

Overview of Modifications to Income Recognition under Section 451 by Public Law 115-97



**Prepared by the Staff of the Joint Committee on Taxation
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Overview

- Public Law 115-97 made two changes to the income recognition rules for accrual method taxpayers:
 - New section 451(b) –
 - Modifies the all events test to provide that sales, gross receipts, and other items are included in income no later than the taxable year in which such income is included as revenue for book purposes
 - Overrides certain special rules for bonds and other debt instruments and provides that such items are instead subject to the all events test (as modified)
 - New section 451(c) – Advance payments may only be deferred using the one-year deferral method
- Effective for taxable years beginning after December 31, 2017
 - However, in the case of income from a debt instrument with original issue discount (“OID”), the changes are effective for taxable years beginning after December 31, 2018

Background

- ❑ Determining whether gross income is subject to tax generally is a two step process
- ❑ Step 1: Section 61 (realization)
 - Does the taxpayer have gross income (e.g., has the taxpayer entered into a transaction)?
 - Gross income generally includes all items that are clearly realized accessions to wealth in any form
- ❑ Step 2: Section 451 (recognition)
 - When should the taxpayer recognize such gross income?
 - Generally determined under the taxpayer's overall method of accounting:
 - Cash method
 - Accrual method

Background: Realization

- Gross income generally includes all items that are clearly realized accessions to wealth in any form
 - Generally a factual determination
 - To have a “clearly realized accession to wealth” generally requires that there be a transaction involving the taxpayer
- For certain situations, the Code prescribes the time at which realization is deemed to occur
 - For example, taxpayers that mark to market securities are deemed to have sold such securities on the last day of the tax year and must include in taxable income the resulting deemed gain or loss

Background: Gross Income for Businesses Involving the Sale of Property

- For businesses involving the sale of property, gross income for the taxable year generally is equal to total sales less the cost of goods sold
 - Total sales: Amount determined under taxpayer's method of accounting for sales and/or gross receipts (*i.e.*, section 451)
 - Cost of goods sold: Amount determined under taxpayer's method of accounting for:
 - Liabilities to provide property to others under the economic performance rules of section 461(h)
 - Inventory under sections 471 and 472
 - Direct and indirect costs incurred to produce and/or acquire the property under the uniform capitalization rules under section 263A

Background: Cash Method

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- ❑ Taxpayer generally recognizes items of income when actually or constructively received
- ❑ Public Law 115-97 expanded the universe of taxpayers eligible to use the cash method to include:
 - Businesses (excluding tax shelters) with average annual gross receipts that do not exceed \$25 million (over the prior three taxable years)
 - Businesses with average annual gross receipts in excess of \$25 million (over the prior three taxable years) that are not required to maintain inventories and that are:
 - Qualified personal service corporations
 - S corporations
 - Partnerships that do not have a C corporation partner
 - Sole proprietorships
 - Farming businesses that are not a C corporation (or that do not have a C corporation partner)
- ❑ All other businesses generally are required to use an accrual method

Background: Accrual Method

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- ❑ Taxpayer generally recognizes items of income when all the events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy (the “all events test”)
- ❑ Taxpayers generally have a fixed right to receive income upon the earlier of when an amount is:
 - Due
 - Paid
 - Earned
- ❑ For services, when an amount may be considered earned depends on the type of services provided:
 - Severable services: as each separate portion of the services is provided
 - Severable services generally are those performed on a regular basis over a period of time and for which performance may be considered partially complete upon the completion of interim tasks, deliverables, or milestones (for example, periodic cleaning or janitorial services provided at regular intervals)
 - Non-severable services: when all services have been provided
 - Non-severable services generally are those which cannot be separated into components and are performed as a single task to meet the needs of the customer (for example, certain construction services)
- ❑ Special methods of accounting that provide an exception to the all events test may apply (for example, long-term contracts subject to section 460)

Background: Accrual Method

- ❑ Taxpayer receiving an advance payment for goods or services generally includes such payment in income in the year of receipt under the all events test
- ❑ However, prior to Public Law 115-97, the taxpayer could elect to apply special deferral rules:
 - One-year deferral
 - Deferral may not exceed the income deferred for book purposes
 - Rev. Proc. 2004-34
 - Two-year deferral
 - Only applicable to substantial advance payments for inventorable goods
 - Treas. Reg. sec. 1.451-5(c)
 - Multiyear deferral
 - Only applicable to an advance payment for goods
 - Treas. Reg. sec. 1.451-5(b)(1)(ii)

Background: Changes to Book Accounting

- For reporting periods beginning after December 15, 2017, the generally accepted accounting principles (“GAAP”) for revenue recognition also changed
 - Effective for reporting periods beginning after December 15, 2018, for nonpublic companies
 - Published in Accounting Standards Update No. 2014-09 and codified in Accounting Standards Codification (“ASC”) 606, *Revenue Recognition*
- Specifically, the changes affect the GAAP rules for determining:
 - The amount of revenue to which a company expects to be entitled (*i.e.*, realization)
 - The timing of when such amount is included in revenue in the company’s financial statements (*i.e.*, recognition)
- The revised GAAP rules generally result in the acceleration of revenue related to long-term arrangements and contingent future events

