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Tax Accounting Corner

Proposed Regulations and the Accounting Method Provisions

By Sharon A. Kay and Caleb Cordonnier

Just in time for our final column, the government has again issued regulations related to major statutory changes made by the Tax Cuts and Jobs Act ("TCJA") to accounting method provisions.[1] First, the IRS released proposed regulations that provide rules for accrual-method taxpayers with audited financial statements regarding the acceleration of income under Code Sec. 451(b), another set of proposed regulations that provide for the deferral of certain advance payments under Code Sec. 451(c), and automatic method changes to adopt early either or both of these proposed revenue recognition regulations. Additionally, the IRS released final and newly proposed regulations for bonus depreciation.

All of the guidance released has a combination of anticipated rules and some surprises. For each proposed regulation, the IRS allows a taxpayer to rely on the proposed regulation provided that the taxpayer applies all the applicable rules contained in the proposed regulation.

Acceleration of Revenue Under Code Sec. 451(b)

New Proposed Reg. §1.451-3 provides the general rules for accrual-method taxpayers regarding the acceleration of income under Code Sec. 451(b).[2] The TCJA amended Code Sec. 451(b) to provide that for an accrual-method taxpayer, the all-events test with respect to any item of gross income (or portion thereof) shall not be treated as met any later than when such item (or portion thereof) is taken into account as revenue in the taxpayer's applicable financial statements ("AFS"), or such other financial statement as the Treasury Secretary may specify.[3] Code Sec. 451(b), as revised by the TCJA, is generally effective for tax years beginning after December 31, 2017. However, special rules apply to income from a debt instrument having original issue discount ("OID").[4]

As a result of the statutory change, the all-events test was modified so that all events are considered to be met no later than the year in which the revenue is recognized for financial accounting purposes. The provision was enacted to prevent the deferral of unbilled receivables on partially performed services and on credit card fees to the extent already recognized for financial statement purposes.[5] However, the legislative history also stated that the provision was not intended to revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in

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situations if the Federal income tax realization event has not yet occurred.[6]

Proposed Reg. §1.451-3 repeats the general rule in the statute that for taxpayers with AFS, the all-events test with respect to any item of *gross income* (or portion thereof) is met no later than when that item is taken into account as revenue in the AFS.[7] However, Treasury did not provide for a cost of goods sold offset to the revenue accelerated under the provision, and thus the proposed regulations effectively require the acceleration of gross receipts, not gross income.[8] This generally results in the related costs to perform being deferred until incurred under Code Sec. 461, which may be in a later year. The preamble requests comments on the authority for including cost offsets for future costs of goods sold. The acceleration of gross receipts without the acceleration of the related costs to perform will be especially burdensome for taxpayers that recognize revenues over time in their books and records.

Because not all aspects of the proposed regulations are taxpayer-favorable, taxpayers must weigh the benefits, including more favorable audit protection against the unfavorable or unclear rules.

Although the preamble to Proposed Reg. §1.451-3 repeats the legislative intent to not require recognition of revenue prior to income being realized, the proposed regulation does not provide any rules with respect to determining whether income has been realized. Proposed Reg. §1.451-3 does provide an example that illustrates the acceleration of unbilled receivables for partially performed contracts for services and another example for a partially performed contract for goods. The examples require the acceleration of income because the taxpayers have a right to partial payment, even when the contract requires acceptance and title transfer before taxpayers have the right to bill. The example for unbilled receivables for the sale of goods in particular creates uncertainty regarding when a taxpayer has realized gross income for a sale if the taxpayer has not received payment, does not have a right to bill, and has not had a sale or exchange take place.

