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Recent Developments in Federal Income Taxation

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I. ACCOUNTING

A. Year of Inclusion or Deduction

1. Accrual-method taxpayers may have to recognize income sooner as a result of legislative changes. The [2017 Tax Cuts and Jobs Act](#), § 13221, amended Code § 451 to make two changes that affect the recognition of income and the treatment of advance payments by accrual method taxpayers. Both changes apply to taxable years beginning after 2017. Any change in method of accounting required by these amendments for taxable years beginning after 2017 is treated as initiated by the taxpayer and made with the consent of the IRS.

All events test linked to revenue recognition on certain financial statements. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(b). New § 451(b) provides that, for accrual-method taxpayers, “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” either (1) an applicable financial statement, or (2) another financial statement specified by the IRS. Thus, taxpayers subject to this rule must include an item in income for tax purposes upon the earlier of satisfaction of the all events test or recognition of the revenue in an applicable financial statement (or other specified financial statement). According to the Conference Report that accompanied the legislation, this means, for example, that any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes. Income from mortgage servicing contracts is not subject to the new rule. The new rule also does not apply to a taxpayer that does not have either an applicable financial statement or another specified financial statement. An “*applicable financial statement*” is defined as (1) a financial statement that is certified as being prepared in accordance with generally accepted accounting principles that is (a) a 10-K or annual statement to shareholders required to be filed with the Securities and Exchange Commission, (b) an audited financial statement used for credit purposes, reporting to shareholders, partners, other proprietors, or beneficiaries, or for any other substantial nontax purpose, or (c) filed with any other federal agency for purposes other than federal tax purposes; (2) certain financial statements made on the basis of international financial reporting standards and filed with certain agencies of a foreign government; or (3) a financial statement filed with any other regulatory or governmental body specified by IRS.

Advance payments for goods or services. The legislation amended Code § 451 by redesignating § 451(b) through (i) as § 451(d) through (k) and adding a new § 451(c). This provision essentially codifies the deferral method of accounting for advance payments reflected in Rev. Proc. 2004-34, 2004-22 I.R.B. 991. New § 451(c) provides that an accrual-method taxpayer who receives an advance payment can either (1) include the payment in gross income in the year of receipt, or (2) elect to defer the category of advance payments to which such advance payment belongs. If a taxpayer makes the deferral election, then the taxpayer must include in gross income any portion of the advance payment required to be included by the applicable financial statement rule described above and include the balance of the payment in gross income in the taxable year following the year of receipt. An advance payment is any payment: (1) the full inclusion of which in gross income for the taxable year of receipt is a permissible method of accounting (determined without regard to this new rule), (2) any portion of which is included in revenue by the taxpayer for a subsequent taxable year in an applicable financial statement (as previously defined) or other financial statement specified by the IRS, and (3) which is for goods, services, or such other items as the IRS may identify. The term “advance payment” does *not* include several categories of items, including rent, insurance premiums, and payments with respect to financial instruments.

a. Guidance on accounting method changes relating to new § 451(b). [Rev. Proc. 2018-60](#), 2018-51 I.R.B. 1045 (11/29/18). [Rev. Proc. 2018-60](#) modifies [Rev. Proc. 2018-31](#), 2018-22 I.R.B. 637, to provide procedures under § 446 and Reg. § 1.446-1(e) for obtaining automatic consent with respect to accounting method changes that comply with § 451(b), as amended by [2017 Tax Cuts and Jobs Act](#), § 13221. In addition, [Rev. Proc. 2018-60](#) provides that for the first taxable year beginning after December 31, 2017, certain taxpayers are permitted to make a method change to comply with § 451(b) without filing a Form 3115, Application for Change in Accounting Method.

