

¶580 Special Rules for Accrual-Method Taxpayers on Deferral of Advance Payments and Including Amounts in Income Based on Financial Accounting Treatment

NEW LAW EXPLAINED

Special rules added on time for including amounts in income.—Two special rules have been added on the proper time for including amounts in income by accrual-method taxpayers. Under the first rule, amounts are generally included in income no later than when the amounts are included for financial accounting purposes (Code Sec. 451(b), as added by the Tax Cuts and Jobs Act). The second rule allows taxpayers to elect to defer including certain advance payments in income until the tax year after the tax year in which the payments were received, subject to limitations (Code Sec. 451(c), as added by the 2017 Tax Cuts Act). These income recognition rules generally apply to tax years beginning after December 31, 2017 (Act Sec. 13221(c) of the 2017 Tax Cuts Act). However, in the case of income from a debt instrument having original issue discount (OID), the rules apply to tax years beginning after December 31, 2018 (Act Sec. 13221(e)(1) of the 2017 Tax Cuts Act).

Amounts included in income based on financial accounting treatment. For an accrual-method taxpayer, the all-events test is met with respect to 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 (Code Sec. 451(b)(1)(C), as added by the 2017 Tax Cuts Act). However, the all-events test with respect to any item of gross income or portion of such item cannot be treated as met any later than when the item of gross income or portion of such item is taken into account in revenue in the taxpayer's applicable financial statement or other financial statement specified by the IRS (Code Sec. 451(b)(1)(A), as added by the 2017 Tax Cuts Act).

Applicable financial statement. A taxpayer's applicable financial statement is:

- 1) a financial statement that is certified as being prepared according to generally accepted accounting principles and is:
 - a) a 10-K or Annual Statement to Shareholders that is required to be filed with the U.S. Securities and Exchange Commission (SEC),
 - b) if there is no statement described in (a), an audited financial statement that is used for credit purposes, reporting to shareholders, partners, or other proprietors, or to beneficiaries, or any other substantial non-tax purpose, or
 - c) if there is no statement described in (a) or (b), a financial statement filed with any federal agency for purposes other than federal tax purposes;
- 2) if there is no statement described in (1), above, a financial statement that is made on the basis of international financial reporting standards and is filed with a foreign government agency that is equivalent to the SEC and which has reporting standards that are not less stringent than the SEC standards; or
- 3) if there is no statement described in (1) or (2), above, a financial statement filed with any other regulatory or governmental body specified by the IRS (Code Sec. 451(b)(3), as added by the 2017 Tax Cuts Act).

If the financial results of a taxpayer are reported on the applicable financial statement for a group of entities, the statement is treated as the applicable financial statement of the taxpayer (Code Sec. 451(b)(5), as added by the 2017 Tax Cuts Act).

Allocation of transaction price. In the case of a contract that 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 applicable financial statement (Code Sec. 451(b)(4), as added by the 2017 Tax Cuts Act).

Exceptions to financial statement rule. The rule for including amounts in income no later than they are included for financial accounting purposes does not apply to a taxpayer that does not have an applicable financial statement or other financial statement specified by the IRS. In addition, the rule does not apply to any item of gross income in connection with a mortgage servicing contract (Code Sec. 451(b)(1)(B), as added by the 2017 Tax Cuts Act). Income from mortgage servicing rights should continue to be recognized under the current rules where: (1) "normal" mortgage servicing rights are included in income upon the earlier of earned or received under the all-events test and not averaged over the life of the mortgage, and (2) "excess" mortgage servicing rights are treated as stripped coupons and subject to the original issue discount (OID) rules (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

The rule for including amounts in income no later than they are included for financial accounting purposes also does not apply with respect to any item of gross income for which the taxpayer uses a special method of accounting provided under the income tax provisions of the Internal Revenue Code, other than the rules for bonds and debt instruments in Code Secs. 1271-1288 (Code Sec. 451(b)(2), as added by the 2017 Tax Cuts Act). Thus, accrual-method taxpayers apply the applicable financial statement rule before applying the special rules in Code Secs. 1271-1288, which cover the original issue discount (OID) rules and also rules on the treatment of market discount on bonds, discounts on short-term obligations, OID on tax-exempt bonds, and stripped bonds and stripped coupons (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Accrual-method taxpayers allowed to defer including advance payments in income. Generally, for tax years beginning after December 31, 2017, an accrual-method taxpayer who receives an advance payment during the tax year must either:

- 1) include the advance payment in gross income for the tax year of receipt; or
- 2) make an election to defer the inclusion of the advance payment in gross income with respect to the category of advance payments to which the advance payment belongs (Code Sec. 451(c)(1), as added by the 2017 Tax Cuts Act).

