the remaining portion of the advance payment in gross income in the next succeeding taxable year.

(ii) *When payment is earned.* 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 (b)(5) 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, the taxpayer may determine that amount:

(A) On a statistical basis if adequate data are available to the taxpayer;

(B) On a straight line ratable basis over the term of the agreement if the taxpayer receives advance payments under a fixed term agreement and if it is not unreasonable 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) By the use of any other basis that in the opinion of the Commissioner results in a clear reflection of income.

(5) *Contracts with multiple obligations*—(i) *In general.* If a taxpayer receives a payment that is attributable to more than one item described in paragraph (b)(1)(i)(C) of this section, the taxpayer must allocate the payment to such items in a manner that is based on objective criteria.

(ii) *Objective criteria.* A taxpayer's allocation method with respect to a payment described in paragraph (d)(5)(i) of this section is based on objective criteria if the allocation method is based on payments the taxpayer regularly 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).

(6) *Acceleration of advance payments.* For purposes of this paragraph (d), the acceleration rules provided in paragraph (c)(2) of this section apply to a taxpayer that uses the non-AFS deferral method.

(7) *Advance payments in certain acquisitions and other financial statement adjustments.* For purposes of this paragraph (d), the rules provided in paragraph (c)(3) of this section apply to a taxpayer that uses the non-AFS deferral method.

(8) *Short taxable year rule.* For purposes of this paragraph (d), the short taxable year rule provided in paragraph (c)(4) of this section applies to a taxpayer that uses the non-AFS deferral method.

(9) *Eligible gift card sale.* For purposes of paragraphs (b)(1)(i)(B) and (d)(4) of this section, if an eligible gift card is redeemable by an entity described in paragraph (b)(3)(ii), 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 the entity during the taxable year.

(10) *Examples.* The rules of this paragraph (d) are illustrated by the examples in paragraphs (d)(10)(i) and (ii). In each of these examples, the taxpayer uses the non-AFS deferral method described in this paragraph (d).

(i) *Example 1.* A, a video arcade operator, receives payments in 2018 for game tokens that are used by customers to play the video games offered by A. The tokens cannot be redeemed for cash. The tokens are imprinted with the name of the video arcade, but they 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 the current year, x percent of tokens are expected to be used in the current year, y percent of tokens are expected to be used in the next year, and the remaining z percent of tokens are expected to never be used. Based on the study, A treats as earned for 2018 x percent (for tokens expected to be used in that year) as well as z percent (for tokens that are expected to never be used). Using the study, A determines the extent to which advance payments are earned in the taxable year of receipt. A may determine the extent to which a payment is earned in the taxable year of receipt on a statistical basis provided that any portion that is not included in the taxable year of receipt is included in the next succeeding taxable year. Thus, for federal income tax purposes, A must include x percent and z percent of the advance payments in gross income for 2018 and y percent of the advance payments in gross income for 2019.

(ii) *Example 2.* B is in the business of providing internet services. On September 1, 2018, 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. For federal income tax purposes, B may determine the extent to which the payment is earned in the year of receipt on a straight line ratable basis over the term of the agreement if it is not unreasonable 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.

(e) *Method of accounting.* The use of the deferral method under paragraph (c) of this section or the non-AFS deferral method under paragraph (d) of this section is the adoption of, or a change in, a method of accounting under section 446 of the Internal Revenue Code or the accompanying regulations. 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 accompanying regulations. A taxpayer may change its method of accounting to use the methods described in paragraphs (c) or (d) of this section, or change its manner of recognizing advance payments in revenue in an AFS only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations.

(f) *Applicability date.* The rules of this section are applicable for taxable years beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2017, provided that the taxpayer applies all the applicable rules contained in these proposed regulations, and consistently applies these proposed regulations to all advance payments. See section 7805(b)(7).

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 2019–19197 Filed 9–5–19; 4:15 pm]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–104870–18]

RIN 1545–BO68

Taxable Year of Income Inclusion Under an Accrual Method of Accounting

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the timing of income inclusion under section 451 of the Internal Revenue Code (Code). The proposed regulations reflect changes made by the Tax Cuts and Jobs Act. These proposed regulations affect taxpayers that use an accrual method of accounting and have an applicable financial statement.

DATES: Written or electronic comments and requests for a public hearing must be received by November 8, 2019.

ADDRESSES: Send submissions to Internal Revenue Service, CC:PA:LPD:PR (REG–104870–18), Room 5205, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to Courier's Desk, Internal Revenue Service, CC:PA:LPD:PR (REG–104870–18), 1111 Constitution Avenue NW, Washington, DC 20224. Alternatively, persons may submit comments electronically via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS REG–104870–18).

FOR FURTHER INFORMATION CONTACT: Concerning §§ 1.446–2, 1.451–3(d)(2), 1.451–3(i), 1.1275–2(l), and any other provisions within the jurisdiction of the Associate Chief Counsel (Financial Institutions and Products), Charles Culmer, (202) 317–4528; concerning the rest of the proposed regulations, Charles Gorham, (202) 317–5091; concerning submissions of comments and requests for a public hearing, Regina L. Johnson, (202) 317–6091 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 451(b). On December 22, 2017, section 451(b) was amended by section 13221 of the Tax Cuts and Jobs Act, Public Law 115–97 (131 Stat. 2054) (the Act) to provide that, for a taxpayer using an accrual method of accounting, the all events test with respect to any item of gross income (or portion thereof) is not treated as met any later than when the item (or portion thereof) is included in revenue for financial accounting purposes on an applicable financial statement (AFS) or other financial statement specified by the Secretary. The amendments made to section 451(b) do not change the time at which income subject to the all events test is taken into income for accrual method taxpayers without an AFS or other specified financial statement. Unless otherwise indicated, all references to section 451(b) hereinafter are references to section 451(b), as amended by the Act.

In general, section 451 provides that the amount of any item of gross income is included in gross income for the taxable year in which it is received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Under § 1.451–1, accrual method taxpayers generally include items of income in gross income in the taxable year when all the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (the all events test). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. Revenue Ruling 2003–10 (2003–1 CB 288); Revenue Ruling 84–31 (1984–1 CB 127); Revenue Ruling 80–308 (1980–2 CB 162).

On April 12, 2018, the Treasury Department and the IRS issued Notice 2018–35 (2018–18 IRB 520) requesting, in part, comments on future guidance under section 451(b). The record of public comments received in response to Notice 2018–35 may be requested by sending an email to *Notice.comments@irscounsel.treas.gov*. This document provides guidance on the application of section 451(b) taking into account comments that were received regarding section 451(b). The application of section 451(c) is addressed in separate guidance published in the same issue of the **Federal Register** as these proposed regulations.

Explanation of Provisions

The proposed regulations describe and clarify the statutory requirements of section 451(b) by providing new § 1.451–3.

1. Applicability of Section 451(b)(1)

Section 451(b)(1) generally provides that, for an accrual method taxpayer with an AFS or other specified financial statement, the all events test with respect to any item of gross income, or portion thereof, is not treated as met any later than when such item, or portion thereof, has been taken into account as revenue in an AFS or other specified financial statement (the AFS income inclusion rule). The AFS income inclusion rule generally increases financial accounting and tax accounting conformity. On May 28, 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) jointly announced new financial accounting standards for revenue recognition, titled ''Revenue from Contracts with Customers (Topic 606).'' See ASC Topic 606 and IASB International Financial Reporting Standard (IFRS) 15 (New Standards). Under the New Standards, items of income may be included as revenue in an AFS earlier than they would have been included in income under the all events test prior to the Act.

A. Taxpayers Subject to the AFS Income Inclusion Rule

The proposed regulations clarify how the AFS income inclusion rule applies to accrual method taxpayers with an AFS. Some taxpayers use an accrual method of accounting for all applicable items of income (overall accrual method taxpayers) and others use an accrual method of accounting for only some items of income. Both types of taxpayers (collectively, accrual method taxpayers) compute taxable income, at least in part, under an accrual method. Accordingly, proposed § 1.451–3(b) provides that the AFS income inclusion rule generally applies to accrual method taxpayers with an AFS when the timing of income inclusion for one or more items of income is determined using the all events test.

The proposed regulations do not include special rules regarding the applicability of the AFS income inclusion rule to foreign persons. The Treasury Department and the IRS are aware that applying the AFS income inclusion rule to a controlled foreign corporation (CFC) may create mismatches between the CFC's taxable income for U.S. Federal and foreign tax purposes. As a result, certain taxpayers may lose the ability to credit foreign taxes imposed on a CFC's income, particularly where such taxes relate to amounts includible in gross income under section 951A and are therefore ineligible to be carried back or forward under section 904(c). Comments are requested regarding whether special rules are needed to address the applicability of the AFS income inclusion rule to foreign persons, including whether and how the rules for determining the taxable income of a CFC can be adjusted to better align the U.S. Federal and foreign income tax bases.

B. Exceptions to the AFS Income Inclusion Rule

Proposed § 1.451–3(d)(1) clarifies that the AFS income inclusion rule applies only to taxpayers that have one or more AFS covering the entire taxable year. This approach is consistent with the exception in section 451(b)(1)(B)(i), which provides that the AFS income inclusion rule does not apply to taxpayers without an AFS for a taxable year. In addition, some accrual method taxpayers may have an AFS in one taxable year and no AFS in another taxable year. To address this situation, 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.

Consistent with section 451(b)(1)(B)(ii), proposed § 1.451–3(d)(2) also provides that the AFS income inclusion rule does not apply to items of income in connection with a mortgage servicing contract. A letter addressed to the Treasury Department indicated that it is unclear whether this exclusion can be applied to income relating to interest rate lock commitments (IRLCs) entered into by mortgage lenders. The proposed regulations do not address this issue because section 475 generally would require mortgage lenders to include income relating to IRLCs in taxable income in accordance with the mark-to-market method of accounting. As a result, a mortgage lender generally would not apply section 451(b) to determine when income relating to IRLCs is includible in income.

C. Transactions Treated Differently for Federal Income Tax and AFS Purposes

Except as provided in proposed § 1.451–3(e), proposed § 1.451–3(e) clarifies that the AFS income inclusion rule does not change the treatment of a transaction for Federal income tax purposes. The treatment of a transaction or event in a taxable year may be different for Federal income tax and AFS purposes. For example, a rental agreement that is treated as a lease for Federal income tax purposes may be treated as a sale or financing for AFS purposes, or vice versa. Similarly, a transaction that is deemed to occur (for example, under a mark-to-market method) for AFS purposes may not be deemed to occur for Federal income tax purposes. The AFS income inclusion rule generally was not intended to require taxpayers to recharacterize a transaction for Federal income tax purposes to conform to the characterization of the transaction in the taxpayer's AFS. As stated in the Conference Report, ''The provision does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred.'' H.R. Rep. No. 115–466, at 428 fn. 872 (2017) (Conf. Rep.).

However, as also stated in the Conference Report, the AFS income inclusion rule was intended to include unbilled receivables for partially performed services:

> ''Under the provision, an accrual method taxpayer with an applicable financial statement will include an item in income under section 451 upon the earlier of when the all events test is met or when the taxpayer includes such item in revenue in an applicable financial statement. For example, under the provision, any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes.''

H.R. Rep. No. 115–466, at 428 fn. 874 (2017) (Conf. Rep.). Commenters suggested that the intent to include unbilled receivables conflicts with the intent to not change the treatment of a transaction to match the taxpayer's AFS treatment. The Treasury Department and the IRS do not agree. In applying the AFS income inclusion rule to unbilled receivables, a taxpayer is not changing the treatment of the transaction when it includes in income amounts included in its AFS. Moreover, these proposed regulations also apply to unbilled receivables for the sale of goods because there is no distinction in section 451(b) between unbilled receivables for services and unbilled receivables for the sale of goods, and service providers and sellers of goods that are including unbilled receivables in revenue for AFS purposes should be treated similarly for Federal income tax purposes under section 451(b). Accordingly, the proposed regulations provide that the AFS inclusion rule applies to unbilled receivables included in revenue for AFS purposes related to both services and goods.