Overview

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- Public Law 115-97 made two changes to the income recognition rules for accrual method taxpayers:
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 - Modifies the all events test to provide that sales, gross receipts, and other items are included in income no later than the taxable year in which such income is included as revenue for book purposes
 - Overrides certain special rules for bonds and other debt instruments and provides that such items are instead subject to the all events test (as modified)
 - New section 451(c) – Advance payments may only be deferred using the one-year deferral method
- Public Law 115-97 did not change:
 - Tax realization principles under section 61
 - Income recognition rules for:
 - Cash method taxpayers
 - Accrual method taxpayers that do not have an applicable financial statement

Scope

- Section 451(b) and (c) are only applicable to taxpayers that:
 - Are required to use an accrual method, and
 - Have an applicable financial statement (“AFS”)
- An AFS generally includes (in order of priority):
 - Audited annual financial statement filed with the Securities and Exchange Commission (“SEC”)
 - Audited financial statement used for
 - Credit purposes
 - Reporting to shareholders, partners, beneficiaries, or other proprietors, or to beneficiaries
 - Any other substantial nontax purpose
 - Audited financial statement filed with any other Federal agency for nontax purposes (but only if none of the above statements exist)
 - Financial statement prepared using international accounting standards and filed with a foreign agency similar to the SEC with similar reporting requirements
 - Financial statement filed with any other regulatory or governmental body specified by the Secretary of the Treasury (but only if none of the above statements exist)

Deferral of Advance Payments

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- ❑ Taxpayers may defer including all or a portion of an advance payment for goods or services in income until the following tax year if such amount is also deferred for book purposes
- ❑ Generally codifies the one-year deferral method previously provided in Rev. Proc. 2004-34 for advance payments for goods and services
 - Treasury may issue guidance applying section 451(c) to advance payments for other items as well
 - However, the statute prescribes a list of items for which a one-year deferral is not available (see appendix for the list)
- ❑ Repeals the two-year and multiyear deferral methods

Deferral of Advance Payments: Example

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- ❑ Taxpayer agrees to manufacture 500 widgets at a price of \$10 each for a customer
- ❑ Taxpayer receives a prepayment of \$5,000 in Year 1
- ❑ Taxpayer manufactures the widgets during Year 2 and Year 3
- ❑ Taxpayer delivers all 500 widgets to the customer in Year 3
- ❑ Taxpayer's financial statements include the \$5,000 in revenue during Year 3

Deferral of Advance Payments: Example (cont'd)

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- Under the all events test (absent a special rule allowing deferral): Taxpayer recognizes \$5,000 in income in Year 1 (*i.e.*, in the year of receipt)
- Under the prior-law rules for advance payments, Taxpayer could select from two potential methods:
 - Rev. Proc. 2004-34 (one-year deferral method): Taxpayer recognizes \$5,000 in income in Year 2 (*i.e.*, in the year following receipt of the advance payment), or
 - Treas. Reg. sec. 1.451-5(c) (two-year deferral method): Taxpayer recognizes \$5,000 in income in Year 3 (*i.e.*, in the year included in revenue for book purposes)
- Under new section 451(c) (one-year deferral method): Taxpayer recognizes \$5,000 in income in Year 2 (*i.e.*, in the year following receipt of the advance payment)

Modification of the All Events Test

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- ❑ Taxpayers must include sales, gross receipts, and other items in gross income no later than the taxable year in which such income is included in revenue for book purposes
- ❑ Generally amends the all events test to include a fourth prong such that income is recognized upon the earlier of when the amount is:
 - Due
 - Paid
 - Earned
 - Included in revenue in the taxpayer's financial statement

Modification of the All Events Test: Example (Severable Services)

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- ❑ Taxpayer enters into a one-year contract to provide cleaning services twice per month for \$100 per cleaning service
- ❑ Taxpayer invoices the customer and receives payment of \$200 after the end of each month
- ❑ Taxpayer provides cleaning services 10 times during Year 1 and 14 times during Year 2
- ❑ Taxpayer receives payment of \$800 in Year 1 and \$1,600 in Year 2
- ❑ Taxpayer includes in revenue in its financial statement \$1,000 in Year 1 and \$1,400 in Year 2

Modification of the All Events Test: Example (Severable Services - continued)

