DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9941]

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Taxable Year of Income Inclusion Under an Accrual Method of Accounting and Advance Payments for Goods, Services, and Other Items

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding the timing of income inclusion under an accrual method of accounting, including the treatment of advance payments for goods, services, and certain other items. The regulations reflect changes made by the Tax Cuts and Jobs Act and affect taxpayers that use an accrual method of accounting and have an applicable financial statement. These final regulations also affect taxpayers that use an accrual method of accounting and receive advance payments.

DATES:

Effective Date: The regulations are effective on December 30, 2021.

Applicability Dates: For dates of applicability, see §§ 1.451–3(m), 1.451–8(h), and 1.1275–2(l)(2).

FOR FURTHER INFORMATION CONTACT: Concerning any provisions in § 1.451–3 within the jurisdiction of the Associate Chief Counsel (Income Tax & Accounting), Jo Lynn Ricks, (202) 317–4615, Sean Dwyer, (202) 317–4853, or Doug Kim, (202) 317–4794, and concerning any provisions in § 1.451–8 within the jurisdiction of the Associate Chief Counsel (Income Tax & Accounting), Jo Lynn Ricks, (202) 317–4615, or David Christensen, (202) 317–4861; concerning any provisions in § 1.451–3 or § 1.451–8 within the jurisdiction of the Associate Chief Counsel (Financial Institutions & Products), Deepan Patel, (202) 317–3423, or Charles Culmer, (202) 317–4528 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 451(b) and (c) of the Internal Revenue Code (Code).

On December 22, 2017, section 451(b) and (c) were amended by section 13221 of Public Law 115–97 (131 Stat. 2054), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 451(b) was amended to provide that, for a taxpayer using an accrual method of accounting (accrual method taxpayer), the all events test for an item of gross income, or portion thereof, is met no later than when the item, or portion thereof, is included in revenue for financial accounting purposes on an applicable financial statement (AFS). Section 451(c) was amended to provide that an accrual method taxpayer may use the deferral method of accounting provided in section 451(c) for advance payments. Unless otherwise indicated, all references to section 451(b) and section 451(c) hereinafter are references to section 451(b) and section 451(c), as amended by the TCJA.

I. Section 451(b)

In general, section 451(a) 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(a), 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 (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 C.B. 288; Revenue Ruling 84–31, 1984–1 C.B. 127; Revenue Ruling 80–308, 1980–2 C.B. 162.

Section 451(b)(1)(A) provides that, for an accrual method taxpayer, the all events test for an item of gross income, or portion thereof, is met no later than when the item, or portion thereof, is included as revenue in an AFS (AFS Income Inclusion Rule).

Section 451(b)(1)(B) lists exceptions to the AFS Income Inclusion Rule. The AFS Income Inclusion Rule does not apply to taxpayers that do not have an AFS for a taxable year or to any item of gross income from a mortgage servicing contract.

Section 451(b)(1)(C) codifies the all events test, stating that the all events test is met for any item of gross income if all the events have occurred which fix the right to receive such income and the amount of such income can be determined with reasonable accuracy.

Section 451(b)(2) provides that the AFS Income Inclusion Rule does not apply for any item of gross income the recognition of which is determined using a special method of accounting, ''other than any provision of part V of subchapter P (except as provided in clause (ii) of paragraph (1)(B)).''

Section 451(b)(3) defines an AFS, as referenced in section 451(b)(1)(A)(i), by providing a hierarchical list of financial statements.

Section 451(b)(4) provides that for purposes of section 451(b), in the case of a contract which contains multiple performance obligations, the allocation of the transaction price to each performance obligation is equal to the amount allocated to each performance obligation for purposes of including such item in revenue in the taxpayer's AFS.

Section 451(b)(5) provides that, if the financial results of a taxpayer are reported on the AFS for a group of entities, the group's financial statement shall be treated as the AFS of the taxpayer.

II. Section 451(c)

Section 451(c) provides special rules for the treatment of advance payments. Section 451(c)(1)(A) provides the general rule requiring an accrual method taxpayer to include an advance payment in gross income in the taxable year of receipt. However, section 451(c)(1)(B) permits a taxpayer to elect to include any portion of the advance payment in gross income in the taxable year following the year of receipt to the extent income is not included in revenue in the AFS in the year of receipt. Section 451(c)(1)(B) generally codifies Revenue Procedure 2004–34, 2004–22 I.R.B. 991, which provided for a similar deferral period.

Section 451(c)(2)(A) provides the Secretary of the Treasury or his delegate (Secretary) with the authority to provide the time, form and manner for making the election under section 451(c)(1)(B), and the categories of advance payments for which an election can be made. Under section 451(c)(2)(B), the election is effective for the taxable year that it is first made and for all subsequent taxable years, unless the taxpayer receives the consent of the Secretary to revoke the election. Section 451(c)(3) provides that the deferral election does not apply to advance payments received in the taxable year that the taxpayer ceases to exist.

