

Internal Revenue Service, Treasury

§ 1.451-8

see section 1033(e) and the regulations thereunder.

[T.D. 7526, 42 FR 64624, Dec. 27, 1977]

§ 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)(I) through (II) 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 $\frac{1}{4}$ (\$25) of the advance payment in AFS revenue for 2021, $\frac{1}{2}$ (\$50) for 2022, and $\frac{1}{4}$ (\$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 $\frac{1}{4}$ (\$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 $\frac{1}{4}$ (\$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: $\frac{1}{4}$ (\$20) in AFS revenue for 2021; $\frac{1}{2}$ (\$40) in AFS revenue for 2022; and the remaining $\frac{1}{4}$ (\$20) in AFS revenue for 2023. Regarding the \$20 allocable to the customer support payment, P includes $\frac{1}{2}$ (\$10) in AFS revenue for 2021, and the remaining $\frac{1}{2}$ (\$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 $\frac{1}{6}$ (\$80) of the payment as AFS revenue for 2021, and $\frac{5}{6}$ (\$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 $\frac{1}{6}$ (\$80) of the payment in gross income for 2021, and the remaining $\frac{5}{6}$ (\$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 $\frac{1}{12}$ (\$80) of the payment as AFS revenue for 2021, $\frac{1}{2}$ (\$480) of the payment as AFS revenue for 2022, and $\frac{5}{12}$ (\$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 $\frac{1}{12}$ (\$80) of the payment in gross income for 2021, and the remaining $\frac{11}{12}$ (\$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 $\frac{3}{4}$ of the work under the agreement has been completed. B takes into account $\frac{3}{4}$ (\$75) of the payment as AFS revenue for 2021, and $\frac{1}{4}$ (\$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 $\frac{3}{4}$ (\$75) of the payment in gross income for 2021, and the remaining $\frac{1}{4}$ (\$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 $\frac{1}{4}$ (\$25) of the payment as AFS revenue for 2021, $\frac{1}{2}$ (\$50) of the payment as AFS revenue for 2022, and $\frac{1}{4}$ (\$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 $\frac{1}{4}$ (\$25) of the payment in gross income for 2021 and the remaining $\frac{3}{4}$ (\$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 $\frac{1}{3}$ of the payment as AFS revenue for 2021 and the remaining $\frac{2}{3}$ as AFS revenue

for 2022. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, G must include $\frac{1}{3}$ of the payment in gross income for 2021 and the remaining $\frac{2}{3}$ 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 $\frac{1}{12}$ of the payment as AFS revenue for 2021 and $\frac{11}{12}$ 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 $\frac{1}{12}$ of the payment in gross income for 2021, and the remaining $\frac{11}{12}$ 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 $\frac{1}{4}$ (\$25x) of the first installment payment as AFS revenue for 2021 and $\frac{3}{4}$ (\$75x) as AFS revenue for 2022. K takes

into account $\frac{1}{4}$ (\$25x) of the second payment as AFS revenue for 2022 and $\frac{3}{4}$ (\$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 $\frac{1}{4}$ (\$25x) of the first \$100x installment payment in gross income for 2021 and $\frac{3}{4}$ (\$75x) of the first installment payment in gross income for 2022. In addition, K must include $\frac{1}{4}$ (\$25x) of the second \$100x payment in gross income for 2022 and $\frac{3}{4}$ (\$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 sec-

ond 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 $\frac{1}{4}$ (\$25) of the payment as AFS revenue for 2021, $\frac{1}{2}$ (\$50) as AFS revenue for 2022, and the remaining $\frac{1}{4}$ (\$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 $\frac{1}{4}$ (\$25) of the payment in gross income for 2021 and $\frac{3}{4}$ (\$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 in-

cludes 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 ex-

tent 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 ($1,000 \times \$10 = \$10,000$). 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 determine 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 sim-

plified 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 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.

(ii) *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).

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