The proposed regulation broadens the definition of AFS to include more foreign entities by applying the definition of AFS in Rev. Proc. 2004-34. Code Sec. 451(b)(3) did not expressly include certain financial statements that have traditionally been treated as AFS under Rev. Proc. 2004-34, such as IFRS financial statements used for credit purposes, reporting to shareholders, partners, or other proprietors or to beneficiaries, or any other substantial nontax purposes. Thus, certain foreign entities may have concluded that Code Sec. 451(b) was not applicable based on the statutory definition of AFS, but those entities are subject to Code Sec. 451(b) under the proposed regulations. Taxpayers who do not have AFS are exempt from the provision. Additionally, the proposed regulations establish priority rules for taxpayers with multiple types of AFS. Taxpayers included in a group AFS must use the group AFS unless the taxpayers have a stand-alone AFS of equal or higher priority to the group AFS. Taxpayers determine their allocable share of revenue using source documents if financial results are not separately stated within the group AFS. Taxpayers that have an AFS in one year but not the next must apply the acceleration rule in the taxable year in which it has an AFS, but not in the year in which the taxpayer does not have an AFS.

The proposed regulations provide helpful examples into how to apply the AFS income inclusion rule and the traditional all-events test to a multi-year contract, which the statute did not address.[9] Under the proposed regulations, taxpayers with multi-year contracts must take into account the cumulative amounts included in income in prior taxable years for a contract, if any, in order to determine the amount to be included in income for the taxable years remaining under the contract. The cumulative approach appears to more clearly reflect income, because an annualized approach could artificially accelerate income recognition or result in double-counting. The examples in the regulations demonstrate how a taxpayer must track each prong of the all-events test (payment dates, due dates, and performance dates) cumulatively for multi-year contracts to determine whether the amount of income recognized under the traditional all-events tests exceeds the amount of income recognized under the taxpayer's AFS.

In another significant difference from the statute, the proposed regulations limit how Code Sec. 451(b) applies to OID. The preamble provides that the AFS income acceleration rule is not intended to change the OID income timing rules, except for certain credit card

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fees (*e.g.*, cash advance fees, late fees, and interchange fees and certain other specified fees), because it would result in significant administrative burden and very little additional tax revenue. The proposed regulations provide special rules for certain credit card fees to ensure that the fees are subject to the acceleration rule and are not treated as OID.

The proposed regulations otherwise contain many new definitions and special rules that clarify the types of transactions that are not impacted by the provision including, for example, a nonexclusive list of special methods of accounting such as Code Secs. 453, 460, and 467, and nonrecognition transactions such as Code Secs. 332, 337, 351, 355, 368, 721, 1031, and 1033. Additionally, the proposed regulations note that the acceleration provision does not recharacterize a transaction, *e.g.*, it does not change the treatment of a lease for federal income tax purposes to a sale because it is reported as a sale in the taxpayer's AFS.

Deferral of Advance Payments Under Code Sec. 451(c)

New Proposed Reg. §1.451-8 provides the rules related to Code Sec. 451(c), which codified parts of the one-year deferral of advance payments allowed in Rev. Proc. 2004-34. The TCJA amended Code Sec. 451(c) to provide that an accrual-method taxpayer may recognize certain advance payments in the year of receipt or recognize advance payments to the extent recognized in the AFS in year of receipt and the remaining portion in next taxable year. The provision allows taxpayers to elect whether to apply the method to each category of advance payments. Unlike Rev. Proc. 2004-34, the statute does not have as expansive a list of qualifying advance payments and does not allow a one-year deferral for taxpayers without AFS.

The legislative history states that this provision is intended to override any deferral method provided by Reg. §1.451-5 for advance payments received for goods, which would include the two-year deferral for inventoriable goods. The IRS subsequently issued a final regulation (T.D. 9870) that removes Reg. §1.451-5.

The deferral of advance payments under Proposed Reg. §1.451-8 expands the rules beyond the statutory language by predominantly relying on the rules in Rev. Proc. 2004-34. For example, in welcome relief to many taxpayers, the proposed regulations provide that taxpayers without an AFS may continue to defer advance payments in certain situations.[10] Additionally, the types of revenues that may be eligible are generally consistent with the expansive list contained in Rev. Proc. 2004-34, and include, for example, goods, services, software, and gift cards.[11] The regulations propose the favorable rule from Rev. Proc. 2004-34 that ignores a 92-day or less short-year for determining the amount of advance payments includable in income in the taxable year following the taxable year of receipt.[12] The regulations also propose to provide acceleration rules consistent with Rev. Proc. 2004-34 that require taxpayers to include advance payments in gross income in certain situations, including if the taxpayer ceases to exist or the obligation with respect to advance payments ends.[13] The regulations do not further clarify when a taxpayer's obligation ends.