Section 451(c)(4)(A) defines advance payment for purposes of section 451(c). Under section 451(c)(4)(A), the term advance payment means any payment that meets the following three requirements: (1) The full inclusion of the payment in gross income in the year of receipt is a permissible method of accounting; (2) any portion of the advance payment is included in revenue in an AFS for a subsequent tax year; and (3) the advance payment is for goods, services, or such other items that the Secretary has identified. Section 451(c)(4)(B) lists certain payments that are excluded from the definition of advance payment and gives the Secretary the authority to identify other payments to be excluded from the definition. Section 451(c)(4)(C) provides a special definition of the term ''receipt'' for purposes of the definition of advance payment, and section 451(c)(4)(D) states that rules similar to those for allocating the transaction price among performance obligations in section 451(b)(4) also apply for purposes of section 451(c).

III. Prior Guidance

On April 12, 2018, the Department of the Treasury (Treasury Department) and the IRS issued Notice 2018–35, 2018–18 I.R.B. 520, providing interim guidance on the treatment of advance payments and requesting suggestions for future guidance under section 451(b) and section 451(c). On September 27, 2018, the Treasury Department and the IRS issued Notice 2018–80, 2018–42 I.R.B. 609, announcing that the Treasury Department and the IRS intend to issue proposed regulations providing that accrued market discount is not includible in income under section 451(b).

On September 9, 2019, the Treasury Department and the IRS published proposed regulations under section 451(b) (REG–104870–18, 84 FR 47191) (proposed section 451(b) regulations) and proposed regulations under section 451(c) (REG–104554–18, 84 FR 47175) (proposed section 451(c) regulations), referred to collectively hereinafter as the ''proposed regulations.'' The notices of proposed rulemaking for section 451(b) and (c) reflect consideration of the comments received in response to Notice 2018–35.

A public hearing on the proposed regulations was held on December 10, 2019, at which two speakers provided testimony. The Treasury Department and the IRS received approximately ten written comments responding to the proposed regulations.

After the comment period for the proposed regulations closed, the Treasury Department and the IRS received a comment letter regarding the allocation of transaction price for contracts that include both income subject to section 451 and income subject to a special method of accounting provision, specifically, section 460. In response to these comments, in the Explanation of Provisions of a notice of proposed rulemaking (REG–132766–18) that was published on August 5, 2020 (85 FR 47508), the Treasury Department and the IRS suggested allocation rules and requested comments regarding the application of section 451(b)(2) and (4) to contracts with income that is accounted for in part under proposed § 1.451–3 and in part under a special method of accounting. No formal comments were received regarding these suggested rules.

Comments received before these regulations were substantially developed, including all comments received on or before the deadline for comments on November 8, 2019, were carefully considered in developing these regulations. Copies of the comments received are available for public inspection at *http://www.regulations.gov* or upon request. After consideration of the comments received and the testimony at the public hearing, this Treasury decision adopts the proposed regulations as revised in response to such comments and testimony. The comments and the revisions are discussed in the Summary of Comments and Explanation of Revisions section of this preamble.

Summary of Comments and Explanation of Revisions

I. Overview

This Summary of Comments and Explanation of Revisions section summarizes the formal written comments and some of the informal commentary, both in writing and at public events, addressing the proposed regulations. Comments merely summarizing or interpreting the proposed regulations or recommending statutory revisions generally are not discussed in this preamble. Similarly, comments outside the scope of this rulemaking generally are not addressed in this Summary of Comments and Explanation of Revisions section.

II. Comments and Explanation of Revisions Regarding the Proposed Section 451(b) Regulations

A. Realization and Recognition

As noted in the preamble to the proposed section 451(b) regulations, footnote 872 of the Conference Report to the TCJA states that section 451(b) was not intended to revise the rules associated with when an item is realized for Federal income tax purposes and does not require the recognition of income in situations where the Federal income tax realization event has not taken place. See H.R. Rep. No. 115–466, at 428 fn. 872 (2017) (Conf. Rep.). As also noted in the preamble to the proposed section 451(b) regulations, footnote 874 of the Conference Report provides, by way of example, that the timing rules of section 451(b) apply to unbilled receivables for partially performed services. *Id.* at 428 fn. 874.

Commenters provided little commentary on footnote 874, except to state that it is contrary to footnote 872. Instead, the commenters presented two views. First, some commenters highlighted footnote 872 and cited case law to support the claim that a realization event is, and has always been, a prerequisite for income recognition. These commenters acknowledged, however, that the case law frames the issue not in terms of ''realization'' but rather in terms of whether a seller has a fixed right to income under the all events test.

Second, some commenters suggested definitions of realization. However, these recommended definitions differ, particularly as to whether realization applies to the provision of services. For example, some commenters described realization as applying to both contracts for the provision of services and contracts for the sale of goods, and stated that realization occurs when the taxpayer has a ''fixed and unconditional right to payment'' under the contract. One commenter reasoned that existing judicial precedents require realization without distinguishing between whether the income is for the performance of services or the sale of property. Another commenter asserted that realization means there has been a sale or disposition under section 1001(a), suggesting that realization applies only to the sale of property. In sum, these commenters suggested that the proposed section 451(b) regulations do not give effect to footnote 872 in the Conference Report and ask that the final regulations either explicitly define realization or clarify when realization occurs in certain circumstances, such as where a taxpayer produces goods for customers or where a taxpayer provides non-severable services to customers.

The Treasury Department and the IRS have considered these comments and decline to define the term realization in the final regulations. Congress did not explicitly define realization in the Conference Report. Some of the suggested definitions of realization, particularly the ones equating realization with the all events test, would nullify the AFS Income Inclusion Rule entirely, which is clearly contrary to Congress' intent. Accordingly, it is reasonable to conclude that Congress intended a different concept of realization that would give full effect to the statute. Further, the final regulations do not clarify when realization occurs in specific circumstances. Realization is a factual determination that, while closely aligned with the all events test, has different meanings in different contexts.