Commenters raised concerns about the interaction between sections 61 and 461 with the AFS income inclusion rule. For AFS purposes, taxpayers may be required to include variable consideration when determining the transaction price of a contract. Under the New Standards, variable consideration includes items such as discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, and other similar items. Variable consideration may also include promised consideration that taxpayers are not yet entitled to under the contract because it is contingent on the occurrence or nonoccurrence of a future event. For Federal income tax purposes, these items of variable consideration may be contingent future income under section 61 or liabilities subject to section 461. Section 451(b) could be read to accelerate the timing of contingent future income and liabilities to match their inclusion in revenue for AFS purposes. However, section 451(b) was intended to change only the timing of income to ensure that those items of income are not included later than when they are included for AFS purposes. See H.R. Rep. No. 115–466, at 428 fn. 874 (2017) (Conf. Rep.) and Joint Committee on Taxation, General Explanation of Public Law 115–97 (JCS–1–18) at 166 (Dec. 20, 2018). Accordingly, proposed § 1.451–3(c)(6) provides that the transaction price that is used to determine whether an amount has been included in revenue does not include items to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event, reductions for amounts subject to section 461 (including allowances, adjustments, rebates, chargebacks, refunds, rewards, and amounts included in the cost of goods sold), and amounts collected for third parties. However, in order to reduce compliance burden and prevent abuse and undue administrative burden, proposed § 1.451–3(c)(6) presumes that an amount included in the transaction price for AFS purposes is not contingent future income unless, upon examination of all of the facts and circumstances existing at the end of the taxable year, it can be established to the satisfaction of the Commissioner that the amount is contingent on the occurrence or nonoccurrence of a future event.

In addition, section 451(b) was intended to accelerate income inclusion when (i) the taxpayer's customer controls the asset that is created or enhanced, or (ii) the taxpayer has a right to partial payment, even when a contract requires delivery, acceptance, and title transfer before a taxpayer can bill its customer. See Examples 2 and 4 of the Joint Committee on Taxation, General Explanation of Public Law 115–97 (JCS–1–18) at 162–163 (Dec. 20, 2018). Accordingly, proposed § 1.451–3(c)(6)(ii) provides that an amount included in the transaction price for AFS purposes may not be treated as contingent on the occurrence or nonoccurrence of a future event if the taxpayer has been paid or has an equitable, contractual, or other right to partial payment for performance completed to date. Additionally, proposed § 1.451–3(c)(6)(iii) provides that transaction price may not be reduced for amounts subject to section 461, including, in the case of credit card transactions, reward amounts.

Comments are requested on the interaction among sections 61, 461, and 451(b), and specific situations in which future contingent income and liabilities might be included in revenue for AFS purposes. Comments are requested, for example, on the applicability of the proposed rules to escalating rental agreements not subject to section 467, where amounts included in revenue in an AFS as rent for one year of a multi-year rental agreement exceed actual rent received for that year. Specifically, does the excess of the amount included in revenue as rent over the amount of actual rent in a particular year represent a contingency or merely an allocation of the overall transaction price? Comments are requested on the extent to which certain contract terms might affect the result. Comments also are requested on the proposed presumption that the AFS income inclusion rule should apply when an item is included in revenue in an AFS and what a taxpayer should be required to demonstrate in order to successfully rebut the presumption. Finally, comments are requested on how reassessments of variable consideration after the taxable year of the commencement of the contract should be treated for Federal income tax purposes.

D. Interaction With Exclusion Provisions and Effect on Non-Recognition Transactions

Commenters noted that the AFS income inclusion rule may appear to overturn numerous exclusion provisions and adversely affect the treatment of non-recognition transactions in the Code. For example, the AFS income inclusion rule could be read to apply to a transaction that is treated as a sale of property with profit or loss for AFS purposes but that is treated as a reorganization under section 368 for Federal income tax purposes. 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, the Income Tax Regulations, or other guidance published in the Internal Revenue Bulletin, consistent with Congressional intent that the provision does not revise the rules associated with the time at which an item is realized for Federal income tax purposes. H.R. Rep. No. 115–466, at 428 fn. 872 (2017) (Conf. Rep.) and Joint Committee on Taxation, General Explanation of Public Law 115–97 (JCS–1–18) at 166 (Dec. 20, 2018).

E. Special Methods of Accounting

Section 451(b)(2) provides that the AFS income inclusion rule does not apply to any item of gross income for which the taxpayer uses a special method of accounting provided under any provision of Chapter 1, other than any provision of part V of subchapter P. Commenters raised questions about the interaction between the AFS income inclusion rule and special methods of accounting. In response, proposed § 1.451–3(b) amplifies the meaning of the term ''special method of accounting'' and, except as provided in proposed § 1.451–3(b), provides that the AFS income inclusion rule does not apply to any item of income, or portion of an item of income, when the timing of income inclusion is determined under a required or permitted special method of accounting used for Federal income tax purposes. The proposed regulations also clarify that when a taxpayer uses a special method of accounting, the special method of accounting determines the timing of the income inclusion. The proposed regulations provide a non-exclusive list of examples of special methods of accounting. In addition, the proposed regulations make clear that because the AFS income inclusion rule affects the time at which the all events test is met, the rule applies only to items of income that are subject to the all events test. For a discussion of special methods of accounting under the provisions of part V of subchapter P (relating to income from certain debt instruments), see section 7 of this preamble.

2. Application of the AFS Income Inclusion Rule to Multi-Year Contracts

Section 451(b) does not address how to apply the AFS income inclusion rule and all events test to a multi-year contract. Proposed § 1.451–3(k) provides that a taxpayer with a multi-year contract applies the all events test by applying a cumulative approach reflecting amounts previously included under section 451 rather than an annualized approach.

An annualized approach would look at payments received in each taxable year in isolation and compare the amounts included in the taxpayer's AFS and under the all events test to determine whether an amount should be included for Federal income tax purposes. This approach would generally result in an overall acceleration of income relative to income included in revenue for AFS purposes, could cause amounts to be included for Federal income tax purposes earlier than under a contract's terms, and could result in double counting of income. Section 451(b)(1) does not require this treatment.

A cumulative approach better reflects the economic reality of a multi-year transaction. Accordingly, the proposed regulations require taxpayers to take into account the cumulative amounts previously included in prior taxable years in determining a given contract year's income inclusions under section 451(b)(1). Comments are requested regarding the treatment of multi-year contracts under the AFS income inclusion rule.

3. Applicable Financial Statement (AFS)

The proposed regulations describe and clarify the definition of AFS under section 451(b)(3). Section 451(b)(3) generally defines AFS to mean financial statements prepared according to generally accepted accounting principles (GAAP financial statements), certain financial statements prepared according to international financial reporting standards (IFRS financial statements), and financial statements filed with certain regulatory or government bodies. Section 451(b)(1)(A)(ii) provides the Secretary with authority to specify other financial statements for purposes of section 451(b)(1).

The list of financial statements qualifying as an AFS under section 451(b)(3) is similar, but not identical, to the list of financial statements in Revenue Procedure 2004–34 (2004–1 CB 991). The general priority for identifying the AFS in section 451(b)(3)(A) through (C) is similar to the priority provided in Revenue Procedure 2004–34. Certain financial statements that have traditionally been treated as AFS under Revenue Procedure 2004–34, such as IFRS financial statements used for (1) credit purposes, (2) reporting to shareholders, partners, or other proprietors or to beneficiaries, and (3) any other substantial nontax purposes, are not expressly included in section 451(b)(3). However, the legislative history indicates that Congress intended for Revenue Procedure 2004–34 to be followed. See H.R. Rep. No. 115–466, at 429 (2017) (Conf. Rep.). Accordingly, proposed § 1.451–3(c)(1) is generally consistent with the list of AFS from Revenue Procedure 2004–34.

The proposed regulations also clarify the financial statements filed with certain regulatory or government bodies that qualify as an AFS under section 451(b)(3)(C), which is similar to section 4.06(3) of Revenue Procedure 2004–34. The proposed regulations clarify that financial statements that are filed with a state government or state agency, or a self-regulatory organization, also qualify as an AFS under section 451(b)(3)(C). For example, the Financial Industry Regulatory Authority and state agencies that regulate insurance companies or public utilities are agencies requiring reports that qualify as an AFS.

Proposed § 1.451–3(h) addresses various issues relating to how financial results are reported for certain taxpayers. These proposed regulations propose rules consistent with the rules provided in § 1.56–1 because Congress indicated a desire for rules similar to those found in Revenue Procedure 2004–34 and the rules in Revenue Procedure 2004–34 follow certain rules in § 1.56–1. See IRS Announcement 2004–48 (2004–22 IRB 998).

Section 451(b)(5) and proposed § 1.451–3(h)(1), (2), and (3) provide that, for purposes of the general rule in section 451(b)(1), if the financial results of a taxpayer are reported on the AFS, as defined in section 451(b)(3), for a group of entities, such statement shall be treated as the AFS of the taxpayer. When a consolidated or combined AFS or other financial statement lists items separately for each member taxpayer, the amount of revenue attributable to a particular taxpayer is determined based on its respective separately stated item. If the amounts are aggregated, however, the taxpayer must rely on the source documents that were used to create the group's AFS to determine its percentage of each aggregated item reported on the consolidated or combined AFS. The source documents should be used to determine the taxpayer's respective share of revenue on the AFS, so as to properly reflect the correct amount of gross income under section 451(b).

Proposed § 1.451–3(h)(4) provides guidance for taxpayers with a financial reporting period that is different than the taxpayer's taxable year. The proposed regulations provide that the taxpayer must use one of three permissible methods in order to determine whether an item of income has been included in revenue on an AFS. Under one method a taxpayer uses the accounting principles used to create its AFS to determine the items of income to be reported in revenue as if its financial reporting period coincided with its taxable year. Under the second method a taxpayer makes a reasonable estimate of revenue for the pro rata portion of the taxable year for which the financial statement year and taxable year do not align. Under the third method, if a taxpayer's financial accounting year ends five or more months after the end of its taxable year, the taxpayer computes revenue based on the revenue reported on the AFS for the financial accounting year ending within its taxable year.

Proposed § 1.451–3(h)(5) provides guidance on a restatement of a taxpayer's financial statements. The rules generally provide that the taxpayer must determine the reason for the restatement of the AFS. For example, if a taxpayer restates revenue on an AFS and such restatement changes the time at which an item of income or a portion thereof is taken into account as revenue on the AFS, the change constitutes a change in method of accounting under section 446. This rule is consistent with current practice regarding the determination of a change in method of accounting.

The regulations under section 6001 require a taxpayer to keep books and records sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in an income tax return, which includes the identification of items includible in gross income under section 451. This requirement includes any books and records sufficient to establish a taxpayer's calculation of income when its financial results are included in an AFS of a group of entities.

4. Revenue in an AFS

Proposed § 1.451–3(c)(4) defines the term revenue for purposes of section 451(b)(1) broadly to include all items of income under section 61 (gains, profits, and income for Federal income tax purposes). This definition is consistent with the current application of the all events test under § 1.451–1(a) and ensures greater financial accounting and tax accounting conformity.

One commenter discussed the effect of the New Standards on sections 451(b) and (c). The commenter noted that, under the New Standards, certain revenue may be included earlier than under section 451 prior to amendment by the Act. The commenter also noted that an amount booked to retained earnings should be treated as revenue for purposes of section 451(b) even though that amount may not be shown as book revenue for financial accounting purposes. A narrow reading of the term revenue could result in items of income that are taken into account on an AFS and that otherwise would be required to be included in gross income escaping section 451(b) altogether. For example, taxpayers may include items, or portions of items, in other comprehensive income on an AFS that are excluded from the revenue line(s) on the AFS. Accordingly, a broad reading of revenue ensures that the correct amount of income that is taken into account in an AFS is subject to section 451(b).

Multiple commenters proposed allowing a cost offset when income is included under the AFS income inclusion rule. For example, one commenter suggested that, in determining the amount of income to include under section 451(b), taxpayers selling goods should reduce AFS revenue by the cost of goods sold associated with a sale that does not presently reduce AFS revenue. The commenter acknowledged that costs are not taken into account for Federal income tax purposes until the all events test is satisfied, which includes the economic performance rules under section 461. Because of the resulting inconsistency with sections 461 and 471, these regulations do not follow the commenter's suggestion that a cost offset or cost of goods sold reduction should apply without regard to the economic performance rules of section 461 and inventory accounting rules of section 471.

Congress has addressed various cost recovery mechanisms in the past. In 1955, Congress repealed the reserve method for estimated expenses under section 462 of the Code. See An Act to Repeal Sections 452 and 462 of the Internal Revenue Code of 1954, Public Law 84–74, section 1(b) (1955). Section 462 of the Code was a companion to section 452, which allowed taxpayers to report certain types of prepaid income over time. In the Senate Report discussing the repeal of sections 452 and 462, Congress noted that ''the problem presented by section 462 is that of the timing of deductions when a taxpayer changes accounting methods.'' S. Rep. 84–372, at 4 (1955). The Senate noted that taxpayers would be entitled to the deductions even without section 462. In addition, section 462 increased the possibility of distortions of income because expenses were being deducted when the amount had not yet been incurred.