There are a few major changes in the proposed regulations when compared to Rev. Proc. 2004-34. For example, the proposed regulations exclude advance payments for "specified goods."[14] Specifically, the regulations propose to exclude 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.[15] While the rest of the list of exclusions should be familiar as they were adopted straight from Rev. Proc. 2004-34, the preamble does not explain why the IRS believes that "specified goods" should not be allowed the one-year deferral.

The proposed regulations provide several new examples that are very helpful as they illustrate that a variety of loyalty/reward points, discount vouchers, airline miles, and other similar types of variable consideration treated as separate performance obligations in AFS may constitute advance payments eligible for a deferral method.[16] These examples are particularly beneficial to taxpayers in the retail, consumer products, airline and other industries.

The proposed regulations largely rely on definitions in Proposed Reg. §1.451-3, including for the definition of AFS, performance obligation, revenue, and transaction price.[17] Therefore, there is a lot of overlap between the two regulations.

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Automatic Procedures to Adopt Proposed Regulations Early Under Code Sec. 451(b) and/or (c)

The IRS also issued Rev. Proc. 2019-37, which provides automatic consent procedures to change methods of accounting to adopt the proposed regulations early. Last year, the IRS issued Rev. Proc. 2018-60 to provide new procedures for obtaining automatic consent to change methods of accounting to comply with Code Sec. 451(b)(1)(A) and (b)(4).

Rev. Proc. 2019-37 modifies, in part, Rev. Proc. 2018-31, which provides a comprehensive list of automatic-consent accounting method changes. Rev. Proc. 2019-37 modifies Section 16.12 to provide additional automatic changes in method of accounting under Proposed Reg. §§1.451-3 and 1.451-8, expands the audit protection provisions in Section 16.11 related to revenue recognition changes in the first year a taxpayer adopts ASC 606, and add additional automatic changes for taxpayers that change the manner in which amounts are recognized in revenue in an AFS under Section 16.10.

The procedures add three new changes to Section 16.12 for:

- Taxpayers with an AFS to change to a method of accounting that complies with Proposed Reg. §1.451-3. This change includes a change for a specified credit card fee under Proposed Reg. §§1.451-3(i) and 1.1275-2(l), but does not apply to other specified fees defined in Proposed Reg. §1.451-3(i)(2).
- Taxpayers with an AFS to change to the AFS deferral method under Proposed Reg. §1.451-8(c).
- Taxpayers without an AFS to change to the non-AFS deferral method under Proposed Reg. §1.451-8(d). Somewhat similar to Rev. Proc. 2004-34, taxpayers without an AFS may not use the automatic procedures if earned income is determined using the income on a statistical basis.[18]

Rev. Proc. 2019-37 allows taxpayers to implement certain accounting method changes to apply the acceleration rules under either Code Sec. 451(b)(1)(A) or Proposed Reg. §1.451-3 under Section 16.12 of Rev. Proc. 2018-31 with a choice of cut-off basis or with a Code Sec. 481(a) adjustment, provided the taxpayer makes a concurrent method change under Section 16.11 of Rev. Proc. 2018-31 for revenue recognition changes due to the ASC 606. Taxpayers changing to apply the deferral of advance payment rules in Proposed Reg. §1.451-8(c) are also allowed a choice between cut-off or a Code Sec. 481(a) adjustment.

However, the following method changes cannot be implemented on a cut-off basis:

- Method changes by taxpayers with a zero Code Sec. 481(a) adjustment that do not file a Form 3115,
- Method changes to comply with Proposed Reg. §1.451-8(d) by taxpayers without AFS deferral method, and
- Method changes for specified credit cards fees under Proposed Reg. §§1.451-3(i) and 1.1275-2(l). The Code Sec. 481(a) adjustment period is six years for method changes for specified credit cards for the first taxable year beginning after December 31, 2018.