Section 451 is a timing provision and the amendments to section 451(b)(1)(A) by TCJA were intended to modify the timing of income to require an accrual method taxpayer with an AFS to treat the right to income as fixed, under the all events test, no later than the time at which the item (or portion thereof) is taken into account in its AFS. The statute thus reflects Congress' intent to incorporate timing concepts from the financial reporting rules in the tax timing rules for including items in gross income. It does not seek to answer whether the AFS income inclusion has been realized. Accordingly, the focus of the final regulations is on the appropriate taxable year of AFS income inclusion.

B. Scope of AFS Income Inclusion Rule

1. Proposed § 1.451–3(b): General Rule

The general AFS Income Inclusion Rule in the proposed section 451(b) regulations provides that, if a taxpayer includes an item of gross income, or portion thereof, in revenue in the taxpayer's AFS, the taxpayer must include the item in gross income under section 451(b). In addition to commenting that the general rule in the proposed section 451(b) regulations potentially overrides the realization requirement, contrary to footnote 872 of the Conference Report, commenters suggested that the rule is overbroad and could cause taxpayers to incur a tax liability without having the money to pay the liability.

The Treasury Department and the IRS note that the potential to incur a tax liability without having the money to pay the liability is inherent in the accrual method. However, the Treasury Department and the IRS acknowledge that the proposed AFS Income Inclusion Rule could exacerbate this situation and that the proposed rule could result in inclusions that would be inconsistent with footnote 872 of the Conference Report. Accordingly, the final regulations provide that, under the AFS Income Inclusion Rule, the all events test under § 1.451–1(a) for any item of gross income, or portion thereof, is met no later than when that item, or portion thereof, is ''taken into account as AFS revenue.'' In determining when an item of gross income is ''taken into account as AFS revenue,'' AFS revenue is reduced by amounts that the taxpayer does not have an enforceable right to recover if the customer were to terminate the contract on the last day of the taxable year. The determination of whether the taxpayer has an enforceable right to recover amounts of AFS revenue is governed by the terms of the contract and applicable Federal, state, or international law, and includes amounts recoverable in equity and liquidated damages.

The revised rule is designed to reconcile the intended preservation of the realization concept, consistent with footnote 872 of the Conference Report, with the intended scope of section 451(b), as illustrated in footnote 874 of the Conference Report. The revised rule is also consistent with concepts illustrated in Example 4 in the Joint Committee on Taxation, General Explanation of Public Law 115–97 (JCS–1–18) at 163 (Dec. 20, 2018) (Blue Book). In the example, the taxpayer enters into a contract with a customer for a customized piece of machinery. Under the contract, the taxpayer will not invoice the customer until the item is delivered to the customer, the customer accepts the machinery, and title to the machinery has transferred to the customer. The contract specifically provides that, if the customer withdraws from the agreement, the taxpayer has an enforceable right to payment as the work is performed, even if the contract is not completed. The taxpayer does not complete the machinery in year one but includes an amount in revenue in its AFS in year one. Example 4 concludes that, under the AFS Income Inclusion Rule, the taxpayer is required to recognize the amount in year one. The revised AFS Income Inclusion Rule in the final regulations incorporates the key elements reflected in Example 4.

To reduce any additional compliance burdens, the final regulations provide an alternative method to determine when an item of gross income is treated as ''taken into account as AFS revenue'' under the AFS Income Inclusion Rule. Under the ''alternative AFS revenue method'', the taxpayer does not reduce AFS revenue by amounts that the taxpayer lacks an enforceable right to recover if the customer were to terminate the contract on the last day of the taxable year. The alternative AFS revenue method is a method of accounting that applies to all items of gross income in the trade or business that are subject to the AFS income inclusion rule. Taxpayers using the alternative AFS revenue method may also use the AFS cost offset method provided in the final regulations.

Under the final regulations two additional adjustments to AFS revenue are made in determining whether an item of gross income is treated as ''taken into account as AFS revenue.'' These adjustments apply both under the AFS Income Inclusion Rule and under the alternative AFS revenue method. First, if the transaction price, as defined in § 1.451–3(a)(14), was increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, then any AFS revenue attributable to such increase is disregarded. In such situations, total AFS revenue taken into account over the term of the contract exceeds the stated consideration in the contract and such excess is, for AFS purposes, offset by a corresponding interest expense. Because such excess is generally not imputed income for Federal income tax purposes and a deduction for the AFS interest expense is generally not imputed for Federal income tax purposes, it is necessary to adjust AFS revenue to prevent the improper acceleration, or overreporting, of gross income. If situations arise in which imputed income and imputed deductions are also required for Federal income tax purposes, an adjustment to AFS revenue is still appropriate as the amount and timing of the imputed income would be outside the scope of section 451 and the regulations thereunder. Second, to the extent that AFS revenue reflects a reduction for (1) amounts that are cost of goods sold or liabilities that are required to be accounted for under other provisions of the Code, such as section 461, including liabilities for allowances, rebates, chargebacks, rewards issued in credit card and other transactions and other reward programs, and refunds (for example, estimated returns based on historic practice), regardless of when any such amount is incurred (Liability Amounts); or (2) amounts anticipated to be in dispute or anticipated to be uncollectable, the taxpayer must increase AFS revenue by such amounts. The Treasury Department and the IRS have determined that adjustments for such amounts are necessary to prevent the taxpayer from effectively taking such amounts into account for Federal income tax purposes in a taxable year prior to the taxable year in which they are otherwise permitted to be taken into account under other provisions of the Code. Additionally, if AFS revenue is not adjusted for Liability Amounts in the taxable year that such amounts are otherwise permitted to be taken into account, then a taxpayer may obtain an improper double benefit by taking such amounts into account to reduce taxable income under another provision of the Code while also deferring an equal amount of gross income to a later year under § 1.451–3. The AFS revenue adjustments in the final regulations do not preclude a taxpayer from accounting for trading stamps and premium coupons under § 1.451–4. However, the Treasury Department and the IRS are still evaluating whether the rules in § 1.451–4 should be modified or clarified in light of certain financial reporting changes under ASC 606.