Thirty years later, Congress repealed the use of the reserve method for determining losses from bad debts under section 166 in the Tax Reform Act of 1986. In repealing the reserve method, Congress noted that this method was inconsistent with the rules for other deductions under the all events test and could result in deductions being allowed for Federal income tax purposes for losses that may never occur. S. Rep. No. 99–313, at 155 (1986). Moreover, ''if a deduction is allowed prior to the taxable year in which the loss occurs, the value of the deduction to the taxpayer will be overstated.'' S. Rep. No. 99–313, at 155 (1986).

These proposed regulations do not allow a cost offset provision because similar potential distortions of income could result. An allowance to account for future cost of goods sold, for future estimated costs, or other cost offsets also is inconsistent with sections 461 (in particular section 461(h)), 263A, and

471, and the regulations under those sections. In addition, these proposed regulations do not allow a cost offset provision because there is nothing in the statute or legislative history that indicates that in amending section 451 Congress intended to change sections 461, 263A or 471, and the regulations under those sections. See also, General Explanation of Public Law 115–97 (JCS–1–18) at 150–151, and 164–165 (Dec. 20, 2018).

Nevertheless, the Treasury Department and the IRS continue to consider whether any exceptions are an appropriate use of the Secretary's authority under section 461(h) or 460. To facilitate further consideration of any potential exceptions, detailed comments that specifically address the following issues are requested:

1. Under what authority would it be appropriate for the Secretary to permit a taxpayer to use a book percentage-of-completion method (PCM) as its tax method? When inventory is involved, what limitations could be instituted to ensure that book PCM could not be used to recover costs related to inventoriable goods prior to the time when such costs could be recovered under sections 471 and 263A? Under what specific authority would it be appropriate to permit a book PCM method to be used to recover costs related to inventoriable goods?

2. Would elective use of book PCM for tax purposes provide an appropriate cost offset? Would such a method be characterized as one that reports contract revenue according to a taxpayer's book method, while accounting for costs, including nondeductible costs, as deductions under the Code? If not, how would such a method account for costs for Federal income tax purposes?

3. Rather than make book PCM elective, would it be appropriate for the definition of ''unique item'' for purposes of section 460 to be expanded?

4. Section 460 requires use of the look-back method to compensate for improper acceleration or deferral of income under PCM. It also requires that all contract income be reported no later than the year following contract completion. Would elective use of a PCM under section 460 without these provisions invite abuse? If so, how could such abuse be prevented?

5. Allocation of Transaction Price

The proposed regulations describe and clarify the allocation of transaction price under section 451(b)(4). Section 451(b)(4) provides that, in the case of a contract with multiple performance obligations, the allocation of the transaction price to each performance obligation shall be equal to the amount allocated to each performance obligation for purposes of including such item in revenue in the AFS of the taxpayer. Consistent with the definition of performance obligation found in the New Standards, proposed § 1.451–3(c)(3) defines ''performance obligation'' to mean a promise in a contract with a customer to transfer to the customer either a good or service (or a bundle of goods or services) that is distinct, or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. See ASC Topic 606 and IFRS 15.

Comments are requested on allocation of the transaction price (i) to performance obligations that are not contractually based, (ii) for arrangements that include both income subject to section 451 and long-term contracts subject to section 460, and (iii) when the income realization event for Federal income tax purposes differs from the income realization event for AFS purposes.

6. Taxpayers Including Income Over Time for AFS Purposes

Commenters proposed allowing taxpayers that include items of income as revenue in an AFS over a period of time under the New Standards (AFS over-time method) to follow that method for Federal income tax purposes. Allowing taxpayers to follow their AFS over-time method for Federal income tax purposes would potentially defer income beyond what is permitted under section 451(b), section 451(c), and the all events test. The AFS income inclusion rule operates only to accelerate income inclusion; the AFS income inclusion rule can never cause income inclusion to occur later than when the all events test is satisfied. Allowing taxpayers to follow their AFS over-time method for Federal income tax purposes may also affect the treatment of costs in a manner that is inconsistent with sections 461 and 471. However, the Treasury Department and the IRS continue to study the commenters' proposal and request additional comments on this issue. Specifically, additional comments are requested regarding: The size of taxpayers likely to be affected; the industries likely to be affected; the number of taxpayers likely to be affected; the compliance burden and administrative complexity likely to be avoided; and the degree to which an over-time method under the New Standards accelerates or defers income relative to the all events test and the AFS income inclusion rule.

7. Rules for Certain Debt Instruments

A. Credit Card Fees and Other Fees

The Treasury Department and the IRS have treated certain credit card fees associated with pools of credit card receivables as creating or increasing original issue discount (OID) on those pools. See Revenue Procedure 2004–33 (2004–1 CB 989) (the IRS will not challenge the treatment of late fees as creating or increasing OID); Revenue Procedure 2005–47 (2005–2 CB 269) (the IRS will not challenge the treatment of cash advance fees as creating or increasing OID); Revenue Procedure 2013–26 (2013–22 IRB 1160) (safe harbor method of accounting for OID on a pool of credit card receivables for purposes of section 1272(a)(6)); and Chief Counsel Notice CC–2010–018 (Sept. 27, 2010) (as a result of the Tax Court's decision in *Capital One Financial Corp. and Subsidiaries* v. *Commissioner,* 133 T.C. 136 (2009), the IRS will no longer challenge or litigate the issue of whether interchange fee income creates or increases OID).

With the enactment of section 451(b), however, Congress expressed its intention to overturn the tax treatment of those credit card fees as OID, including the use of the OID timing rules, and subject them to the all events test. The Conference Report to the Act states, ''[section 451(b)] directs accrual method taxpayers with an applicable financial statement to apply the income recognition rules under section 451 before applying the special rules under part V of subchapter P . . .'' (which includes the OID rules). H.R. Rep. No. 115–466, at 428 (2017) (Conf. Rep.). In particular, the legislative history describes the treatment of credit card late fees, credit card cash advance fees, and interchange fees as creating or increasing OID for Federal tax purposes and lists these fees as examples of amounts to which section 451(b), as amended, would apply. Id. at 427, 429. These three credit card fees are not generally treated as discount for AFS purposes.

Congress clearly expressed its intention to overturn the tax treatment of credit card late fees, cash advance fees, and interchange fees (specified credit card fees) and to subject these fees to the all events test as modified by section 451(b). Id. at 429. The legislative history quoted in the preceding paragraph further suggests that Congress intended that other fees associated with a lending transaction that might otherwise be accounted for in calculating OID are to be subjected to the AFS income inclusion rule before the application of the OID rules. Based on the legislative history, however, taxpayers have stated that section 451(b) was not intended to affect the application of the general OID timing rules to OID other than with respect to items not treated as discount for financial reporting purposes, such as the specified credit card fees. Id. at 427–429. Moreover, taxpayers have stated that the application of section 451(b) to OID other than items not treated as discount for financial reporting purposes would result in significant administrative burden and very little additional tax revenue. The Treasury Department and the IRS agree with commenters on this issue. Therefore, in the absence of a clear indication in the legislative history that Congress intended for section 451(b) to override the general timing rules for OID, and in order to reduce administrative burden, the proposed section 451(b) regulations would not apply to determine the time at which OID generally is includible in income. See § 1.451–3(c)(5)(ix) of the proposed regulations.

The proposed regulations contain two provisions that implement Congressional intent regarding the treatment of fees, including the specified credit card fees. First, under proposed § 1.451–3(i), if a fee is not treated by a taxpayer as discount or as an adjustment to the yield of a debt instrument over the life of the instrument (such as points) in its AFS and the fee otherwise would be treated as creating or increasing OID for Federal income tax purposes (specified fee), then the rules in the proposed regulations under section 451(b) apply before the rules in sections 1271 through 1275 and the regulations thereunder. For example, proposed § 1.451–3(i) applies to the specified credit card fees. Second, proposed § 1.1275–2(l) includes a proposed amendment to the final regulations under section 1275 to clarify that an item of income that is subject to the timing rules in the proposed regulations under section 451(b) (such as the specified credit card fees) is not taken into account in determining the amount of OID (if any) on the debt instrument. Removing specified fees and specified credit card fees from the calculation of OID will permit taxpayers to apply only the rules of section 451(b) to these fees, without also having to apply the rules relevant to OID. In addition, the Treasury Department and the IRS propose to obsolete Revenue Procedure 2004–33, Revenue Procedure 2005–47, Revenue Procedure 2013–26, and Chief Counsel Notice CC–2010–018. The Treasury Department and the IRS request comments on the proposed obsolescence of these documents.

B. Market Discount

Taxpayers requested guidance as to whether market discount is includible in income under section 451(b). The Treasury Department and the IRS previously announced that proposed regulations would provide that accrued market discount is not includible in income under section 451(b). Notice 2018–80 (2018 IRB 609), issued September 27, 2018.

A bond is generally treated as having market discount when the principal amount of the bond exceeds the holder's basis immediately after it was acquired by the holder. Under section 1276(a), market discount is includible in income only upon disposition of a market discount bond at a gain or the receipt of a partial principal payment, unless the holder of the bond elects otherwise. In each case, the market discount inclusion is limited to accrued market discount as defined in section 1276(b). In general, the timing rules for income inclusion in section 1276 are a codification of the pre-1984 timing rules for market discount and confirm that the all events test generally does not determine when accrued market discount is includible in income. The proposed regulations therefore include the market discount rules on the list of special methods of accounting to which section 451(b) does not apply.

Statement of Availability of IRS Documents

The IRS notices, revenue rulings, and revenue procedures cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *http://www.irs.gov.*

Proposed Applicability Date

These regulations are proposed generally to apply to taxable years beginning on or after the date the final regulations are published in the **Federal Register**. However, in the case of a specified fee, proposed § 1.451–3(i)(2) is proposed to apply for a taxpayer's first taxable year beginning one year after the date the Treasury decision adopting these regulations as final is published in the **Federal Register**. In general, this delayed effective date for specified fees is provided because the treatment of these fees is unclear for tax purposes (and in some cases for financial reporting purposes). This additional time will allow the Treasury Department and the IRS to determine the types of fees that should be subject to section 451(b), which will provide taxpayers with more certainty in complying with section 451(b) and will help to minimize controversies with the IRS with respect to fees.

Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, a taxpayer may rely on these proposed regulations (other than the proposed regulations relating to specified fees) for taxable years beginning after December 31, 2017, provided that the taxpayer: (1) Applies all the applicable rules contained in these proposed regulations (other than those applicable to specified fees), and (2) consistently applies these proposed regulations to all items of income during the taxable year (other than specified fees). Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, in the case of specified credit card fees, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2018, provided that the taxpayer: (1) Applies all the applicable rules contained in these proposed regulations for specified credit card fees, and (2) consistently applies these proposed regulations to all items of income during the taxable year (other than specified fees).

Special Analyses

I. Regulatory Planning and Review

Executive Orders 13771, 13563, and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits, including potential economic, environmental, public health and safety effects, distributive impacts, and equity. Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility. The Executive Order 13771 designation for any final rule resulting from the proposed regulation will be informed by comments received. The preliminary Executive Order 13771 designation for this proposed rule is regulatory.

The proposed regulation has been designated by the Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of

Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these proposed regulations as significant under section 1(b) of the MOA. Accordingly, these proposed regulations have been reviewed by OIRA.

1. Background

In plain language, section 451 of the Internal Revenue Code (the ''Code'') and the proposed regulations deal with differences between when income is recognized for Federal tax purposes and when it is recognized on businesses' financial accounting statements. The recently enacted section 451(b) more closely aligns the timing rules of the tax system with general financial accounting standards.

Under section 451(a) of the Code, any item of gross income is required to be included as income by the taxpayer (''recognized'') when it is received by the taxpayer unless, under the taxpayer's method of accounting, the income is properly accounted for in a different period. For this purpose, businesses and individuals are generally required to use the accounting method that is used regularly to keep their financial records. This may be a cash receipts and disbursements accounting method, under which income is recognized when payment is actually or constructively received, or it may be an accounting system based on income and expense accrual principles. Certain corporations and some partnerships are required to use an accrual method, and generally taxpayers employing inventories in their trade or business must use an accrual method with regard to purchases and sales of inventory.

Current regulations require taxpayers using an accrual accounting method to report income in the taxable year in which all events that fix the right to receive such income have occurred, provided the amount can be determined with reasonable accuracy. Under IRS guidance, this ''all events test'' is met upon the earliest of when (i) payment is earned through performance by the taxpayer (*e.g.,* provision of the contracted goods or services), (ii) payment is due to the taxpayer, or (iii) payment is received by the taxpayer.