The procedures continue to allow certain small taxpayers and taxpayers with a zero Code Sec. 481(a) adjustment to not file a Form 3115, but such taxpayers do not receive audit protection. The new procedures make the audit protection rules even more generous by allowing audit protection for changes to Proposed Reg. §1.451-3 or Proposed Reg. §1.451-8(c) for taxpayers that do file a Form 3115 and that are under exam at the time of filing. However, unless such taxpayers meet an exception, the Code Sec. 481(a) adjustment is only two years (except for specified credit card changes made in the first year.)

Rev. Proc. 2018-31 has been superseded by Rev. Proc. 2019-43, which now contains all of the above modifications to the procedures in one comprehensive listing, which will make it easier for taxpayers to trace whether their proposed changes in method of accounting are eligible under the automatic procedures.

Final and Newly Proposed Bonus Depreciation Regulations

The IRS has released final and newly proposed regulations that provide guidance to taxpayers regarding the 100 percent bonus depreciation deduction under Code Sec. 168(k), as amended by the TCJA, for qualified depreciable property acquired and placed in service after September 27, 2017.[19] These regulations generally finalize many of the rules from the proposed regulations published on August 8, 2018 (the "2018 proposed regulations"), which we discussed in our column a year ago. However, the IRS did make some changes in the final regulations, and additionally, pulled some proposals out into new, separate proposed regulations (the "2019 proposed regulations") in response to comments and questions.

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The final regulations provide taxpayers with several important new rules and clarifications that are mostly taxpayer favorable. One rule that generated many comments was related to the definition of self-constructed property. The 2018 proposed regulations had made changes to the definition of self-constructed property, as compared to the existing regulations under Reg. §1.168(k)-1(b)(4)(iii), which applies to property acquired before September 27, 2017. In the final regulations, the IRS reversed its position that property that is manufactured, constructed, or produced for the taxpayer by another person is not considered self-constructed property for purposes of determining the acquisition date of the property. The final regulations under Reg. §1.168(k)-2 are now more consistent with the definition in the prior existing regulations, which generally treat the taxpayer as acquiring the property as the manufacture, construction, or production begins.[20] This relieves much of the awkwardness and burden that would have arisen had the property been subject to the written binding contract rules, instead.

The final regulations also clarify and further define "predecessor" for purposes of determining prior use of property. To be qualified property for bonus depreciation, an asset must not have been used by the taxpayer prior to the acquisition. The 2018 proposed regulations define "use" as the taxpayer *or a predecessor* having a depreciable interest in the property. The statute did not contain the word "predecessor." Although the 2018 proposed regulations included "predecessor," the term was not defined. The final regulations provide that a predecessor includes (i) a transferor of an asset to a transferee in a transaction to which Code Sec. 381(a) applies, (ii) a transferor of an asset to a transferee in a transaction in which the transferee's basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the hands of the transferor, (iii) a partnership that is considered as continuing under Code Sec. 708(b)(2), (iv) the decedent in the case of an asset acquired by an estate, or (v) a transferor of an asset to a trust.[21] The final regulations also add a safe harbor look-back period of five calendar years prior to the current taxable year to determine if the asset was used by the taxpayer or a predecessor.[22] The final regulations expand the used property rules to include that if property was used by a taxpayer or predecessor prior to a substantial renovation, then the taxpayer reacquires it after the renovation, the taxpayer will not be treated as having had a depreciable interest in the property.[23] Property is substantially renovated if no more than 20 percent of the total cost of the property is related to used parts.

Although requested by many commentators, the IRS did not provide regulatory relief or guidance regarding the statutory glitch for the treatment of qualified improvement property placed in service after 2017 to be eligible for bonus depreciation. Legislative intent indicated that such property was intended to have a 15-year recovery period, and thus be eligible for bonus depreciation, but due to a technical glitch the statute does not provide the shorter recovery period. The IRS continues to state that a legislative change must be enacted.