b. Proposed regulations issued on requirement of § 451(b)(1) that an accrual method taxpayer with an applicable financial statement treat the all events test as satisfied no

later than the year in which it recognizes the revenue in an applicable financial statement. [REG-104870-18, Taxable Year of Income Inclusion Under an Accrual Method of Accounting](#), 84 F.R. 47191 (9/9/19). The Treasury Department and the IRS have issued proposed regulations regarding the requirement of § 451(b)(1), as amended by the 2017 Tax Cuts and Jobs Act, that accrual method taxpayers with an applicable financial statement must treat the all events test with respect to an item of gross income (or portion thereof) as met no later than when the item (or portion thereof) is taken into account as revenue in either an applicable financial statement (AFS) or another financial statement specified by the IRS (AFS income inclusion rule). New Prop. Reg. § 1.451-3 clarifies how the AFS income inclusion rule applies to accrual method taxpayers with an AFS. Under Prop. Reg. § 1.451-3(d)(1), the AFS income inclusion rule applies only to taxpayers that have one or more AFS's covering the entire taxable year. In addition, the proposed regulations provide that the AFS income inclusion rule applies on a year-by-year basis and, therefore, an accrual method taxpayer with an AFS in one taxable year that does not have an AFS in another taxable year must apply the AFS income inclusion rule in the taxable year that it has an AFS, and does not apply the rule in the taxable year in which it does not have an AFS. The proposed regulations clarify that the AFS income inclusion rule does not change the applicability of any exclusion provision, or the treatment of non-recognition transactions, in the Code, regulations, or other published guidance. Generally, the proposed regulations (1) clarify how the AFS inclusion rule applies to multi-year contracts; (2) describe and clarify the definition of an AFS for a group of entities; (3) define the meaning of the term "revenue" in an AFS; (4) define a transaction price and clarify how that price is to be allocated to separate performance obligations in a contract with multiple obligations; and (5) describe and clarify rules for transactions involving certain debt instruments. The regulations are proposed to apply generally to taxable years beginning on or after the date final regulations are published in the Federal Register. Because the tax treatment of certain fees (such as certain credit card fees), referred to as "specified fees," is unclear, there is a one-year delayed effective date for Prop. Reg. § 1.451-3(i)(2), which applies to specified fees. Until final regulations are published, taxpayers can rely on the proposed regulations (other than the proposed regulations relating to specified fees) for taxable years beginning after December 31, 2017, provided that they: (1) apply all the applicable rules contained in the proposed regulations (other than those applicable to specified fees), and (2) consistently apply the proposed regulations to all items of income during the taxable year (other than specified fees). Taxpayers can similarly rely, subject to the same conditions, on the proposed regulations with respect to specified credit card fees for taxable years beginning after December 31, 2018.

c. Proposed regulations issued on advance payments for goods or services received by accrual method taxpayers with or without an applicable financial statement. [REG-104554-18, Advance Payments for Goods, Services, and Other Items](#), 84 F.R. 47175 (9/9/19). The Treasury Department and the IRS have issued proposed regulations regarding accrual method taxpayers with or without an applicable financial statement (AFS) receiving advance payments for goods or services. The proposed regulations generally provide that an accrual method taxpayer with an AFS includes an advance payment in gross income in the taxable year of receipt unless the taxpayer uses the deferral method in § 451(c)(1)(B) and Prop. Reg. § 1.451-8(c) (AFS deferral method). A taxpayer can use the AFS deferral method only if the taxpayer has an AFS, as defined in § 451(b)(1)(A)(i) or (ii). The term AFS is further defined in Prop. Reg. § 1.451-3(c)(1), issued on the same day as these proposed regulations. Under the AFS deferral method, a taxpayer with an AFS that receives an advance payment must include: (i) the advance payment in income in the taxable year of receipt, to the extent that it is included in revenue in its AFS, and (ii) the remaining amount of the advance payment in income in the next taxable year. The AFS deferral method closely follows the deferral method of Rev. Proc. 2004-34 (as modified by Rev. Proc. 2011-14, 2011-4 I.R.B. 330, and as modified and clarified by Revenue Procedure 2011-18, 2011-5 I.R.B. 443, and Rev. Proc. 2013-29, 2013-33 I.R.B. 141). A similar deferral method is provided in § 1.451-8(d) for accrual method taxpayers that do not have an AFS (non-AFS deferral method). Under the non-AFS deferral method, a taxpayer that receives an advanced payment must include (1) the advance payment in income in the taxable year of receipt to the extent that it is earned, and (2) the remaining amount of the advance payment in income in the next taxable year. In Prop. Reg. § 1.451-8(b)(1)(i), the proposed regulations clarify that the definition of advance payment under the AFS and non-AFS deferral methods is consistent with the definition of advance payment in Revenue Procedure 2004-34, which § 451(c) was

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