In contrast, U.S. generally accepted accounting principles (''GAAP'') and international financial reporting standards (''IFRS''), having different purposes from tax law, may often dictate alternative rules as regards the timing of revenue recognition. Differences between these financial accounting standards and the Code in the timing of revenue recognition may arise for a number of reasons. For example, under certain circumstances, financial accounting rules may require revenue to be recognized when the costs of providing goods or services pursuant to a contract are incurred, while the all events test may not be satisfied until the contract obligation is fulfilled. If meeting the taxpayer's performance obligation occurs over more than a single accounting period, then this timing pattern can result in a disparity between the year in which the associated revenue is booked for financial accounting purposes and the year in which the associated taxable gross income is recognized.

Congress enacted new section 451(b) in part because conformity in the timing of income recognition between the accrual system of accounting and the tax system (''book-tax conformity'') will generally ''promote simplification and reduced compliance costs.'' See Senate Budget Explanation of the Bill (2017–11–20) at p. 161.

Section 451(b) applies only to taxpayers that use the accrual method and have an Applicable Financial Statement (''AFS''). In plain language, an AFS is a financial statement certified as having been prepared under GAAP or IFRS. All publicly traded U.S. corporations possess an AFS, as do many privately held corporations and partnerships, which may have such certified accounting statements for credit purposes or for shareholder or partner reporting purposes. The income recognition rules for accrual-method taxpayers without an AFS and cash-method taxpayers are not altered by the enactment of section 451(b) or by the proposed regulations. The Treasury Department and the IRS project that there were approximately 3.1 million tax-reporting entities in taxable year 2016 that used an accrual method of accounting. They further project that fewer than 10 percent of these, or approximately 296,000 entities had an AFS, and thus could have been affected by section 451(b) and the proposed regulations had these been in effect in taxable year 2016.

For these taxpayers, Section 451(b) modifies the all-events test by stating that the test is not met for any item of income any later than when it is taken into account as revenue in an AFS or other designated financial statement (the ''AFS income inclusion rule''). Thus, this new rule requires taxpayers to recognize income upon the earlier of when the all-events test is met or when the taxpayer includes the amount in revenue (broadly defined) in its AFS (''AFS income inclusion rule''). The AFS income inclusion rule operates only in one direction—to accelerate in time the recognition of gross income for tax purposes. This acceleration occurs in situations where income has been recognized for financial accounting purposes before the all events test has been satisfied.

2. Need for the Proposed Regulations

The proposed regulations deliver certainty and clarity to taxpayers affected by the Act's introduction of the new section 451(b) and allow them to comply with the new statutory provision with a higher level of confidence.

The Treasury Department and IRS published a Notice in April 2018, requesting public comments regarding the application of the AFS income inclusion rule, the meaning of various concepts and terms used in section 451(b), and other implementation issues not explicitly addressed in the statute. As explained earlier in this Preamble, the proposed regulations address the comments and questions subsequently raised by the public.

3. Overview of the Proposed Regulations

The proposed regulations include applicability and definitional guidance regarding section 451(b). Specifically, 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.

4. Economic Analysis

A. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

B. Summary of Economic Effects

The proposed regulations provide increased certainty, clarity, and consistency in the application of section 451(b) by providing definitions and clarifications regarding the statute's terms and rules. In the absence of such guidance, the chances that different taxpayers would interpret the statute differently would be exacerbated.

Similarly situated taxpayers might interpret the statutory provisions pertaining to the recognition of income differently, with one taxpayer pursuing a project that another comparable taxpayer might decline to make because of different interpretations of how the income would be treated under section 451(b). If this second taxpayer's activity were more profitable, an economic loss arises. Even in situations where taxpayers would generally adopt similar interpretations of the Code under the baseline, the lack of guidance increases opportunities for that interpretation to differ from what Congress intended. In this case, guidance provides value by bringing economic decisions closer in line with Congressional intent. In the context of economic activity by businesses that are subject to section 451(b) or that interact with such businesses, the proposed regulations thus help to ensure that similar economic activities, representing similar timing of income, are taxed similarly, thereby improving U.S. economic performance.

The Treasury Department and the IRS have not undertaken quantitative estimates of these possible efficiency gains because any such quantitative estimates would be highly uncertain. For example, the proposed regulations include provisions to clarify how income should be included from multi-year contracts. The Treasury Department and the IRS do not have readily available data or models to determine how businesses might apply the AFS inclusion rule to multi-year contracts in the absence of the proposed regulations or under alternative regulatory approaches. Furthermore, even in the event that most businesses could be presumed to adopt a particular treatment under the baseline, the Treasury Department and the IRS further do not have readily available data or models of the volume or pattern of their multi-year contract payments and they thus cannot project with any degree of precision the differences in tax treatment taxpayers would experience between the proposed regulations and the baseline or alternative regulatory approaches. Such differences are a key component of the marginal effective tax rate that these contracts would experience, which in turn would determine how economic activity would be affected by the proposed regulations relative to the baseline or alternative regulatory approaches.

The Treasury Department and the IRS further project that issuance of the proposed regulations will reduce compliance and enforcement costs relative to the baseline because the enhanced certainty and clarity they provide should make it easier for businesses to calculate their tax liability relative to the baseline. Greater efficiencies should also result from the promulgation of the proposed regulations, relative to the baseline, by reducing taxpayer disputes with the IRS that otherwise would have to be dealt with through sub-regulatory guidance or resolved through increased litigation. By providing greater certainty of how the law will be applied, the Treasury Department and the IRS project that the proposed regulations will reduce these implementation costs. The Treasury Department and the IRS have not made a quantitative estimate of the reduction in compliance and enforcement costs resulting from the proposed regulations. They have not made such an estimate in part because models of compliance cost are not currently available to provide a reasonably precise estimate of compliance costs in the absence of the proposed regulations.

With these limitations in mind, part II.4.C of this Special Analyses section explains the rationale behind the approaches taken by the proposed regulations and qualitatively evaluates the alternatives considered.

The Treasury Department and the IRS solicit comments on the economic effects of the proposed regulations.

C. Economic Effects of Specific Provisions

The proposed regulations embody certain regulatory decisions that reflect the regulatory discretion of the Treasury Department and the IRS. These decisions specify more fully how the AFS income inclusion rule is to be implemented.

The Treasury Department and IRS solicit comments on the economics of each of the items discussed below and of any other items of the proposed regulations not discussed in this section. The Treasury Department and the IRS particularly solicit comments that provide data, other evidence, or models that could enhance the rigor of the process by which the final regulations might be developed.

i. Application of the AFS Income Inclusion Rule to Multi-Year Contracts

The proposed regulations clarify how section 451(b) applies to multi-year contracts. The Treasury Department and the IRS considered two alternative approaches for such contracts: (i) An annualized approach and (ii) a cumulative approach. Under an annualized approach, for each year under the contract a taxpayer would compare the income included as revenue in its AFS for that year and the gross income recognized under the all events test for that same year to determine its gross income inclusion, with the proviso that the total amount of gross income recognized under the contract is not to exceed the total contract price. In contrast, under a cumulative approach, in each year a taxpayer would compare the cumulative amount of revenue included in its AFS up to and including that year with the cumulative amount of gross income recognized under the all events test up to and including that year.

Example 4 of the proposed regulations, the summary table of which is reproduced in the first three rows of the following table, shows the treatment of gross income under a cumulative approach. The fourth row in this table shows the treatment of gross income under the annualized approach.

	2018	2019	2020	2021	Total
Payments	$25x	$25x	$25x	$25x	$100x
AFS Revenue	50x	0x	20x	30x	100x
Gross Income (cumulative)	50x	0x	25x	25x	100x
Gross Income (annualized)	50x	25x	25x	0x	100x

An annualized approach could accelerate the recognition of taxable income to a greater degree than what is reflected in revenue for AFS purposes. In this example, such an approach would ignore in 2019 the fact that cumulative AFS revenue of $50x had been recognized as taxable gross income in 2018. Accordingly, the annualized approach would require that an additional $25x of income be recognized in 2019, since a payment of that amount was received in that year. In effect, an annualized approach would accelerate the recognition of $25x from 2021 to

2019 relative to gross income recognition under the cumulative AFS income inclusion rule.

The Treasury Department and IRS concluded that the extent of acceleration of income that may occur when using an annualized approach would be excessive relative to the cumulative approach when considered against the intents and purposes of the statute. The proposed regulations therefore adopt the cumulative approach.

ii. Applicable Financial Statement Covering a Group of Entities

The proposed regulations provide rules for taxpayers whose financial results are included on an AFS covering a group of entities. These rules specify that, if a taxpayer's financial results are reported on the AFS for a group of entities, the taxpayer's AFS is the group's AFS. However, if the taxpayer also reports financial results on a separate AFS that is of equal or higher priority, then the separate AFS is the taxpayer's AFS. The rules also specify how a taxpayer using a group AFS is to determine the amount of revenue allocated to the taxpayer. The Treasury Department and the IRS considered as an alternative not providing substantive rules on how taxpayers should apply the AFS income inclusion rule when their financial results are included in an AFS for a group of entities. This alternative was rejected because it would have increased compliance burdens and potentially led to similarly situated taxpayers applying the AFS income inclusion rule differently.

The Code does not specify how the AFS income inclusion rule is to function whenever the AFS accounting period and the taxable year do not coincide. The proposed regulations do not adopt a single, one-size-fits-all approach, but rather provide taxpayers three separate options for addressing this situation. A change from one option to another, however, would be considered a change in method of accounting requiring the permission of the IRS. By providing taxpayers with several options, the proposed regulations will minimize taxpayer compliance costs when dealing with non-congruent tax and financial accounting periods relative to an alternative approach of specifying a single option, with no significant revenue implications or effects on economic decisions.

iii. Revenue in an AFS

The proposed regulations describe and clarify the definition of revenue to broadly include all items of income under section 61. Because this definition of revenue is based on tax principles, there may be items of revenue included in this definition that adjust retained earnings on financial statements but are not reflected in the revenue line on such financial statements. The Treasury Department and the IRS considered and rejected a narrower definition of revenue or a definition that was tied to the AFS definition of revenue. The definition of revenue advanced in the proposed regulations is consistent with the current application of the all events test under § 1.451–1(a) and ensures that all financial statement items are taken into account for tax purposes. In contrast, a narrow definition of revenue would allow, or even encourage, taxpayers to avoid the AFS income inclusion rule by not classifying an item as revenue on their financial statement.

iv. Allocation of Transaction Price

Section 451(b)(4) specifies that, in the case of a contract which contains multiple performance obligations, the allocation of the transaction price to each obligation is determined using the allocation used in the AFS. The Code, however, does not define either transaction price or performance obligation, thus the proposed regulation defines these terms. The proposed regulations clarify that a transaction price does not include amounts collected on behalf of third parties. Transaction price also does not include amounts that are contingent on the occurrence or non-occurrence of a future event. Without these exclusions, section 451(b) could be used to override other provisions of the Code concerning the definition of what constitutes gross income. This result would be at odds with the purpose of section 451, which is not to determine the existence or the amount of gross income, but rather to determine the timing of its recognition. Consequently, alternatives to these rules were not considered here.

Amounts included in the transaction price for an AFS are presumed to be not contingent, unless the taxpayer demonstrates otherwise. The Treasury Department and the IRS project that this rule will lead to reduced compliance burden for taxpayers, and reduced administrative costs for taxpayers and IRS and should lead to fewer taxpayer disputes on this issue relative to an alternative presumption regarding possible contingent amounts.

v. Rules for Certain Debt Instruments

Section 451(b)(2) states that the AFS inclusion rule does not apply to items of gross income for which a taxpayer uses a special method of accounting provided under the Code. However, the Code does not apply this exception to special accounting rules that apply to original issue discount (''OID''), market discount, and certain other items with respect to debt instruments under part V of Subchapter P of the Code.

The proposed regulations implement this provision regarding special methods of accounting, and clarify the effect of section 451(b) on the excepted Subchapter P rules.