The 2019 proposed regulations provide taxpayers with guidance that in many cases was lacking from the prior 2018 proposed regulations, or that is substantially different from the original guidance. For example, the 2019 regulations propose new binding contract rules related to components of larger properties. In a significant change from the 2018 proposed regulations, the 2019 proposed regulations provide an election for components of self-constructed property, similar to the election in Rev. Proc. 2011-26, which allows bonus depreciation on the components acquired after September 27, 2017, related to a property for which the manufacture, construction or production began prior to September 28, 2017. The 2019 proposed regulations also provide that property not acquired pursuant to a written binding contract is generally considered acquired on the date on which the taxpayer pays or incurs more than 10 percent of the total cost of the property (similar to the safe harbor for self-constructed property in the final regulations and the prior existing regulations under Reg. §1.168(k)-1).

The acquisition date rules in the 2018 proposed regulations were not clear on applying the rules to transactions involving the acquisition of substantially all of the assets of a trade or business. The 2019 proposed regulations provide that a contract to acquire all or substantially all of the assets of a trade or business, or to acquire an entity, is binding only if it is enforceable under State law. Additionally, regulatory hurdles and minor terms to be negotiated do not prevent the contract from being binding.

The proposed regulations update and clarify certain rules related to used property and prior use for partnerships, consolidated groups, and a series of related transactions. Taxpayers that hold property for 90 days or less and then dispose of it to an unrelated party are not considered to have a prior depreciable interest if they reacquire that same property at a future point in time. The 2019 proposed regulations also state that a partner is considered to have a depreciable interest in a portion of property equal to the partner's total share of depreciation deductions with

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respect to the property as a percentage of the total depreciation deductions allocated to all partners with respect to that property during the current calendar year and five calendar years immediately prior to the partnership's current year. The IRS has clarified that the rule for a series of related transactions only applies in testing relatedness for the Code Sec. 179 tests, and not in the case of a transaction described under Code Sec. 168(i)(7), relating to step-in-the-shoes rules for nonrecognition transactions such as Code Sec. 721. However, such relatedness is generally disregarded for a party that is neither the original transferor nor ultimate transferee if another special rule applies (for example, if such party acquires and disposes of the property in the same year, or if it never places the property into service).

Finally, the IRS has included industry-specific guidance for taxpayers that are regulated public utilities or that have had floor plan financing.

Not all of the rules that are proposed will be welcomed by taxpayers that were looking to Treasury for more favorable guidance and flexibility. For example, many commentators were hoping for more and different guidance with respect to certain partnership issues. The 2018 proposed regulations provided that many partnership basis adjustments, such as Code Sec. 734(b) adjustments, were ineligible for bonus depreciation, because the adjustment is made to the partnership's basis in property that the partnership has previously used. Treasury declined to change many of those provisions. However, the final regulations clarified that a partnership is permitted to claim the bonus depreciation deduction with respect to the portion of the Code Sec. 743(b) basis increase that is attributable to Code Sec. 704(c) built-in gain, even if the partnership is using the remedial allocation method with respect to the property.[24] Thus, if a partnership qualifies to apply the exception, the final regulations provide that the entire Code Sec. 743(b) basis increase is eligible for the additional first-year depreciation. However, there is an exception in the case of publicly traded partnerships. Additionally, the final regulations clarify the special partnership rule for Rev. Rul. 99-5, Situation 1 transactions to deem the contributing partner to place the property in service prior to contribution.[25] Under the language in the 2018 proposed regulations, it was unclear whether the depreciation allocated to the contributing partner could actually be taken, because it was not clear that the contributing partner had placed the property in service. The new language in the final regulation deems the property to be placed in service.

Taxpayers must apply the final regulations to taxable years ending on or after September 24, 2019. Alternatively, taxpayers may choose to apply the final regulations in their entirety, or the originally proposed regulations in their entirety, to qualified property acquired and placed in service after September 27, 2017, during taxable years ending on or after September 28, 2017, and before September 24, 2019.