On a separate issue relating to the scope of the AFS Income Inclusion Rule, taxpayers questioned, in light of the realization discussion in footnote 872, whether the AFS Income Inclusion Rule applies to the sale of goods. Since Example 4 of the Blue Book involves the sale of goods, it is reasonable to conclude that Congress intended for the AFS Income Inclusion Rule, as revised, to extend to contracts for the sale of goods. Accordingly, as with the proposed section 451(b) regulations, the final regulations provide that the AFS Income Inclusion Rule applies to contracts for the sale of goods.

2. Proposed § 1.451–3(b): Cost Offset for AFS Income Inclusions

Proposed § 1.451–3(b) does not provide for a cost offset when an amount is included under the AFS Income Inclusion Rule. The preamble to the proposed section 451(b) regulations discusses reasons for not providing a cost offset, including the potential for income distortions and Congressional intent that a cost offset not be provided. The preamble to the proposed section 451(b) regulations requests comments on this issue.

Multiple commenters proposed allowing an offset for the cost of goods sold (COGS) when income is included under the AFS Income Inclusion Rule. Commenters pointed out that the term ''item of gross income'' generally means total sales net of COGS. See, for example, § 1.61–3(a). Commenters also described situations where income might be distorted by inclusions in early years of a multi-year contract with the costs being allowed in later years without income to offset. Commenters expressed concern that, in these situations, or more generally, the AFS Income Inclusion Rule might operate as a tax on gross receipts.

One commenter suggested that the statute uses the AFS as a backstop to timing recognition of revenue because the AFS provides a good standard by which to determine when a taxpayer receives an economic benefit. The commenter acknowledged that there has been a policy interest in achieving greater book-tax conformity in a variety of areas. The commenter recommended that, if the final regulations use the AFS to measure the receipt of an economic benefit, then the final regulations also should reflect the AFS standards that require certain items of income be reported ''net'' of offsetting items.

Commenters also noted that, for AFS purposes, credit card issuers generally report interchange fees net of estimated reward costs and report credit card late fees net of estimated uncollectable amounts. Commenters explained that reward costs and uncollectable credit card late fees ''are so closely aligned with the realization of income that AFS standards require those items to be presented separately in the revenue section of the income statement but concurrently as to timing.'' One commenter expressed concern that not reducing interchange fees by estimated reward costs and credit card late fees by estimated uncollectable amounts in determining the amount of income recognized under the AFS Income Inclusion Rule would result in the inclusion of more income for Federal income tax purposes than was reported on the AFS.

Accordingly, commenters recommended that the final regulations provide that the all events test and the economic performance requirement under section 461 should be deemed to be met for items that are ''closely aligned'' with income amounts recognized under the AFS Income Inclusion Rule. Commenters explained that section 461 should be deemed to be met for items such as estimated reward costs and estimated uncollectable late fees to the extent these items are reported on the revenue section of the AFS as a reduction to amounts subject to the AFS Income Inclusion Rule. One commenter further explained that this treatment would be consistent with the clear reflection of income doctrine of section 446. Alternatively, one commenter recommended modifying the definition of transaction price under proposed § 1.451–3(c)(6) to reduce interchange fees by the amount of reward costs that satisfy section 461 and credit card late fees by amounts that are considered uncollectable for AFS purposes.

The Treasury Department and the IRS have considered these comments and have determined that a cost offset based on estimates of future costs would be inappropriate. As discussed in the preamble to the proposed section 451(b) regulations, allowing a cost offset based on estimated costs would be inconsistent with sections 461, 263A, and 471, and the regulations under those sections of the Code. In addition, a cost offset based on estimated costs would increase the possibility of income distortions as the costs of goods would effectively be recovered, through income deferral, prior to the taxable year in which the cost was actually incurred.

However, the Treasury Department and the IRS agree with comments suggesting that taxpayers should be afforded the flexibility of applying an offset for costs incurred against AFS income inclusions from the future sale of inventory, the ''AFS cost offset method.'' Accordingly, a taxpayer that uses the AFS cost offset method determines the amount of gross income includible for a year prior to the year in which ownership of inventory transfers to the customer by reducing the amount of revenue it would otherwise be required to include under the AFS Income Inclusion Rule for the taxable year (AFS inventory inclusion amount) by the cost of goods related to the item of inventory for the taxable year, the ''cost of goods in progress offset.'' The net result is the amount that is required to be included in gross income for that year under the AFS Income Inclusion Rule. The deferred revenue, that is, the revenue that was reduced by the cost of goods in progress offset for a taxable year prior to the taxable year that ownership of the item of inventory is transferred to the customer, is generally taken into account in the taxable year in which ownership of the item of inventory is transferred to the customer.