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- Under the prior-law all events test:
 - Taxpayer recognizes income upon the earlier of:
 - Due (*i.e.*, after the end of each month in which cleaning services are provided)
 - Paid (*i.e.*, after the end of each month in which cleaning services are provided)
 - Earned (*i.e.*, each time cleaning services are provided)
 - Year 1: Taxpayer recognizes \$1,000 in income (10 cleaning services times \$100 per service) as the income is earned each time cleaning services are provided
 - Year 2: Taxpayer recognizes \$1,400 in income (14 cleaning services times \$100 per service) as the income is earned each time cleaning services are provided

Modification of the All Events Test: Example (Severable Services - continued)

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- Under the modified all events test:
 - Taxpayer recognizes income upon the earlier of:
 - Due (*i.e.*, after the end of each month in which cleaning services are provided)
 - Paid (*i.e.*, after the end of each month in which cleaning services are provided)
 - Earned (*i.e.*, each time cleaning services are provided)
 - Included in revenue in the taxpayer's financial statement (*i.e.*, each time cleaning services are provided)
 - Year 1: Taxpayer recognizes \$1,000 in income (10 cleaning services times \$100 per service) as the income is earned each time cleaning services are provided
 - Year 2: Taxpayer recognizes \$1,400 in income (14 cleaning services times \$100 per service) as the income is earned each time cleaning services are provided
- Taxpayer's income recognition timing is not affected by new section 451(b)

Modification of the All Events Test: Example (Non-Severable Services)

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- ❑ Taxpayer provides construction services for \$100,000
- ❑ Taxpayer begins providing the construction services in Year 1 and the work is completed in Year 2
- ❑ Taxpayer is entitled to bill and collects from the customer \$50,000 in Year 1 when construction begins and \$50,000 in Year 2 when construction is complete
- ❑ Taxpayer includes in revenue in its financial statement \$60,000 in Year 1 and \$40,000 in Year 2

Modification of the All Events Test: Example (Non-Severable Services - continued)

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- Under the prior-law all events test:
 - Taxpayer recognizes income for Year 1 upon the earlier of:
 - Due (*i.e.*, when construction begins)
 - Paid (*i.e.*, upon receipt of the first payment)
 - Earned (*i.e.*, when the construction services are complete)
 - Year 1: Taxpayer recognizes \$50,000 in income (the amount due in Year 1) upon receipt of the first payment
 - Year 2: Taxpayer recognizes the remaining \$50,000 in income (the amount not previously recognized in Year 1) when the construction services are complete

Modification of the All Events Test: Example (Non-Severable Services - continued)

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- Under the modified all events test:
 - Taxpayer recognizes income for Year 1 upon the earlier of:
 - Due (*i.e.*, when construction begins)
 - Paid (*i.e.*, upon receipt of the first payment)
 - Earned (*i.e.*, when the construction services are complete)
 - Included in revenue in the taxpayer's financial statement (*i.e.*, based on the amount of construction services performed to date)
 - Year 1: Taxpayer recognizes \$60,000 in income (the amount included in revenue in the Taxpayer's financial statements in Year 1)
 - Year 2: Taxpayer recognizes \$40,000 in income (the amount not previously recognized in Year 1) when the construction services are complete
- Taxpayer's income recognition timing is accelerated by new section 451(b)

Interaction with Debt Instrument Rules

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- Taxpayers must include certain income items related to bonds and other debt instruments in gross income under the all events test (as modified)
 - Generally results in the taxpayer including such items in income upfront (when the income is also recognized in the financial statements) rather than including the items in income over time
- Affected income items include:
 - Original issue discount (section 1272)
 - Market discount that is taken into account as income as it ratably accrues (section 1278(b))
 - Stripped bonds (section 1286)
- Common examples of affected items include various fees associated with credit cards, such as late-payment fees, cash-advance fees, and interchange fees

Additional Resources

- ❑ Joint Committee on Taxation, *General Explanation of Public Law 115-97 (JCS-1-18)*, December 2018, pp. 148-171.
- ❑ [Notice 2018-35](#) (allows taxpayers to continue to rely on Rev. Proc. 2004-34 until guidance under new section 451(c) is published)
- ❑ [Notice 2018-80](#) (announcement of intent to issue proposed regulation that provides that accrued market discount is not subject to new section 451(b))
- ❑ [Rev. Proc. 2018-60](#) (provides automatic consent procedures for taxpayers changing their method of accounting to comply with new section 451(b))
- ❑ [REG-104872-18](#) (proposed regulation to repeal the two-year deferral and multiyear deferral methods previously provided for advance payments in Treas. Reg. sec. 1.451-5)

Appendix

- ❑ Advance payments for the following items are excluded from the one-year deferral method:
 - Rent
 - Insurance premiums governed by Subchapter L
 - Payments with respect to financial instruments
 - Payments with respect to warranty or guarantee contracts under which a third party is the primary obligor
 - Payments subject to sections 871(a), 881, 1441, or 1442
 - Payments in property to which section 83 applies
 - Any other payment identified by the Secretary of the Treasury
- ❑ This is consistent with the items previously excluded from the one-year deferral method under Rev. Proc. 2004-34