Taxpayers may rely on the newly proposed regulations, pending the issuance of final regulations, for qualified property acquired and placed in service after September 27, 2017, for taxable years ending on or after September 28, 2017, and ending before the taxable year that includes the date on which the final regulations are published in the Federal Register.

Additionally, taxpayers may choose to rely on the newly proposed regulations, in their entirety, for qualified property acquired and placed in service after September 27, 2017, during taxable years ending on or after September 28, 2017. Taxpayers may also apply the newly proposed regulations, in their entirety, to components acquired or self-constructed after September 27, 2017, of larger self-constructed property for which the manufacture, construction, or production begins before September 28, 2017.

Conclusion

The revenue recognition guidance package provides needed clarification in many areas as well as opportunities for audit protection. Passthrough entities should consider the interaction between the proposed regulations and the tax implications of adopting ASC Topic 606, as accounting for the differences can become quite burdensome, particularly if the taxpayer no longer maintains books and records necessary for Federal income tax because financial statement reporting no longer requires it.

Taxpayers may generally apply the revenue recognition proposed regulations to taxable years beginning after December 31, 2017. Taxpayers implementing the proposed regulations cannot selectively apply the rules. However, implementation of the new statute under Code Sec. 451(b) is not elective in the meantime. The effective dates of the bonus depreciation rules are much more complex, but similarly allow taxpayers to rely on the 2019 proposed regulations. Many of the bonus depreciation changes may provide for more favorable treatment for property that would have been considered acquired prior to September 28, 2017, under the 2018 proposed regulations, but are not under the final regulations. Because not all aspects of the proposed regulations are taxpayer-favorable, taxpayers must weigh the benefits, including more favorable audit protection against the unfavorable or unclear rules.

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ENDNOTES

1. All references to "TJCA" are to the Act known as the "Tax Cuts and Jobs Act" until final passage, for which the official title as enacted on December 22, 2017, is "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018" (P.L. 115-97).
2. Notice of Proposed Rulemaking, REG-104870-18, 84 FR 47191, September 9, 2019.
3. *See* Code Sec. 451(b)(1)(A)(i) or (ii) for definition of AFS, which generally include audited financial statements.
4. For income from a debt instrument having OID, the rules of Code Sec. 451(b) apply to taxable years beginning after December 31, 2018, and the Code Sec. 481(a) adjustment is spread over six taxable years for a qualified change in method of accounting.
5. *See* the "General Explanation of Public Law 115–97," drafted by the Joint Committee on Taxation (December 2018), at 276, footnote 876. *See also* discussion of credit card fees on pages 274–275.
6. *Id.*, at footnote 872.
7. Proposed Reg. §1.451-3(b).
8. Proposed Reg. §1.451-3(c)(6).
9. Proposed Reg. §1.451-3(m), Examples 4 and 5.
10. Proposed Reg. §1.451-8(d).
11. Proposed Reg. §1.451-8(b)(1)(i)(C).
12. Proposed Reg. §1.451-8(c)(4).
13. Proposed Reg. §1.451-8(c)(2).
14. Proposed Reg. §1.451-8(b)(1)(ii)(H).
15. Proposed Reg. §1.451-8(b)(9).
16. Proposed Reg. §1.451-8(c)(8). *See* Examples 20–24.
17. Proposed Reg. §1.451-8(b).
18. *See also* Rev. Proc. 2019-43, which further modified Section 16.12.
19. T.D. 9874 and Notice of Proposed Rulemaking, REG-106808-19, 84 FR 50152, September 24, 2019.
20. Reg. §1.168(k)-2(b)(5)(ii)(A) and (b)(5)(iv).
21. Reg. §1.168(k)-2(a)(2)(iv).
22. Reg. §1.168(k)-2(b)(3)(iii)(B).
23. *Id.*
24. Proposed Reg. §1.168(k)-2(g)(1).
25. *Id.*

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