The proposed regulations implement this provision by providing a non-exhaustive list of special methods of accounting, and by clarifying how section 451(b) applies to certain credit card receivables. The proposed regulations specifically except from section 451(b) the timing rules for accrued market discount on bonds and the general OID timing rules, as well as the timing rules for OID determined with respect to special debt instruments (contingent payment and variable rate debt instruments, certain hedged debt instruments, and inflation-indexed debt instruments). Nevertheless, following the legislative history of the Act (see Conference Report, p. 276), the proposed regulations provide that credit card late fees, credit card cash advance fees, and interchange fees are subject to the AFS income inclusion rule. The proposed regulations further specify that if these credit card fees are subject to a taxpayer's AFS, they are not to be taken into account in determining whether a debt instrument associated with them has OID. Existing rules continue to apply to these items for taxpayers not possessing an AFS. The Treasury Department and the IRS expect that this treatment will provide a straightforward application of section 451(b) consistent with Congressional intent without unnecessarily complicating OID calculations and adding to taxpayer compliance burdens.

The Treasury Department and the IRS considered and rejected a broader application of the AFS income inclusion rule to include all amounts determined under the OID and market discount accounting methods, even in cases where the items are treated as discount or as an adjustment to the yield of a debt instrument over the life of the instrument in its AFS for financial reporting purposes. The proposed regulations do not subject these amounts to the AFS income inclusion rule because these special accounting methods do not generally rely on the all events test to determine the timing of income inclusion and these current special accounting methods provide workable income-recognition timing rules that appropriately measure income. The Treasury Department and the IRS expect that subjecting these items to the AFS income inclusion rule of section 451(b) would disrupt and complicate current tax accounting practices with no general economic benefit.

II. Paperwork Reduction Act

These proposed regulations do not impose any additional information collection requirements in the form of reporting, recordkeeping requirements or third-party disclosure requirements. However, because section 451(b) and the proposed regulations provide methods of accounting affecting the timing of income inclusion, the consent of the Commissioner under section 446(e) is required before using such method. The IRS expects that these taxpayers will request this consent by filing Form 3115, *Application for Change in Accounting Method*. Filing of Form 3115 (for taxpayers who are required to do so or who elect certain methods of accounting described in the proposed regulations) is the sole collection of information requirement imposed by the statute and the proposed regulations. See subsequent paragraphs for a description of taxpayers who would be required to change the method of accounting under the statute and the proposed regulations.

For purposes of the Paperwork Reduction Act, the reporting burden associated with these collections of information will be reflected in the IRS Form 3115 Paperwork Reduction Act Submissions (OMB control number 1545–0074 for individual income tax returns; OMB control number 1545–0123 for business taxpayers). On December 17, 2018, the Treasury Department and the IRS published Revenue Procedure 2018–60, 2018–51 IRB 1045, which provides procedures for taxpayers to make a change in method of accounting to comply with section 451(b)(1)(A) and/or (b)(4). Taxpayers are able to request these section 451 changes using reduced filing requirements, such as by filing a short Form 3115, or for certain taxpayers, by using a streamlined method change procedure that involves not filing a Form 3115. See also the revenue procedure accompanying these regulations for similar simplified method change procedures to make a change in method of accounting to comply with these proposed regulations.

In 2018, the IRS released and invited comment on a draft of Form 3115 in order to give members of the public the opportunity to benefit from certain specific provisions made to the Code. The IRS received no comments on the forms during the comment period. Consequently, the IRS made the forms available in January 2019 for use by the public. The IRS notes that Form 3115 applies to changes of accounting methods generally and is therefore broader than section 451(b).

Additionally, proposed § 1.451–3(h) provides additional methods of accounting that require a taxpayer to request consent of the Commissioner under section 446(e) before using such method. Under proposed § 1.451–3(h)(4)(iii), for a taxpayer with a financial accounting year that is different from its tax accounting year, a change in the method by which the taxpayer computes its revenue is a change in method of accounting. Under proposed § 1.451–3(h)(5), a restatement of an AFS that changes the timing of which an item of income, or portion thereof, is taken into account in revenue on the AFS is also a change in method of accounting. The Treasury Department and the IRS expect that taxpayers will request this consent by filing Form 3115.

For a taxpayer with an AFS required to comply with section 451(b) and/or proposed § 1.451–3, a change in the taxpayer's revenue recognition policies for financial accounting purposes requires the taxpayer to seek the consent of the Commissioner under section 446(e) to use the method for Federal income tax purposes. See proposed § 1.451–3(l). The reporting burden associated with the collection of information for a statement in lieu of the Form 3115 will be reflected in the Paperwork Reduction Act Submission associated with Revenue Procedure 2018–31, 2018–22 IRB 637 (or successor) (OMB control number 1545–1551). See the revenue procedure accompanying these proposed regulations.

The current status of the Paperwork Reduction Act submissions that will be revised as a result of the information collections in the proposed regulations is provided in the accompanying table. As described above, the reporting burdens associated with the information collections in the proposed regulations are included in the aggregated burden estimates for OMB control numbers 1545–0074 (in the case of individual filers of Form 3115), 1545–0123 (in the case of business filers of Form 3115), and 1545–1551 (in the case of filers subject to Revenue Procedure 2018–31). The overall burden estimates associated with the OMB control numbers below are aggregate amounts that relate to the entire package of forms associated with the applicable OMB control number and will in the future include, but not isolate, the estimated burden of the tax forms that will be created or revised as a result of the information collections in the proposed regulations. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by the proposed regulations. These burdens have been reported for other income tax regulations that rely on the same information collections and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burdens imposed by tax provisions prior to the Act. No burden estimates specific to the forms affected by the proposed regulations are currently available. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations. For the OMB control numbers discussed in the preceding paragraphs, the Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Those estimates capture both changes made by the Act and those that arise out of discretionary authority exercised in the proposed regulations (when final) and other regulations that affect the compliance burden for that form.

The Treasury Department and IRS request comment on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. In addition, when available, drafts of IRS forms are posted for comment at *https://apps.irs.gov/app/picklist/list/draftTaxForms.htm*. IRS forms are available at *https://www.irs.gov/forms-instructions*. Forms will not be finalized until after they have been approved by OMB under the PRA.

<table>
<tr><th>Form/ Revenue Procedure</th><th>Type of Filer</th><th>OMB Number(s)</th><th>Status</th></tr>
<tr><td rowspan="6">Form 3115</td><td>All other Filers (mainly trusts and estates) (Legacy system)</td><td>1545-2070</td><td>Published in the Federal Register on 2/15/17. Public comment period closed on 4/17/17.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2017/02/15/2017-02985/proposed-information-collection-comment-request</td></tr>
<tr><td>Business (NEW Model)</td><td>1545-0123</td><td>Published in the Federal Register on 10/8/18. Public comment period closed on 12/10/18.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd</td></tr>
<tr><td>Individual (NEW Model)</td><td>1545-0074</td><td>Limited scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 2019.</td></tr>
<tr><td colspan="3">Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031</td></tr>
<tr><td rowspan="2">Revenue Procedure 2018-31</td><td>IRS Research estimates</td><td>1545-1551</td><td>Published in the Federal Register on 8/31/16. Public Comment period closed on 9/30/16.</td></tr>
<tr><td colspan="3">Link: https://www.federalregister.gov/documents/2016/08/31/2016-20993/submission-for-omb-review-comment-request</td></tr>
</table>

D. Regulatory Flexibility Act

It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6).

New section 451(b) of the Act requires that an item of income be included in gross income for tax purposes no later than when the item is counted as revenue in an applicable financial statement. This typically moves the recognition of income forward by a year or two compared to previous law. These proposed regulations provide general guidance on the rule, including the scope of the rule, exceptions to the rule, definitions of key terms, and examples demonstrating applicability of the rule.

The Treasury Department and the IRS have estimated the number of small business entities that may be affected by the statute and these proposed regulations. The statute and proposed regulations affect only those business entities that (i) use an accrual method of accounting, and (ii) have an applicable financial statement.

Regarding an accrual method of accounting, many small business entities use the cash receipts and disbursements method of accounting (cash method), as opposed to an accrual method, and thus are not subject to this provision. The percent of returns that use an accrual method of accounting, by entity types and for entities with gross receipts not greater than $25 million, are shown in the accompanying table.

TOTAL RETURNS AND RETURNS USING ACCRUAL METHOD OF ACCOUNTING

[Taxable Year 2016]

Entity	Total returns (thousands)	Returns using an accrual method of accounting (thousands)	Percent of returns using accrual method of accounting
Entities with gross receipts not greater than $25 million			
C corporations	1,567	700	45
S corporations	4,551	1,140	25
Partnerships	3,743	860	23
Sole proprietors and LLCs	25,524	358	1
All entities	35,385	3,058	9

Source: Internal Revenue Service, Statistics of Income.

The Treasury Department and the IRS next examined the second condition, that only entities with an Applicable Financial Statement (''AFS'') are affected by the statute and the proposed regulations. The Treasury Department and the IRS do not have readily available data to measure the prevalence of entities with an AFS. However, Schedule M–3, which is used to reconcile an entity's net income or loss for tax purposes with its book income or loss, reports whether an entity has a certified audited income statement. Unfortunately for the current exercise, the Schedule M–3 is required to be filed only by entities possessing at least $10 million of assets. Nevertheless, it is this population that is far more likely to possess an AFS. Furthermore, data are currently available only for electronic filers.

For taxable year 2016, approximately 87 percent of accrual-method entities filing Forms 1120, 1120–S, and 1065 with gross receipts of $25 million or less were filers of electronic tax forms. About 11 percent, or 265,000 of these returns, included a Schedule M–3. About 40 percent of the returns with Schedule M–3, or 106,000, indicated they had a certified audited income statement.[1] Based on the assumption that filers of paper tax forms have the same incidence as electronic filers and that entities that do not file a Schedule M–3 generally do not have an AFS, then the Treasury Department and the IRS estimate that roughly 122,000 (=106,000/0.87) entities with gross receipts of $25 million or less are accrual-method entities that have an AFS. If 5 percent of entities that do not file a Schedule M–3 also have an AFS then approximately 247,000 entities with gross receipts of $25 million or less are potentially affected by the proposed regulations. These estimates of affected filing entities are reproduced in the following table.

CORPORATION AND PARTNERSHIP RETURNS USING AN ACCRUAL METHOD OF ACCOUNTING TAXABLE YEAR 2016

[Thousands of returns]

	E-Filed returns	Paper-Filed returns	Total returns
Entities with gross receipts not greater than $25 million			
Returns	2,441	361	2,802
Returns with a Schedule M–3	265	* *39*	* *374*
Returns with a Schedule M–3 and an audited income statement	106	* *16*	* *122*
Returns without a Schedule M–3	2,176	* *322*	* *2,498*
Returns without a Schedule M–3, but with an audited income statement	** *109*	** *16*	** *125*
Returns with an audited income statement	** *215*	** *32*	** *247*

* Estimates are obtained by assuming paper-filed returns are similar to e-filed returns as regards the incidence of a filing entity having a Schedule M–3 and an audited income statement.

** Estimates are obtained by assuming that 5% of returns without a Schedule M–3 have an audited income statement. This compares with approximately 40% of returns with a Schedule M–3 having such a statement.

Source: Non-italic entries are estimates taken from the IRS's Research, Applied Analytics and Statistics Division using data from the Compliance Data Warehouse. The total number of accrual method returns of corporations and partnerships (2,802,000) differs slightly from that reported in the earlier table (2,700,000) due to the use of different data sources for the two estimates. Italicized entries are additional estimates obtained in the manner indicated in the table notes.

This rule would not have a significant economic impact on small entities affected. The costs to comply with these proposed regulations are not significant. Taxpayers needing to make method changes pursuant to section 451(b) or the proposed regulations will be required to file a Form 3115. The Treasury Department and the IRS have provided streamlined procedures for certain taxpayers to change their method of accounting to comply with section 451(b), and plan to provide streamlined procedures for taxpayers to change to the methods of accounting described in these proposed regulations. See Revenue Procedure 2018–60, and the revenue procedure accompanying these regulations. Under the streamlined procedures, certain taxpayers would either complete only a portion of the

[1] Data are based on estimates from the IRS's Research, Applied Analytics and Statistics Division using data from the Compliance Data Warehouse.

Form 3115 or would not complete the Form 3115 at all to comply with section 451(b). The streamlined method change procedures are available to taxpayers (other than a tax shelter) who satisfy the gross receipts test under section 448(c) and for taxpayers making such a method change which results in a zero section 481(a) adjustment. (For tax years beginning in 2018, an entity satisfied the gross receipts test if its average annual gross receipts was $25 million or less. For tax years beginning in 2019, this threshold increased to $26 million or less.) In addition, the Treasury Department and the IRS plan to issue a streamlined procedure, using a short Form 3115, for taxpayers using a section 451(b) method who have a change in their AFS for revenue recognition that requires a method change for tax purposes. See the revenue procedure accompanying these regulations.