The final regulations provide that the cost of goods in progress offset for each item of inventory for the taxable year is calculated as (1) the cost of goods incurred through the last day of the taxable year, (2) reduced by the cumulative cost of goods in progress offset amounts attributable to the items of inventory that were taken into account in prior taxable years, if any. However, the cost of goods in progress offset cannot reduce the AFS inventory inclusion amount for the item of inventory below zero. Further, the cost of goods in progress offset attributable to one item of inventory cannot reduce the AFS inventory inclusion amount attributable to a separate item of inventory. Any cost of goods that were not used to offset AFS inventory inclusion amounts because they were subject to limitation are considered when the taxpayer determines the cost of goods in progress offset for that item of inventory in a subsequent taxable year.

The cost of goods in progress offset is determined by reference to the costs and expenditures related to each item of inventory produced or acquired for resale, which costs have been incurred under section 461 and have been capitalized and included in inventory under sections 471 and 263A or any other applicable provision of the Code at the end of the year. However, the cost of goods in progress offset does not reduce the costs that are capitalized to the item of inventory produced or acquired for resale by the taxpayer under the contract. That is, while the cost of goods in progress offset reduces the AFS inventory inclusion amount, it does not affect how and when costs are capitalized to inventory under sections 471 and 263A or any other applicable provision of the Code or when those capitalized costs will be recovered. Instead, the cost of goods in progress offset serves only to reduce or ''offset'' any AFS income inclusion amounts for the item of inventory and defer such amounts to the taxable year in which ownership of the item of inventory is transferred to the customer.

The costs of goods comprising the cost of goods in progress offset must be determined by applying the inventory accounting methods used by the taxpayer for Federal income tax purposes. A taxpayer must calculate its cost of goods in progress offset by reference to all costs that the taxpayer has permissibly capitalized and allocated to items of inventory under its inventory method, but may not consider costs that are not properly capitalized under such method.

In the taxable year in which ownership of the item of inventory is transferred to the customer, any revenue deferred by way of a prior year cost offset is included in gross income in the year of the transfer along with any additional revenue that is otherwise required to be included in gross income under the AFS Income Inclusion Rule for such year. Although no cost offset is permitted in such year, the taxpayer would recover costs capitalized and allocated to the item of inventory transferred as cost of goods sold in such year in accordance with sections 471 and 263A or any other applicable provision of the Code. However, if in a taxable year prior to the taxable year in which ownership of the item of inventory is transferred to the customer, either (A) the taxpayer dies or ceases to exist in a transaction other than a transaction to which section 381(a) applies, or (B) the taxpayer's obligation to the customer with respect to the item of inventory ends other than in a transaction to which 381(a) applies or certain section 351(a) transactions between members of the same consolidated group, then all payments received for the item of inventory that were not previously included in gross income as a result of the application of the cost offset rules are required to be included in gross income in such year.

The Treasury Department and the IRS adopted this approach in the final regulations because the AFS cost offset method provides options for taxpayers. All taxpayers that are required to account for income from the sale of inventory under the AFS income inclusion rule and that report AFS revenue in a taxable year prior to the taxable year in which ownership of the item of inventory is transferred to the customer will generally be required to accelerate income inclusions under such rule. However, taxpayers have the option of using the AFS cost offset method to reduce the amount of income they are required to accelerate under such rule. The AFS cost offset allows taxpayers to reasonably match income inclusions and incurred cost of goods, and more clearly reflects income.

The final regulations adopt a cost of goods sold offset based on incurred costs because the approach is consistent with § 1.61–3 and more objective than a cost of goods sold offset based on projected future costs. In addition, the AFS cost offset method provides a degree of parity for sellers of goods with service providers who deduct costs as incurred without capitalizing the costs to inventory. A cost offset based on projected future cost of goods sold was rejected because it is inconsistent with sections 461(h), 263A and 471, and the regulations under those sections of the Code. Further, Congress rejected the deferral method for advance payments in former § 1.451–5(c), which contained a cost of goods sold offset for estimated future costs. See Conf. Rep. at 429 fn. 880.

The AFS cost offset method is a method of accounting that applies to all items of income eligible for the AFS cost offset method in the trade or business. The method applies to items at the trade or business level so that taxpayers can choose to apply the method only to trades or businesses where the burden of determining costs incurred relative to the related reduction in AFS income inclusion amount warrants the adoption of the method. If a taxpayer uses the AFS cost offset method for a trade or business it must use the method for all eligible items in that trade or business. Further, if a taxpayer uses the AFS cost offset method, it must also use the advance payment cost offset method in § 1.451–8(e). The advance payment cost offset method is discussed later in this preamble. Special coordination rules exist for taxpayers that use the AFS cost offset method and the advance payment cost offset method and that have income from the sale of an item of inventory that is required to be accounted for under both §§ 1.451–3 and 1.451–8 because certain payments received for such item meet the definition of an advance payment under § 1.451–8(a)(1). See § 1.451–3(c)(1) for such coordination rules.