Under the deferral election, any portion of the advance payment that is required to be included in gross income under the financial statement rule described above would be included in gross income in the tax year in which it is received and the remaining portion of the advance payment would be included in gross income in the tax year following the tax year in which it is received (Code Sec. 451(c)(1)(B), as added by the 2017 Tax Cuts Act). 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 (Code Sec. 451(c)(4)(C), as added by the 2017 Tax Cuts Act).

COMMENT

The new rule for deferring advance payments from income essentially codifies IRS guidance in Rev. Proc. 2004-34 on deferral of advance payments with some modifications.

Advance payment defined. An advance payment is any payment:

- 1) the full inclusion of which in the taxpayer's gross income for the tax year of receipt is a permissible method of accounting without regard to this advance payment rule;
- 2) any portion of which is included in revenue by the taxpayer in a 10-K or Annual Statement to Shareholders that is required to be filed with the U.S. Securities and Exchange Commission (SEC) or an audited financial statement that is used for credit purposes, reporting to shareholders, partners, or other proprietors, or to beneficiaries, or any other substantial non-tax purpose, for a subsequent tax year; and
- 3) which is for goods, services, or such items as may be identified by the IRS (Code Sec. 451(c)(4)(A), as added by the 2017 Tax Cuts Act).

An advance payment does not include:

- 1) rent;
- 2) insurance premiums governed by subchapter L (Insurance Companies);
- 3) payments with respect to financial instruments;
- 4) payments with respect to warranty or guarantee contracts under which a third party is the primary obligor;
- 5) payments subject to Code Sec. 871(a) or Code Sec. 881 (tax on certain amounts received from U.S. sources by a nonresident alien or foreign corporation) or Code Sec. 1441 or Code Sec. 1442 (payments subject to the withholding rules for nonresident aliens or foreign corporations);
- 6) payments to which Code Sec. 83 applies (property transferred in connection with the performance of services); and
- 7) any other payment identified by the IRS for this purpose (Code Sec. 451(c)(4)(B), as added by the 2017 Tax Cuts Act).

For purposes of the advance payment rules, rules similar to the allocation of transaction price rules of Code Sec. 451(b)(4), above, apply (Code Sec. 451(c)(4)(D), as added by the 2017 Tax Cuts Act). Thus, if advance payments are received for a combination of services, goods, or other specified items, the taxpayer should allocate the transaction price according to the allocation made in the taxpayer's applicable financial statement (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

Unless otherwise provided by the IRS, the deferral election for advance payments will not apply to advance payments received by a taxpayer during a tax year if the taxpayer ceases to exist during or with the close of such tax year (Code Sec. 451(c)(3), as added by the 2017 Tax Cuts Act). Thus, any deferred advance payment must be included in gross income if the taxpayer ceases to exist (Conference Report on H.R. 1, Tax Cuts and Jobs Act (H. Rept. 115-466)).

How to elect to defer inclusion of advance payments in income. The IRS is instructed to provide details on making the election to defer the inclusion of advance payments in income. This includes the time, form and manner, and the categories of advance payments. The election will be effective for the tax year with respect to which it is first made and for all subsequent tax years, unless the taxpayer obtains the IRS's consent to revoke the election (Code Sec. 451(c)(2), as added by the 2017 Tax Cuts Act).

Change of accounting method. The computation of taxable income under the deferral election for advance payments is treated as a method of accounting (Code Sec. 451(c)(2)(B), as added by the 2017 Tax Cuts Act). In the case of any qualified change of accounting method for the taxpayer's first tax year beginning after December 31, 2017, the change is treated as initiated by the taxpayer and made with the IRS's consent. A qualified change of accounting method is any change of accounting method that is required by the new income recognition rules or was prohibited and is now permitted under the new rules (Act Sec. 13221(d) of the 2017 Tax Cuts Act). For a qualified change of accounting method involving income from a debt instrument with original issue discount (OID), taxpayers should use a six-year period for taking into account any required Code Sec. 481 adjustments (Act Sec. 13221(e)(2) of the 2017 Tax Cuts Act).

Effective date. The amendments made by this provision generally apply to tax years beginning after December 31, 2017 (Act Sec. 13221(c) of the Tax Cuts and Jobs Act). In the case of income from a debt instrument having original issue discount (OID), the amendments made by this provision apply to tax years beginning after December 31, 2018 (Act Sec. 13221(e)(1) of the 2017 Tax Cuts Act).