As noted in the revenue procedure accompanying these regulations, the estimated cumulative annual reporting and/or recordkeeping burden for the statutory method changes described under OMB control number 1545–1551, before publication of the revenue procedure, is 27,336 respondents, and a total annual reporting and/or recordkeeping burden of 30,580 hours. The estimated annual burden per respondent/recordkeeper under OMB control number 1545–1551 before publication of this revenue procedure varies from 1⁄6 hour to 8½ hours, depending on individual circumstances, with an estimated average of 1¼ hours. The estimated cumulative annual reporting and/or recordkeeping burden for the method changes described under OMB control number 1545–1551 after that revenue procedure is accounted for is 27,346 respondents, and a total annual reporting and/or recordkeeping burden is 31,479 hours, leaving the average reporting and recordkeeping burden essentially unchanged. These burdens are essentially unaffected by these proposed regulations.

Notwithstanding this certification, the Treasury Department and the IRS invite comments from the public about the impact of this proposed rule on small entities.

Pursuant to section 7805(f), these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled ''Federalism'') prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the **ADDRESSES** heading. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available at *http://www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Charles Gorham, IRS Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding entries in numerical order to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

* * * * *

Section 1.451–3 also issued under 26 U.S.C. 451(b)(1)(A)(ii) and (b)(3)(C).

* * * * *

§ 1.446–1 [Amended]

■ **Par. 2.** Section 1.446–1 is amended by adding ''(See § 1.451–1 for rules relating to the taxable year of inclusion.)'' between the first and second sentences of paragraph (c)(1)(ii)(A).

■ **Par. 3.** Section 1.446–2 is amended by removing ''or'' at the end of paragraph (a)(2)(i)(E), removing the period at the end of paragraph (a)(2)(i)(F) and adding in its place ''; or'' and adding paragraph (a)(2)(i)(G).

The addition reads as follows:

§ 1.446–2 Method of accounting for interest.

(a) * * *

(2) * * *

(i) * * *

(G) Section 1.451–3(i) (special ordering rule for specified fees).

* * * * *

§ 1.451–1 [Amended]

■ **Par. 4.** Section 1.451–1 is amended by:

■ a. Adding ''(the all events test)'' to the end of the second sentence of paragraph (a);

■ b. Redesignating paragraphs (b) through (g) as (d) through (i); and

■ c. Adding new paragraphs (b) and reserved (c).

The additions read as follows:

§ 1.451–1 General rule for taxable year of inclusion.

* * * * *

(b) *Special rule for timing of income inclusion for taxpayers with an applicable financial statement using an accrual method of accounting.* For the timing of income inclusion with respect to taxpayers with an applicable financial statement using an accrual method of accounting, see also § 1.451–3.

(c) [Reserved]

* * * * *

■ **Par. 5.** Section 1.451–3 is added to read as follows:

§ 1.451–3 Timing of income inclusion for taxpayers with an applicable financial statement using an accrual method of accounting.

(a) *Table of contents.* This paragraph (a) lists captioned paragraphs contained in § 1.451–3.

(b) *General rule.* If a taxpayer has an applicable financial statement (AFS), the all events test under § 1.451–1(a) with respect to any item of gross income, or portion thereof, is met no later than when that item, or portion thereof, is taken into account as revenue in the taxpayer's AFS (the AFS income inclusion rule). Except as provided in paragraph (i) of this section for certain items of income with respect to debt instruments, the AFS income inclusion rule does not apply to any item of gross income, or portion thereof, when the timing of income for that item, or portion thereof, is determined using a special method of accounting, as defined in paragraph (c)(5) of this section. If a special method of accounting is used, income is taken into account as prescribed by that special method of accounting. See, however, paragraph (d) of this section for exceptions for taxpayers without an AFS and income in connection with a mortgage servicing contract.

(c) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Applicable financial statement.* Subject to the rules in paragraph (c)(1)(iv) of this section, *applicable financial statement* (AFS) means the taxpayer's financial statement listed in paragraphs (c)(1)(i) through (iii) of this section that has the highest priority, including priority within paragraphs (c)(1)(i)(B) and (c)(1)(ii)(B) of this section. The financial statements are, in order of descending priority:

(i) *GAAP Statements.* A financial statement that is certified as being prepared in accordance with generally accepted accounting principles (GAAP) and is:

(A) A Form 10–K (or successor form), or annual statement to shareholders, filed with the United States Securities and Exchange Commission (SEC);

(B) An audited financial statement of the taxpayer that is used for:

(*1*) Credit purposes;

(*2*) Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or

(*3*) Any other substantial non-tax purpose; or

(C) A financial statement, other than a tax return, filed with the Federal government or any Federal agency, other than the SEC or the Internal Revenue Service;

(ii) *IFRS Statements.* A financial statement that is certified as being prepared in accordance with international financial reporting standards (IFRS) and is:

(A) Filed by the taxpayer with an agency of a foreign government that is equivalent to the SEC, and has reporting standards not less stringent than the standards required by the SEC;

(B) An audited financial statement of the taxpayer that is used for:

(*1*) Credit purposes;

(*2*) Reporting to shareholders, partners, or other proprietors, or to beneficiaries; or

(*3*) Any other substantial non-tax purpose; or

(C) A financial statement, other than a tax return, filed with the Federal government or any Federal agency, other than the SEC or the Internal Revenue Service, or a foreign government or agency of a foreign government, other than an agency that is equivalent to the SEC or the Internal Revenue Service; or

(iii) *Other Statements.* A financial statement, other than a tax return, filed with the Federal government or any Federal agency, a state government or state agency, or a self-regulatory organization (for example, a financial statement filed with a state agency that regulates insurance companies or the Financial Industry Regulatory Authority). Additional financial statements included in this paragraph (c)(1)(iii) may be provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter).

(iv) *Additional rules for determining priority.* If a taxpayer restates revenue in an AFS prior to the date that the taxpayer files its Federal income tax return for such taxable year, for purposes of determining priority, the restated AFS must be used instead of the original AFS. A taxpayer with different financial accounting and taxable years that is required to file both annual financial statements and periodic financial statements covering less than a year with a government agency must use the annual statement filed with the agency to determine priority.

(2) *Equity method. Equity method* means a method of accounting for financial accounting purposes under which an investment is initially recorded at cost and subsequently increased or decreased in carrying value by the investor's proportionate share of income and losses and such income or losses are reported as separate items on the investor's statement of income.

(3) *Performance obligation. Performance obligation* means a promise in a contract with a customer to transfer to the customer either a good or service, or a combination of both, that is distinct; or a series of distinct goods or services, or a combination of both, that are substantially the same and that have the same pattern of transfer to the customer.

(4) *Revenue. Revenue* means all transaction price amounts includible in gross income under section 61. The characterization of a transaction price in the AFS is not determinative of whether it is taken into account as revenue in a taxpayer's AFS. For example, any transaction price amount that is reported as other comprehensive income in an AFS is taken into account as revenue in an AFS.

(5) *Special method of accounting. Special method of accounting* means a method of accounting permitted or required under any provision of the Code, the Income Tax Regulations, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter) under which an item of income is taken into account in a taxable year other than the taxable year in which the all events test is met. See, however, paragraph (i) of this section relating to certain items of income with respect to debt instruments. The following are examples of special methods of accounting to which the AFS income inclusion rule generally does not apply:

(i) The crop method of accounting under sections 61 and 162;

(ii) Methods of accounting provided in sections 453 through 460;

(iii) Methods of accounting for hedging transactions under § 1.446–4;

(iv) Methods of accounting for REMIC inducement fees under § 1.446–6;

(v) Methods of accounting for gain on shares in a money market fund under § 1.446–7;

(vi) Methods of accounting for certain rental payments under section 467;

(vii) The mark-to-market method of accounting under section 475;

(viii) Timing rules for income and gain associated with a transaction that is integrated under § 1.988–5, and income and gain under the nonfunctional currency contingent payment debt instrument rules in § 1.988–6;

(ix) Except as otherwise provided in paragraph (i) of this section, timing rules for original issue discount (OID) under section 811(b)(3) or 1272 (and the regulations under section 1272), income under the contingent payment debt instrument rules in § 1.1275–4, income under the variable rate debt instrument rules in § 1.1275–5, income and gain associated with a transaction that is integrated under § 1.1275–6, and income under the inflation-indexed debt instrument rules in § 1.1275–7;

(x) Timing rules for de minimis OID under § 1.1273–1(d) and for de minimis market discount (as defined in section 1278(a)(2)(C));

(xi) Timing rules for accrued market discount under sections 1276 and 1278(b); and

(xii) Methods of accounting provided in sections 1502 and 1503 and the regulations thereunder, including the method of accounting relating to intercompany transactions under § 1.1502–13.

(6) *Transaction price.* The transaction price means the gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes in exchange for transferring promised goods, services, or other property, including amounts referred to in paragraph (i) of this section, but not including:

(i) Amounts collected on behalf of third parties (for example, some sales taxes) that are otherwise not income to the taxpayer;

(ii) Increases in consideration to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event (for example, bonuses contingent on performance and insurance contract commissions contingent on renewal) for the period in which the amount is contingent. Amounts included in the transaction price for AFS purposes are presumed to not be contingent on the occurrence or nonoccurrence of a future event, unless, upon examination of all the facts and circumstances existing at the end of the taxable year, it can be established to the satisfaction of the Commissioner that the amount is contingent on the occurrence or nonoccurrence of a future event. An amount included in the transaction price for AFS purposes that is actually or constructively received, that is due and payable, or for which the taxpayer has an enforceable right to payment for performance completed to date, however, will not be treated as contingent on the occurrence or nonoccurrence of a future event; or

(iii) Reductions for amounts subject to section 461, including allowances, adjustments, rebates, chargebacks, refunds, rewards (for example, estimated redemption costs associated with loyalty programs), and amounts included in costs of goods sold.

(d) *Exceptions to the AFS income inclusion rule.* The AFS income inclusion rule does not apply unless all of the taxpayer's taxable year is covered by an AFS. In addition, the AFS income inclusion rule does not apply to any item of income in connection with a mortgage servicing contract.

(e) *No change in the treatment of a transaction.* Except as provided in paragraph (i)(2) of this section, the AFS income inclusion rule does not change the treatment of a transaction for Federal income tax purposes. The following are examples of transactions where the treatment for AFS purposes does not change the treatment of the transaction for Federal income tax purposes:

(1) A transaction treated as a lease, license, or similar transaction for Federal income tax purposes that is treated as a sale or financing for AFS purposes, and vice versa;

(2) A transaction that is not required to be marked-to-market for Federal income tax purposes but that is marked-to-market for AFS purposes;

(3) Asset sale and liquidation treatment under section 336(e) or 338(h)(10);

(4) A distribution of a corporation or the allocable share of partnership items or an income inclusion under section 951, 951A, or 1293(a) for Federal income tax purposes that is accounted for under the equity method for AFS purposes;

(5) A distribution of previously taxed earnings and profits of a foreign corporation; and

(6) A deposit or conduit payment for Federal income tax purposes that is treated as revenue for AFS purposes.

(f) *No change to exclusion provisions and the treatment of non-recognition transactions.* The AFS income inclusion rule does not change the applicability of any exclusion provision, or the treatment of non-recognition transactions, in the Code, the Income Tax Regulations, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter). The following are examples of exclusion provisions and non-recognition transactions that are not affected by the AFS income inclusion rule:

(1) Any non-recognition transaction, within the meaning of section 7701(a)(45), (for example, a liquidation

described in sections 332 and 337, an exchange described in section 351, a distribution described in section 355, a reorganization described in section 368, a contribution described in section 721, or transactions described in sections 1031 through 1045); and

(2) Items specifically excluded from income under sections 101 through 140.

(g) *Contracts with multiple performance obligations*—(1) *In general.* For purposes of this section, if a taxpayer's contract with a customer has more than one performance obligation, transaction price is allocated to performance obligations as transaction price is allocated to performance obligations in the taxpayer's AFS.

(2) *Example.* Taxpayer A, a manufacturer and servicer of airplane parts, is a calendar-year accrual method taxpayer with an AFS. In 2018, A enters into a $100x contract to sell airplane parts and to service those parts, as necessary, in 2018, 2019, and 2020. For AFS purposes, A allocates $40x of the total contract price to the delivery of parts in 2018, $10x to the provision of services in 2018, $20x to the provision of services in 2019, and $30x to the provision of services in 2020. In 2018, A delivers parts and provides services. On its 2018 AFS, A includes the $40x for the delivery of parts and the $10x for the provision of services in revenue. Under paragraph (g)(1) of this section, because the contract involves multiple performance obligations, A must use its transaction price AFS allocation to determine whether income from the sale of airplane parts and services are included in revenue in its AFS for purposes of this section. Accordingly, under the AFS income inclusion rule in paragraph (b) of this section, for the $40x sale of airplane parts and the $10x provision of services in 2018 the all events test is not met any later than A's 2018 taxable year.