The AFS cost offset method reduces the amount of income from the sale of an item of inventory that is required to be accelerated under the AFS Income Inclusion Rule by an amount of incurred cost of goods related to the item. However, the offsets to interchange fees and credit card late fees recommended by the commenters are based on estimated reward costs and uncollectable late fees rather than incurred costs of goods. Accordingly, the final regulations do not allow a cost offset for interchange fees, credit card late fees, and similar items of revenue that are subject to the AFS Income Inclusion Rule and reported net of estimated future amounts for AFS purposes.

3. Proposed § 1.451–3(c)(4) and (c)(6)(ii): Revenue, Transaction Price and Increases in Consideration

Proposed § 1.451–3(c)(4) provides that, for the AFS Income Inclusion Rule, revenue means all transaction price amounts includible in gross income under section 61 of the Code. Proposed § 1.451–3(c)(6) provides that the transaction price is the gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes in exchange for transferring goods, services, or other property, but not including, among other things, ''increases in consideration'' to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event for the period in which the amount is contingent.

Commenters expressed confusion about the phrase ''increases in consideration'' because the definition of transaction price otherwise refers to ''amounts'' and does not distinguish between increases and decreases. Commenters asserted that there is no reason to treat ''increases'' in consideration different from other consideration because all consideration is not realized until the taxpayer has a fixed right to payment. Commenters concluded that any portion of the contract price subject to a contractual contingency, for example, a future performance, is excluded from the transaction price until the contingency is satisfied. In addition, one commenter noted that it is unclear when there is a contingent ''increase'' in consideration, and taxpayers could revise the contract terms to meet this requirement.

The Treasury Department and the IRS agree with these comments. The term ''increases in consideration'' was meant to signal income items that are subject to a condition precedent, such as bonus payments that require complete performance before the taxpayer is entitled to the bonus payment. The final regulations have been revised to remove the reference to ''increases in consideration'' entirely. The concept is now subsumed by the general rule that, to determine when an item of gross income is ''taken into account as AFS revenue'' under the AFS Income Inclusion Rule, AFS revenue is reduced by amounts that the taxpayer does not have an enforceable right to recover if the customer were to terminate the contract at the end of the taxable year. If an amount is contingent due to a condition precedent, such as with some bonus payments, and the taxpayer would not have an enforceable right to recover such amount if the customer were to terminate the contract at the end of the taxable year, the AFS Income Inclusion Rule does not require the taxpayer to include such amount in gross income in the current year.

4. Proposed § 1.451–3(c)(6)(ii): Rebuttable Presumption

Proposed § 1.451–3(c)(6)(ii) provides a rebuttable presumption that amounts included in revenue in an AFS 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.

Commenters requested that the final regulations remove the rebuttable presumption regarding contingent consideration. Commenters reasoned that the rebuttable presumption imposes a higher standard of proof upon taxpayers than is ordinarily required to establish that consideration is contingent. Additionally, commenters noted that basing the presumption on the treatment of the consideration for financial reporting purposes is not sensible because the financial accounting rules do not make the conclusion dependent on whether the consideration is or is not contingent on the occurrence or non-occurrence of a future event. Rather, under the Financial Accounting Standards Board (FASB) and International Accounting Standards Board, Accounting Standards Codification (ASC) Topic 606 and International Financial Reporting Standards (IFRS) 15, *Revenue from Contracts with Customers* (collectively, ASC 606), the recognition of contingent consideration is based on a determination of the likely outcome of the contingency. Accordingly, commenters recommended that the final regulations eliminate the presumption in favor of noncontingency.

As noted earlier, the final regulations have been revised to remove the reference to ''contingent consideration'' entirely. The concept is now subsumed by the general rule that, to determine when an item of gross income is ''taken into account as AFS revenue'' under the AFS Income Inclusion Rule, AFS revenue is reduced by amounts that the taxpayer does not have an enforceable right to recover if the customer terminates the contract at the end of the taxable year. Given this change, the final regulations remove the rebuttable presumption that a taxpayer has an enforceable right to amounts included in AFS revenue.

5. Proposed § 1.451–3(c)(6)(ii): Enforceable Right to Payment

Commenters requested that the final regulations clarify or remove the rule in proposed § 1.451–3(c)(6)(ii) that treats amounts for which the taxpayer has an ''enforceable right to payment'' for performance completed to date as not contingent on the occurrence or nonoccurrence of a future event. First, commenters reasoned that the rule is ambiguous, resulting in controversies with exam. Second, commenters asserted that, assuming the phrase ''enforceable right to payment'' is based on the financial statement rules in ASC 606, this standard effectively overrides the tax realization requirement requiring a fixed, unconditional right to payment. Further, commenters reasoned that the rule is inconsistent with the exception for increases in consideration to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event.

The Treasury Department and the IRS agree with these comments. As discussed earlier, the final regulations modify the general AFS Income Inclusion Rule by reducing the AFS revenue that is accelerated and included in gross income. Under the AFS Income Inclusion Rule, to determine when the item of gross income is ''taken into account as AFS revenue,'' AFS revenue is reduced by amounts that the taxpayer does not have an ''enforceable right'' to recover if the customer were to terminate the contract on the last day of the taxable year. The term ''enforceable right'' is specifically defined in § 1.451–3(a)(9) as any right that a taxpayer has under the terms of a contract or under applicable federal, state, or international law, including rights to amounts recoverable in equity or liquidated damages.

