Overhead rate is the ratio of the sum of the IRS's indirect labor and benefits costs from the supporting and sustaining organizational units—those that do not interact directly with taxpayers—and all non-labor costs to the IRS's labor and benefits costs of its organizational units that interact directly with taxpayers. The IRS calculates the Corporate Overhead rate annually based on cost elements underlying the Statement of Net Cost included in the IRS Annual Financial Statements, which are audited by the Government Accountability Office.

The Corporate Overhead rate of 74 percent (rounded to the nearest hundredth) for costs reviewed during fiscal year (FY) 2018 was calculated based on (FY) 2017 costs, as follows:

Indirect Labor and Benefits Costs	\$ 1,705,152,274
Non-Labor Costs	+ \$ 3,213,504,014
Total Indirect Costs	\$ 4,918,656,288
Direct Labor and Benefits Costs	÷ \$ 6,640,044,003
Corporate Overhead Rate	74.08%

H. Description and Tables Showing Full Cost Determination for Estate Tax Closing Letter

The IRS followed the guidance provided by the OMB Circular to compute the full cost of issuing estate tax closing letters to an authorized person. The OMB Circular explains that the full cost includes all indirect and direct costs to any part of the Federal Government including but not limited to direct and indirect personnel costs, physical overhead, rents, utilities, travel, and management costs.

1. Request Processing Costs

Requests for estate tax closing letters are processed by GS Grade 5 and Grade 8 customer service representatives. Grade 5 representatives perform 80 percent of the work and Grade 8 representatives perform the remaining 20 percent of the work. The customer service representative verifies that the request is authorized and that the address information is correct. Because a separate estate tax closing letter is prepared for each executor, responding to requests often requires more than one letter, with an average of three letters per request. It requires approximately 0.65 staff hours for a customer service representative to review the return, create the estate tax closing letters, and prepare the letters for mailing. The IRS received an average of 17,249 requests for estate tax closing letters in FY 2017 and FY 2018 requiring 11,154 staff hours.

Total hours allocated to the cost must also include indirect hours for campus employees. Indirect hours are calculated by multiplying the direct hours by the indirect rate for employees, which is 60 percent. Using this information, IRS determined the total staff hours to process requests for estate tax closing letters are 17,846 as follows:

Staff Hours	11,154
Indirect Hours (60%)	6,692
Total Hours	17,846

To determine the labor and benefits costs, IRS converted total hours to full time employees (FTE) by dividing the to-

tal hours by 2,080, which is the number of hours worked by a full time employee during the year, resulting in 8.58 FTE. IRS calculated the cost per FTE by adding 80 percent of the average salary and benefits for a GS 5 to 20 percent of the average salary and benefits for a GS 8 campus employee and determined the cost of labor and benefits related to this program is \$ 578,831 (rounded to the nearest whole dollar), as follows:

GS-5 Salary and Benefits (\$ 62,330 x 80%)	\$ 49,864
GS-8 Salary and Benefits (\$ 87,993 x 20%)	\$ 17,599
Total Cost Per FTE	\$ 67,463
Total FTE	8.58
Total Labor & Benefits for processing requests	\$ 578,831

2. Quality Assurance Review Costs

Outgoing estate tax closing letters are subjected to quality review performed by GS 8 Grade quality assurance professionals. Specifically, five of every 100 estate tax closing letters mailed are reviewed for quality assurance. A quality assurance professional opens the return to (1) ensure the estate tax closing letter was authorized, (2) verify that the correct information was included in the letter, and (3) verify the address information. Quality assurance professionals then document their review. On average, quality assurance professionals spend .5 staff hours to review one estate tax closing letter. The estimated labor hours for quality assurance related to estate tax closing letters are 1,294, determined as follows:

Estimated Volume of Requests	17,249
Average Number of Letters per Request x	3
Total Letters Available for Review	51,747
Estimated Letters Reviewed (5%)	2,587
Hours per Review x	0.5
Estimated Quality Assurance Hours	1,294
Indirect Hours (60%)	776
Total Quality Assurance Hours	2,070
Total FTE	1.00
Cost Per Grade 8	\$ 87,993
Total Salary and Benefits for Quality Assurance	\$ 87,563