(h) *Additional AFS issues*—(1) *AFS covering groups of entities*—(i) *In general.* For purposes of this section, if a taxpayer's financial results are reported on the AFS for a group of entities, the taxpayer's AFS is the group's AFS. However, if the taxpayer's financial results are also reported on a separate AFS that is of equal or higher priority to the group's AFS under paragraph (c)(1) of this section, then the taxpayer's AFS is the separate AFS.

(ii) *Example.* Taxpayer B, a reseller of computers and electronics, is a calendar-year accrual method taxpayer. In 2018, B's financial results are included in its parent corporation's consolidated Form 10–K filed with the SEC, but it files a separate Federal income tax return. Under paragraph (h)(1) of this section, because its financial results are reported on the AFS for its parent corporation, B must use its parent corporation's consolidated Form 10–K as its AFS. Accordingly, under the AFS income inclusion rule in paragraph (b) of this section, for the sale of computers and electronics the all events test is not met any later than when the sale is included in its parent corporation's consolidated Form 10–K.

(2) *Separately stated items.* If a group's AFS is treated as the taxpayer's AFS, the taxpayer must look to any separately stated items to determine the amount of revenue allocated to the taxpayer.

(3) *Non-separately stated items.* If a group's AFS does not separately state items, the portion of the revenue allocable to the taxpayer is determined by relying on the source documents that were used to create the group's AFS.

(4) *Computation of revenue when the AFS covers mismatched reportable periods*—(i) *In general.* If a taxpayer's AFS is prepared on the basis of a financial accounting year that differs from the taxpayer's taxable year, the taxpayer must use one of the permissible methods listed in paragraph (h)(4)(ii) of this section to determine revenue for purposes of the AFS income inclusion rule.

(ii) *Permissible methods to determine revenue.* For purposes of paragraph (h)(4)(i) of this section, a taxpayer must use one of the following methods to determine revenue for the taxable year in order to apply the AFS income inclusion rule:

(A) The taxpayer computes revenue by using the accounting principles used to create its AFS to determine whether an item would be included in revenue in an AFS for the taxable year as if its financial reporting period was the same as its taxable year, for example, by conducting an interim closing of its books.

(B) The taxpayer computes revenue by including a pro rata portion of the revenue for each financial accounting year that includes any part of the taxpayer's taxable year. If the taxpayer's AFS for part of the taxable year is not available by the due date of the return (with extension), the taxpayer must make a reasonable estimate of revenue for the pro rata portion of the taxable year for which an AFS is not yet available. See § 1.451–1(a) for adjustments after actual amounts are determined.

(C) If a taxpayer's financial accounting year ends five or more months after the end of its taxable year, the taxpayer computes revenue for Federal income tax purposes based on the revenue reported on the AFS prepared for the financial accounting year ending within the taxpayer's taxable year. For purposes of this paragraph (h)(4)(ii)(C), if a taxpayer uses a 52–53 week year for financial accounting or Federal income tax purposes, the last day of such year shall be deemed to occur on the last day of the calendar month ending closest to the end of such year.

(iii) *Method of accounting.* A change in the method of computing revenue under this paragraph (h)(4) is a change in method of accounting under section 446. A taxpayer may change its method of accounting only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations.

(5) *Restatement of AFS.* If a taxpayer restates revenue on an AFS and such restatement changes the timing of when an item of income, or a portion thereof, is taken into account as revenue on the AFS, the change constitutes a change in method of accounting under section 446. A taxpayer may change its method of accounting only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations. If a taxpayer restates revenue on an AFS to correct an error or the restatement results in a change in the estimate of the taxpayer's pro rata portion of revenue under paragraph (h)(4)(ii)(B) of this section, see § 1.451–1(a).

(i) *Special ordering rule for certain items of income with respect to debt instruments*—(1) *In general.* If an item of income, or portion thereof, with respect to a debt instrument is described in paragraph (i)(2) of this section, the rules of this section apply before the rules in sections 1271 through 1275 and §§ 1.1271–1 through 1.1275–7 (OID rules). Therefore, an item of income, or portion thereof, described in paragraph (i)(2) of this section may not be taken into income later than when that item, or portion thereof, is taken into account as revenue in the taxpayer's AFS, regardless of whether the timing of income inclusion for that item is normally determined using a special method of accounting. See also § 1.1275–2(l) for the treatment of the items described in paragraph (i)(2) of this section under the OID rules.

(2) *Specified fees.* Paragraph (i)(1) of this section applies to fees (specified fees) that are not treated as discount or as an adjustment to the yield of a debt instrument over the life of the instrument (such as points) in the taxpayer's AFS and, but for paragraph (i) of this section and § 1.1275–2(l), would be treated as creating or increasing OID for Federal income tax purposes. For example, the following specified fees (specified credit card fees) are described in this paragraph (i)(2):

(i) A payment of additional interest or a similar charge provided with respect to amounts that are not paid when due on a credit card account (for example, credit card late fees);

(ii) Amounts charged under a credit card agreement when the cardholder uses the credit card to conduct a cash advance transaction (for example, credit card cash advance fees); and

(iii) Amounts a credit or debit card issuer is entitled to upon a purchase of goods or services by one of its cardholders (for example, interchange fees, which are sometimes labeled merchant discount in certain private label credit card transactions).

(3) *Example.* Taxpayer C, a credit card issuer, is a calendar-year accrual method taxpayer with an AFS. In 2019, a cardholder uses C's credit card to purchase $100 of merchandise from a merchant and the cardholder earns a reward of 1% of the purchase price of $100 ($1) as part of C's cardholder loyalty program. Upon purchase, C becomes entitled to an interchange fee equal to 2% of the purchase price of $100 ($2). In 2019, C reports the $2 of interchange fees as revenue in its AFS. C's $2 of interchange fees is described in paragraph (i)(2)(iii) of this section. Under paragraph (i)(1) of this section, C must apply the rules in this section before applying the OID rules. See also § 1.1275–2(l). Therefore, C's $2 of interchange fees is included in taxable income in 2019, the year it is included as revenue in C's AFS. Under paragraph (c)(6)(iii) of this section, the $2 of interchange revenue is not reduced by the $1 reward. Even if C reports interchange fees net of rewards in its AFS for 2019 ($2 of interchange fee minus $1 reward liability), under paragraph (c)(6) of this section, C includes $2 of interchange revenue in taxable income in 2019. See §§ 162 and 461(h) for the treatment of the reward by C.

(j) *Treatment of adjustments to deferred revenue in an AFS*—(1) *In general.* For purposes of this section, if a taxpayer treats an item of income as deferred revenue in its AFS and writes down or adjusts that item, or portion thereof, to an equity account (for example, retained earnings) or otherwise writes down or adjusts that item of deferred revenue in a subsequent taxable year, revenue for that subsequent taxable year includes that item, or portion thereof, that is written down or adjusted.

(2) *Example.* Taxpayer D, a remanufacturer of industrial equipment, is a calendar-year accrual method taxpayer with an AFS. In 2018, D enters into a contract with a customer to remanufacture equipment in 2019 and 2020 for $100x. The contract is not a long-term contract under section 460. In its 2018 AFS, D treats the $100x as deferred revenue. In 2019, all the stock of D is acquired by an unrelated third party. In its 2019 AFS, D adjusts deferred revenue to $90x (the expected cost to provide the services) by charging $10x ($100x − $90x = $10x) to retained earnings. In its 2019 AFS, D includes $50x of the $90x of deferred revenue in revenue. Under paragraph (j)(1) of this section, D's adjustment to deferred revenue in 2019 is treated as revenue under paragraph (c)(4) of this section in 2019. Therefore, under the AFS income inclusion rule in paragraph (b) of this section, D is treated as including $60x ($50x + $10x = $60x) in revenue in its 2019 AFS, and the all events test is met for that $60x no later than D's 2019 taxable year.

(k) *Cumulative rule for multi-year contracts.* In the case of a multi-year contract, a taxpayer must take into account the cumulative amounts included in income in prior taxable years on the contract, if any, in order to determine the amount to be included for the taxable years remaining in the contract. For purposes of this paragraph (k), multi-year contract means a contract that spans more than one taxable year.

(l) *Methods of accounting*—(1) *In general.* A change in the method of recognizing revenue in an AFS that changes or could change the timing of the recognition of income for Federal income tax purposes is a change in method of accounting under section 446. A taxpayer may change its method of accounting only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations. Accordingly, a taxpayer that changes the method of accounting used to recognize revenue in its AFS is required to secure consent of the Commissioner before computing income using this new method for Federal income tax purposes.

(2) *Transition rule for changes in method of accounting*—(i) *In general.* Except as provided in paragraph (l)(2)(ii) of this section, a taxpayer that makes a qualified change in method of accounting for the taxpayer's first taxable year beginning after December 31, 2017, is treated as making a change in method initiated by the taxpayer for purposes of section 481(a)(2). A taxpayer obtains the consent of the Commissioner to make a qualified change in method of accounting by using the applicable administrative procedures that govern voluntary automatic changes in method of accounting under section 446(e). See section § 1.446–1(e)(3).

(ii) *Special rules for OID and specified fees.* The rules of paragraph (l)(2)(i) of this section apply to a qualified change in method of accounting required under section 451(b) and paragraph (i) of this section for the taxpayer's first taxable year beginning after December 31, 2018, if the change relates to a specified credit card fee (as defined in paragraph (i)(2) of this section). The rules of paragraph (l)(2)(i) of this section apply to a qualified change in method of accounting required under section 451(b) and paragraph (i) of this section for the taxpayer's first taxable year beginning one year after the date the Treasury decision adopting these regulations as final is published in the **Federal Register**, if the change relates to a specified fee (as defined in paragraph (i)(2) of this section) other than a specified credit card fee. For purposes of this paragraph (l)(2)(ii), the section 481(a) adjustment period for any adjustment under section 481(a) for a qualified change in method of accounting required under section 451(b) and paragraph (i) of this section is six taxable years.

(iii) *Qualified change in method of accounting.* For purposes of paragraph (l)(2) of this section, a qualified change in method of accounting means any change in method of accounting that is required by section 13221 of the Tax Cuts and Jobs Act, Public Law 115–97 (131 Stat. 2054) (TCJA), or was prohibited under the Internal Revenue Code of 1986 prior to TCJA section 13221 and is now permitted as a result of TCJA section 13221.

(m) *Examples.* The following examples illustrate the provisions of this section:

(1) *Example 1. Mismatched reportable periods.* Taxpayer A is a calendar-year accrual method taxpayer with an AFS. For AFS purposes, A's financial results are reported on a June 30 fiscal year. Using the method described in paragraph (h)(4)(ii)(A) of this section, for the taxable year 2018, A uses the financial results reported on its June 30, 2018, AFS to determine whether an item of income was taken into account as revenue in A's AFS from January 1, 2018, through June 30, 2018, and uses its June 30, 2019, AFS to determine whether an item of income is taken into account as revenue in A's AFS from July 1, 2018, through December 31, 2018.

(2) *Example 2. Provision of installation services.* Taxpayer B is a calendar-year accrual method taxpayer with an AFS. In 2018, B enters into a contract with a customer to provide manufacturing equipment installation services for $100,000. Throughout the contract, the customer retains control of the equipment. B has an enforceable right to payment for services partially performed. The contract is not a long-term contract under section 460. B begins providing the installation services in 2018 and completes the installation services in 2019. Under the contract, B bills the customer $50,000 in 2018 when installation begins. B includes $60,000 in revenue in its 2018 AFS and $40,000 in revenue in its 2019 AFS. Under the AFS income inclusion rule in paragraph (b) of this section, because $60,000 of revenue from the installation services is included in B's 2018 AFS, the all events test for that $60,000 of income is met in B's 2018 taxable year.

(3) *Example 3. Provision of goods.* Taxpayer C is a calendar-year accrual method taxpayer with an AFS. In 2018, C enters into

a contract with a customer to provide 50 customized computers for $80,000. Under the contract, C can bill $80,000 after the customer accepts delivery of the computers. However, because of the customization, the contract provides that C can be paid for work performed to date, even if the contract is not completed for reasons other than C's failure to perform. C delivers all of the computers in 2018. Customer accepts delivery of the computers and C bills the customer in 2019. C includes all $80,000 in revenue in its 2018 AFS. Under the AFS income inclusion rule in paragraph (b) of this section, because $80,000 of revenue from the provision of goods is included in C's 2018 AFS, the all events test for that $80,000 of income is met in C's 2018 taxable year. Under paragraph (c)(6)(ii) of this section, the limitation on C's ability to bill until after the customer accepts delivery of the computers is not a future event that restricts C's enforceable right to payment for the goods.