6. Proposed § 1.451–3(c)(6)(iii): Reductions for Amounts Subject to Section 461 and Disputed Income

Proposed § 1.451–3(c)(6)(iii) provides that the ''transaction price'' does not include reductions for amounts subject to section 461, including amounts anticipated to be in dispute, returns, and rewards issued in credit card transactions. One commenter recommended that the final regulations clarify that rewards issued in credit card transactions are subject to section 461 and do not reduce original issue discount (OID) income in any circumstance, regardless of the structure of the credit card program. The commenter requested this clarification because taxpayers have taken different positions on the treatment of these rewards while the IRS has taken the position that rewards do not reduce OID income. The commenter stated that the better approach is to treat these rewards as liabilities under section 461. The commenter further explained that treating these rewards as amounts subject to section 461 in all circumstances would create uniformity among credit card issuers, reduce controversy between taxpayers and the IRS, and ease the compliance burden on taxpayers by eliminating the need for a facts and circumstances analysis of each credit card program. The Treasury Department and the IRS agree with the commenter and have modified the final regulations in § 1.451–3(b)(2)(i)(A)(*1*) to clarify that rewards issued in a credit card transaction are items subject to section 461.

Commenters also questioned whether the AFS Income Inclusion Rule modifies the treatment of income amounts subject to an actual dispute or a clerical error (disputed income amounts). The AFS Income Inclusion Rule does not modify the treatment of disputed income amounts. The principles set forth in Revenue Ruling 2003–10, 2003–1 C.B. 288, continue to apply. For example, an accrual method taxpayer does not accrue gross income in the taxable year of sale if, during the year of sale, the customer disputes its liability to the taxpayer. In addition, if an accrual method taxpayer overbills a customer due to a clerical mistake, and the customer disputes the liability in the subsequent taxable year, the taxpayer must accrue gross income in the taxable year of sale for the correct amount.

Lastly, if a taxpayer ships excess quantities of goods and the customer does not dispute the shipment and agrees to pay for the excess quantities of goods, the taxpayer accrues gross income in the amount of the agreed payment in the taxable year of the sale.

In response to these comments, the final regulations clarify that, under the AFS Income Inclusion Rule, to the extent that AFS revenue was reduced for amounts anticipated to be in dispute or anticipated to be uncollectable, AFS revenue is increased by such amounts. Accordingly, although ASC 606 reduces the transaction price for anticipated disputes to determine the amount of revenue to include on an AFS, see ASC 606–10–32–6, AFS revenue is increased for amounts anticipated to be in dispute or anticipated to be uncollectable, because those amounts are included in gross income until they are actually disputed.

C. Proposed § 1.451–3(c)(5): Special Method of Accounting

Proposed § 1.451–3(c)(5) provides a non-exhaustive list of examples of special methods of accounting to which the AFS Income Inclusion Rule generally does not apply. Commenters requested that the final regulations include the methods of accounting for notional principal contracts under § 1.446–3 and the timing rules for stripped bonds under section 1286 as examples of special methods of accounting. The Treasury Department and the IRS adopt these comments in the final regulations and have added additional special methods for clarification purposes. The list of special methods of accounting remains non-exhaustive.

D. Proposed § 1.451–3(d): Exceptions to the AFS Income Inclusion Rule

Proposed § 1.451–3(d) describes the exceptions to the AFS Income Inclusion Rule. The proposed rule clarifies that the AFS Income Inclusion Rule does not apply unless all of the taxpayer's entire taxable year is covered by an AFS. In addition, the AFS Income Inclusion Rule does not cover items of income in connection with a mortgage servicing contract. A commenter requested that an exception be added for any amount that has not yet been realized for Federal income tax purposes. As discussed earlier, the Treasury Department and the IRS decline to adopt this suggestion because providing rules on realization is beyond the scope of these final regulations.

E. Proposed § 1.451–3(g): Contracts With Multiple Performance Obligations

1. Proposed § 1.451–3(g): Allocation of Transaction Price to Contracts With Multiple Performance Obligations Subject to Section 451(b)

Proposed § 1.451–3(g) provides that if a taxpayer's contract with a customer has multiple performance obligations subject to section 451(b), transaction price is allocated to performance obligations as transaction price is allocated to performance obligations in the taxpayer's AFS.

The final regulations clarify that each performance obligation yields an item of gross income that must be accounted for separately under the AFS Income Inclusion Rule. When a contract contains multiple performance obligations, to determine the amount of gross income allocated to each performance obligation, the transaction price determined under the taxpayer's applicable accounting principles, is allocated to each corresponding item of gross income in accordance with how the transaction price is allocated to each performance obligation for AFS purposes. If the accounting standards used to prepare the AFS identify a single performance obligation that yields more than one corresponding item of gross income, the portion of the transaction price amount that is allocated to the single performance obligation for AFS purposes must be further allocated among the corresponding items of gross income using any reasonable method.

The final regulations simplify the definition of transaction price. The final regulations define the term transaction price to mean the total amount of consideration to which a taxpayer is, or expects to be, entitled from all performance obligations under a contract. The transaction price is determined under the standards the taxpayer uses to prepare its AFS. Accordingly, adjustments to the transaction price that were reflected in the transaction price definition in the proposed regulations have, to the extent relevant under these final regulations, been moved to operative rules to ensure clarity. See § 1.451–3(b)(2) and (d)(3).

