On July 11, 2019, the Internal Revenue Service (Service) and Department of Treasury (Treasury) issued final regulations to remove Treas. Reg. § 1.451-5, which allowed taxpayers to delay reporting income with respect to advance payments (e.g., an amount received by a taxpayer in the current tax year under an agreement to sell goods in a future tax year). Specifically, Treas. Reg. § 1.451-5 had allowed taxpayers to defer income recognition for advance payments for goods until the tax year in which they were properly included in income under the taxpayer's method of accounting, which in certain circumstances allowed a multiyear deferral. As indicated in the preamble to the final regulations, by finalizing the removal of Treas. Reg. § 1.451-5, the Service has paved the way for the new deferral rules of § 451(c) to apply “uniformly and consistently to all taxpayers.” With the proposed regulations for both §§ 451(b) and 451(c) still under review by the Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA), taxpayers currently face the challenge of changing from their historic practice of deferring income recognition to recognizing it much sooner, without any substantive guidance.

Background

Section 451 provides guidance regarding the timing of income recognition. For accrual method taxpayers, Treas. Reg. § 1.451-1(a) provides that income is includible in gross income when all the events have occurred that fix the right to receive the income, and the income can be determined with reasonable accuracy (All Events Test). There are numerous exceptions to the All Events Test allowing taxpayers to defer income recognition beyond the year of receipt, including the Deferral Method under Rev. Proc. 2004-34 for advance payments for goods and services and the deferral provided under Treas. Reg. §1.451-5 for advance payments for goods. Under the Deferral Method, an advance payment for goods and services is included in gross income for the taxable year of receipt to the extent recognized for financial accounting purposes for that taxable year, and the remaining amount of the advance payment is included in the next succeeding taxable year after the taxable year in which the payment is received (i.e., a one-year deferral). Under Treas. Reg. §1.451-5, taxpayers could defer the inclusion of income for advance payments for goods until the taxable year when such income was properly included in income, which meant that in certain circumstances, companies could defer income recognition for multiple years.

Under the Tax Cuts and Jobs Act (TCJA), these historic rules of income recognition were changed. Section 451(b) was revised to provide that for accrual method taxpayers, the All Events Test for any item of income shall not be treated as satisfied any later than when such income is recognized for financial accounting purposes. Additionally, § 451(c) was added to the Internal Revenue Code and allows a taxpayer to elect to defer the recognition of advance payments to the taxable year following the taxable year of receipt, except any
portion of such payment that is required under § 451(b) to be included in gross income in the taxable year in which the payment is received, generally applying rules similar to Rev. Proc. 2004-34.

The legislative history to § 451(c) indicated that the new income deferral provisions overrode the deferral method provided by Treas. Reg. § 1.451-5.¹ In accordance with that intent, on October 15, 2018, the Service and Treasury published a notice of proposed rulemaking containing proposed regulations under § 451 removing Treas. Reg. § 1.451-5.

Final Regulations

Subsequent to the issuance of the aforementioned proposed regulations, the Service and Treasury received no public comments, and on July 11, 2019, adopted the proposed regulations as final regulations with no modifications. As indicated in the preamble to these final regulations, “removing Treas. Reg. § 1.451-5 ensures the new deferral rules of section 451(c) apply uniformly and consistently to all taxpayers and simplifies tax administration.” This repeal essentially streamlines the treatment of advance payments for goods. It is also important to note that the general rules for changes in accounting methods under § 446 apply to taxpayers changing a method of accounting for advance payments from a method under Treas. Reg. § 1.451-5 to another method, thus requiring taxpayers on Treas. Reg. § 1.451-5 methods to file method changes in the event they choose to change their method of accounting for such items.

Eversheds Sutherland Perspective:

The treatment of advance payments has a long and storied history. Over approximately two decades, there was significant litigation involving whether it was an abuse of discretion for the IRS to require advance payments to be included in income in the year of receipt without regard to satisfaction of the All Events Test. Notwithstanding a trilogy of Supreme Court decisions addressing these issues, litigation persisted because certain courts took the position that income deferral for advance payments was allowed. In Artnell Co. v. Commissioner, for example, the Seventh Circuit Court of Appeals found that prepaid income for advance ticket sales for Chicago White Sox baseball games was not required to be included in income until the year in which the games were played.² The court found that deferral of prepaid income clearly reflects income, and the Commissioner’s rejection of the taxpayer’s approach would be an abuse of discretion.

In an effort to eliminate ongoing disputes and to narrow the disparity between income recognition treatment for book and tax purposes, the IRS issued a series of administrative relief provisions allowing income deferral for advance payments. Treas. Reg. § 1.451-5, which was issued in 1971, allowed deferral of advance payments received under contracts for sales of goods and building, installing, constructing, or manufacturing contracts. The regulations also allowed deferral treatment for advance payments received for certain long-term
contracts. Because the regulations allowed deferral until prepaid income was earned, multiyear deferral was available and many companies have taken advantage of this provision for decades.

With the repeal of Treas. Reg. § 1.451-5 finalized, taxpayers face uncertainty regarding the treatment of items for which deferral has been available for almost 50 years. The repeal of Treas. Reg. § 1.451-5 means that companies must evaluate whether alternative positions may be developed to support continued multiyear deferral. In considering whether to change the historic treatment of advance payments for the 2018 tax year, companies face the challenge of implementing a new approach for advance payments when there is no substantive guidance. While proposed regulations for both §§ 451(b) and (c) are reportedly being reviewed at OIRA, there has been no indication with respect to the timing of their release. Due to this heightened level of uncertainty and lack of definitive guidance, companies will have to take 2018 filing positions without clear direction from the government. Even if proposed regulations under §§ 451 (b) and (c) are released shortly, such guidance will not be finalized in time for the 2018 tax filing season.


2 400 F.2d 981 (7th Cir. 1968).

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