(4) *Example 4. Provision of services included in AFS without deferral of advance payments under section 451(c)(1)(B).* Taxpayer D, an engineering services provider, is a calendar-year accrual method taxpayer with an AFS. In 2018, D enters into a contract with a customer to provide services for four years for a total of $100x. Under the contract, D receives $25x each year of the contract. D does not elect to defer advance payments under section 451(c)(1)(B). For AFS purposes, D reports $50x, $0, $20x, and $30x of revenue from the contract in 2018, 2019, 2020, and 2021, respectively. Under paragraph (g)(1) of this section, the allocation of the transaction price in D's AFS is used to determine when all or part of that item is taken into account for purposes of paragraph (b) of this section. In 2018, D includes all of the $25x payment in income from the contract under the all events test. In addition, under paragraph (b) of this section, because $50x of revenue from the provision of services is included in D's 2018 AFS, the all events test for that portion of the provision of services is not met later than D's 2018 taxable year. Therefore, D must include the additional $25x ($50x − $25x = $25x) reported on the AFS as income in 2018. In 2019, under paragraph (k) of this section, D includes $0 of the $25x payment in income from the contract because the payment received in 2019 relates to income included in 2018. In 2020, D includes all of the $25x payment in income from the contract under the all events test. In 2021, D includes the remaining $25x payment in income under the contract under the all events test. This example is summarized in the table below:

	2018	2019	2020	2021	Total
Payments	$25x	$25x	$25x	$25x	$100x
AFS Revenue	50x	0	20x	30x	100x
Income	50x	0	25x	25x	100x

(5) *Example 5. Provision of services included in AFS with deferral of advance payments under section 451(c)(1)(B).* The facts are the same as in *Example 4* in paragraph (m)(4) of this section, except D elects to defer advance payments under section 451(c)(1)(B). Under paragraph (g)(1) of this section, the allocation of the transaction price in D's AFS is used to determine when all or part of that item is taken into account for purposes of paragraph (b) of this section. In 2018, D includes all of the $25x payment in income from the contract under the all events test. In addition, under paragraph (b) of this section, because $50x of revenue from the provision of services is included in D's 2018 AFS, the all events test for that portion of the provision of services is not met later than D's 2018 taxable year. Therefore, D must include an additional $25x ($50x—$25x = $25x) of income in 2018. In 2019, under paragraph (k) of this section, D includes $0 of the $25x payment in income from the contract because the payment received in 2019 relates to income included in 2018. In 2020, D includes $20x of the $25x payment in income from the contract under the deferral method for advance payments under section 451(c)(1)(B). In 2021, D includes the $5x that was deferred in 2020 under the deferral method for advance payments under section 451(c)(1)(B) and the remaining $25x payment in income under the contract under the all events test. This example is summarized in the table below:

	2018	2019	2020	2021	Total
Payments	$25x	$25x	$25x	$25x	$100x
AFS Revenue	50x	0	20x	30x	100x
Income	50x	0	20x	30x	100x

(6) *Example 6. Sale of goods with AFS revenue adjustments.* Taxpayer E, a manufacturer of automobile parts, is a calendar-year accrual method taxpayer with an AFS. E normally sells parts for $10 per part with a 2% bonus if the parts are delivered on time. Traditionally, 5% of parts sold are returned. In 2018, E enters a contract to sell 1,000 parts to a customer for $10 per part, for a total of $10,000 (1,000 x $10 = $10,000). The contract also provides that E will receive a 2% bonus if it delivers all the parts to the customer by February 1, 2019. E delivers 500 parts to the customer on December 31, 2018. On December 31, 2018, the additional 500 parts were scheduled for shipment to the customer on January 4, 2019. For AFS purposes, E expects to earn the 2% bonus and to have 5% of the parts returned. In its 2018 AFS, E reports $4,850 ($5,000 + $100—$250 = $4,850) of revenue from the contract, including a $100 (2% x $5,000 = $100) adjustment for the expected bonus and a $250 (5% x $5,000 = $250) adjustment for anticipated returns. Under paragraph (c)(6)(iii) of this section, E's transaction price does not include anticipated returns. See § 1.461–4(g)(3) for rules on when the return liability is incurred. Under paragraph (c)(6)(ii) of this section, the performance bonus is presumed not to be contingent on the occurrence or nonoccurrence of a future event. However, at the end of the year, all parts have yet to be delivered within the February 1, 2019 deadline. Under the contract, E has no right to payment of the bonus at the end of the year. Therefore, the presumption is rebutted. In addition, under paragraph (g)(1) of this section, the allocation of the transaction price in E's AFS is used to determine when all or part of that item is taken into account for purposes of paragraph (b) of this section. Accordingly, under paragraph (b) of this section, because $5,000 of revenue from the sale of parts is taken into account in E's 2018 AFS, the all events test for $5,000 of income allocated to those parts is met in E's 2018 taxable year.

(7) *Example 7. Chargebacks.* Taxpayer F, a manufacturer of pharmaceuticals, is a calendar-year accrual method taxpayer with an AFS. In addition to billing the wholesaler for the sale of the pharmaceutical at the wholesale acquisition cost under the contract, F generally credits or pays wholesalers a chargeback of 40% of the wholesale acquisition cost for sales made by those wholesalers to qualifying customers. In 2018, F enters into a contract to sell 1,000 units to W, a wholesaler, for $10 per unit, totaling $10,000 (1,000 x $10 = $10,000). The contract also provides that F will issue a 40% chargeback for sales by W to certain qualifying customers. F delivers 600 units to W on December 31, 2018, and bills W $6,000 under the contract. For AFS purposes, F adjusts its revenue by 40% for all sales to W for anticipated chargebacks. As such, in its 2018 AFS, F reports $3,600 ($6,000 − $2,400 = $3,600) of revenue from the contract with W, decreasing revenue by $2,400 (40% x $6,000 = $2,400) for anticipated chargeback claims. For Federal income tax purposes, under paragraph (c)(6)(iii) of this section, F's 2018 revenue is $6,000 because F's revenue is not reduced for anticipated chargebacks.

(8) *Example 8. Sale of property using a special method of accounting.* Taxpayer G, a

provider of financial services, is a calendar-year accrual method taxpayer with an AFS. In 2018, G sells a building for $100x, payable in five annual payments of $20x starting in 2018. In its 2018 AFS, G reports all $100x of revenue from the sale of the building. For Federal income tax purposes, G uses the installment method under section 453 for the sale of the building. Under paragraph (c)(5) of this section, the installment method under section 453 is a special method of accounting because it requires income to be taken into account in a taxable year other than the taxable year in which the all events test is met. Therefore, under paragraph (b) of this section, this section does not apply to G's sale of the building because it is using a special method of accounting and the income is taken into account as prescribed in section 453.

(9) *Example 9. Non-recognition provisions not changed for Federal income tax purposes.* Taxpayer H (Distributing) is a calendar-year accrual method C corporation with an AFS. On December 31, 2018, Distributing (i) contributes assets to a wholly owned subsidiary (Controlled) in exchange for Controlled stock and $100x, and (ii) distributes all of Controlled's stock pro rata to its shareholders. The transaction qualifies as a reorganization under section 368(a)(1)(D) and a distribution to which section 355 applies (D reorganization). Distributing's realized gain on the transferred assets for book and tax purposes is $150x. On January 15, 2019, in pursuance of the plan of reorganization, Distributing distributes the $100x to its shareholders. Consequently, no gain to Distributing is recognized under section 361(b)(1)(A). On Distributing's 2018 AFS, Distributing recognizes revenue of $150x related to the D reorganization. Under paragraph (f) of this section, nothing in section 451(b) or this section changes the applicability of any deferral, non-recognition, or exclusion provision of the Code, the Income Tax Regulations, or other guidance published in the Internal Revenue Bulletin. Section 361 provides that Distributing does not recognize any gain from the D reorganization. Pursuant to paragraph (f) of this section, nothing in section 451(b) or this section would change the result that Distributing does not recognize gain on Distributing's (i) contribution of assets to Controlled, (ii) receipt of Controlled stock and cash, and (iii) distribution of Controlled stock and cash to Distributing's shareholders.

(10) *Example 10. Insurance contract renewals.* The taxpayer, an insurance agent, is engaged by an insurance carrier to sell insurance. By written binding contract between the taxpayer and the insurance carrier, the taxpayer is entitled to receive a $50 commission from the insurance carrier at the time a policy is sold to a customer. The written binding contract also provides that the taxpayer is entitled to receive an additional $25 commission each time a policy is renewed. The taxpayer sells 1,000 one-year policies in year one, of which 800 are renewed in year two and 700 are renewed in year three. The taxpayer does not have any ongoing obligation to provide additional services to the insurance carrier or the customers after the initial sale of the policy. The taxpayer includes $86,000 in revenue in its AFS for year one, which includes $50,000 of consideration for policies sold in year one and an estimate of $36,000 of consideration for the policies expected to be renewed in years two and three. Under paragraph (c)(6)(ii) of this section, because the taxpayer is able to demonstrate by written binding contract that the amounts related to future insurance contract renewals are contingent on the occurrence of a future event (that is the customer contract renewal), the taxpayer's transaction price from commissions is $50,000 ($50 * 1,000) in year one, $20,000 ($25 * 800) in year two, and $17,500 ($25 * 700) in year three.

(n) *Applicability date*—(1) *In general.* Except as provided in paragraph (n)(2) of this section, these regulations are proposed to apply for taxable years beginning after the date the Treasury decision adopting these regulations as final is published in the **Federal Register**.

(2) *Delayed application with respect to certain fees.* Notwithstanding paragraph (n)(1) of this section, paragraph (i)(2) of this section is proposed to apply to specified fees (as defined in paragraph (i)(2) of this section) other than specified credit card fees (as defined in paragraph (i)(2) of this section) for taxable years beginning one year after the date the Treasury decision adopting these regulations as final is published in the **Federal Register**.

(3) *Early application of this section*—(i) *In general.* Except as provided in paragraph (n)(3)(ii) of this section, until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2017, if the taxpayer applies all the applicable rules contained in these proposed regulations (other than those applicable to specified fees), and consistently applies these proposed regulations to all items of income during the taxable year (other than specified fees).

(ii) *Certain fees*—(A) *Specified credit card fees.* Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, in the case of a specified credit card fee, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2018, if the taxpayer applies all the applicable rules contained in these proposed regulations for a specified credit card fee, and consistently applies these proposed regulations to all items of income during the taxable year (other than specified fees that are not specified credit card fees).

(B) *Specified fees.* Paragraph (n)(3)(i) of this section does not apply to specified fees that are not specified credit card fees.

■ **Par. 6.** Section 1.1275–2 is amended by adding paragraph (l) to read as follows:

§ 1.1275–2 Special rules relating to debt instruments.

* * * * *

(l) *OID rule for income item subject to section 451(b)*—(1) *In general.* Notwithstanding any other rule in sections 1271 through 1275 and §§ 1.1271–1 through 1.1275–7, if, and to the extent, a taxpayer's item of income with respect to a debt instrument is subject to the timing rules in § 1.451–3(i) (including credit card late fees, credit card cash advance fees, or interchange fees), then the taxpayer does not take the item into account to determine whether the debt instrument has any OID. As a result, the taxpayer does not treat the item as creating or increasing any OID on the debt instrument.

(2) *Applicability dates*—(i) *In general.* Except as provided in paragraphs (l)(2)(ii) and (iii) of this section, paragraph (l)(1) of this section applies for taxable years beginning after the date the Treasury decision adopting these regulations as final is published in the **Federal Register**.

(ii) *Early adoption.* Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2018, for a specified credit card fee as defined in § 1.451–3(i)(2), if applied consistently to all specified credit card fees subject to § 1.451–3(i).

(iii) *Applicability date for purposes of accounting method changes.* Paragraph (l)(1) of this section will not apply for purposes of applying section 13221(e) of the Tax Cuts and Jobs Act, Public Law 115–97 (131 Stat. 2054) to determine the section 481(a) adjustment period for any adjustment under section 481(a) for a qualified change in method of accounting required under section 451(b) and § 1.451–3(i) for the items subject to § 1.451–3(i).

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

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