3. Overhead Calculation

The IRS applied the Corporate Overhead rate to the labor and benefits costs to calculate the full cost for issuing an estate tax closing letter. The full cost of the program is \$ 1,160,058, determined as follows:

Total Processing Labor & Benefits	\$ 578,831
Total Quality Assurance Labor & Benefits	\$ 87,563
Total Labor and Benefits	\$ 666,394
Corporate Overhead (74.08%)	+ \$ 493,664
Full Cost	\$ 1,160,058

To calculate the cost per request, IRS divided \$ 1,160,058 by the volume of 17,249 requests. The cost to issue an estate tax closing letter is \$ 67 (rounded to the nearest whole dollar), determined as follows:

Full Cost	\$ 1,160,058
Estimated Volume	÷ 17,249
Cost Per Request	\$ 67

Proposed Applicability Date

These regulations are proposed to apply to requests for an estate tax closing letter received by the IRS after the date that is 30 days after the date of publication in the **Federal Register** of a Treasury decision adopting these rules as final regulations.

Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. The proposed regulations, which prescribe a fee to obtain a particular service, affect decedents' estates, which generally are not "small entities" as defined under 5 U.S.C. 601(6). Thus, these regulations have no economic impact on small entities. In addition, the dollar amount of the

fee (\$67 as currently determined) is not substantial enough to have a significant economic impact on any entities that could be affected by establishing such a fee. Accordingly, the Secretary certifies that the rule will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

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 “ADDRESS-ES” heading. The Treasury Department and IRS request comments on all aspects of the proposed regulations. Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be available at <http://www.regulations.gov> or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments as prescribed in this preamble under the “DATES” heading. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020-4, 2020-17 I.R.B. 1, provides that until further notice, public hearings conducted by the IRS will be

held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

Drafting Information

The principal author of these regulations is Juli Ro Kim of the Office of Associate Chief Counsel (Passthroughs and Special Industries). Other personnel from the Treasury Department and the IRS participated in the development of the regulations.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, Notices, and other guidance cited in this document 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>.

List of Subjects in 26 CFR Part 300

Estate taxes, Excise taxes, Gift taxes, Income taxes, Reporting and recordkeeping requirements, User fees.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 300 is proposed to be amended as follows:

PART 300—USER FEES

Paragraph 1. The authority citation for part 300 continues to read as follows:

Authority: 31 U.S.C. 9701.

Par. 2. Section 300.0 is amended by adding paragraph (b)(13) to read as follows:

§ 300.0 User fees; in general.

* * * * *

(b) * * *

(13) Requesting an estate tax closing letter.

Par. 3. Section 300.13 is added to read as follows:

§ 300.13 Fee for estate tax closing letter.

(a) *Applicability.* This section applies to the request by a person described in paragraph (c) of this section for an estate tax closing letter from the IRS.

(b) *Fee.* The fee for issuing an estate tax closing letter is \$67.

(c) *Person liable for the fee.* The person liable for the fee is the estate of the decedent or other person properly authorized under section 6103 of the Internal Revenue Code to receive and therefore to request the estate tax closing letter with respect to the estate.

(d) *Applicability date.* This section applies to requests received by the IRS after [date that is 30 days after these regulations are published as final regulations in the **Federal Register**].

Douglas W. O'Donnell,
Acting Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on February 11, 2020, 4:15 p.m., and published in the issue of the Federal Register for December 31, 2020, 85 FR 86871)

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.
FR.—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 2020–27 through 2020–52 is in Internal Revenue Bulletin 2020–52, dated December 27, 2020.

Finding List of Current Actions on Previously Published Items¹

Bulletin 2021-3

¹ A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2020-27 through 2020-52 is in Internal Revenue Bulletin 2020-52, dated December 27, 2020.

Internal Revenue Service

Washington, DC 20224

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INTERNAL REVENUE BULLETIN

The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletins are available at www.irs.gov/irb/.

We Welcome Comments About the Internal Revenue Bulletin

If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can email us your suggestions or comments through the IRS Internet Home Page (www.irs.gov) or write to the Internal Revenue Service, Publishing Division, IRB Publishing Program Desk, 1111 Constitution Ave. NW, IR-6230 Washington, DC 20224.