In addition, the final regulations clarify how the transaction price should be allocated to the extent the transaction price includes a reduction for liabilities, amounts anticipated to be in dispute or anticipated to be uncollectable, or a significant financing component that is deemed to exist under the standards the taxpayer uses to prepare its AFS. The final regulations clarify that the taxpayer must determine the specific performance obligation to which such reduction relates and increase the transaction price allocable to the corresponding item of gross income by the amount of the reduction (specific identification approach). If it is impracticable from the taxpayer's records to use the specific identification approach, the final regulations allow taxpayers to use any reasonable method to allocate the amount to the items of gross income in the contract. The final regulations also provide that a pro-rata allocation of this amount across all items of gross income under the contract based on the relative transaction price amounts allocated to the items for AFS purposes is a reasonable method.

Similarly, the final regulations clarify how the transaction price should be allocated if the transaction price was increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS. In this situation, the taxpayer must determine the specific performance obligation to which such amount relates and decrease the transaction price amount allocable to the corresponding item of gross income by such amount (the ''specific identification approach''). If it is impracticable from the taxpayer's records to use the specific identification approach, the taxpayer may use any reasonable method to allocate such amount to the items of gross income in the contract. The final regulations provide that a pro-rata allocation of such amount across all items of gross income under the contract based on the relative transaction price amounts allocated to the items for AFS purposes is a reasonable method.

2. Proposed § 1.451–3(g): Contracts With Income Subject to § 1.451–3 and Income Subject to a Special Method of Accounting

In the proposed regulations, the Treasury Department and the IRS requested comments on the allocation of the transaction price for contracts that include both income subject to section 451 and income subject to a special method of accounting provision, specifically, section 460. A commenter to the proposed regulations suggested that the allocation provisions under section 460 and the regulations thereunder, and not section 451(b)(4), should control the amount of gross income from a long-term contract that is accounted for under section 460. The commenter noted that using this approach is appropriate in light of section 451(b)(2), which reflects Congress's intent to not disturb the treatment of amounts for which the taxpayer uses a special method of accounting.

The Treasury Department and the IRS believe that a rule is necessary to address the application of section 451(b)(2) and (4) to contracts with income that is accounted for in part under § 1.451–3 and in part under a special method of accounting and suggested rules for public comment in the preamble of a separate notice of proposed rulemaking published in the **Federal Register** on August 5, 2020 (85 FR 47508). The suggested rules provided that if an accrual method taxpayer with an AFS has a contract with a customer that includes one or more items of gross income subject to a special method of accounting (as defined in proposed § 1.451–3(c)(5)) and one or more items of gross income subject to section 451, the allocation rules under section 451(b)(4) do not apply to determine the amount of each item of gross income that is accounted for under the special method of accounting provision. Rather, the taxpayer first allocates the transaction price to the item(s) of gross income subject to a special method of accounting (as determined under the special method of accounting). The remainder of the transaction price, the ''residual amount'', is then allocated to the items of gross income that are subject to § 1.451–3. To the extent the contract contains more than one item of gross income that is subject to section 451, the residual amount would be allocated to each such item in proportion to the amounts allocated to the corresponding performance obligations for AFS purposes. The Treasury Department and the IRS requested comments on these suggested allocation rules. However, no formal comments were received regarding these suggested rules.

The final regulations largely adopt the rules suggested in the preamble to the separate notice of proposed rulemaking published in the **Federal Register** on August 5, 2020 (85 FR 47508). Accordingly, the final regulations provide that the transaction price allocation rule in § 1.451–3(d)(1) does not apply to determine the amount of each item of gross income that is subject to a special method of accounting. Rather, the final regulations provide that the transaction price is first allocated to items of gross income subject to a special method of accounting, as determined under the special method of accounting. For this purpose, a special method of accounting has the meaning set forth in § 1.451–3(a)(13), except as otherwise provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d)).

To determine the transaction price allocated to items of gross income subject to a special method of accounting, the taxpayer must first adjust the AFS transaction price by the amounts described in the final paragraph of part II.B.1 of this Summary of Comments and Explanation of Revisions. Accordingly, if the AFS transaction price includes a reduction for cost of goods sold, liabilities, amounts expected to be in dispute or anticipated to be uncollectible, or a significant financing component that exists under the standards the taxpayer uses to prepare its AFS, the taxpayer must increase the transaction price amount by the amount of such reduction. If the AFS transaction price has been increased because a significant financing component exists under the standards the taxpayer uses to prepare its AFS, the taxpayer must decrease the transaction price amount by the amount of such increase.

After the taxpayer makes the adjustments to the transaction price described earlier, the taxpayer first allocates such amount to the item(s) of gross income subject to a special method of accounting, and then allocates the remainder (residual amount) to the item(s) of gross income that are subject to § 1.451–3. If the contract, contains more than one item of gross income that is subject to § 1.451–3, the taxpayer allocates the residual amount to these items in proportion to the amounts allocated to the corresponding performance obligations for AFS purposes or as otherwise provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d)).

F. Proposed § 1.451–3(i): Special Ordering Rule for Certain Items of Income for Debt Instruments

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 corresponding regulations. Proposed § 1.451–3(i)(2) provides three examples of specified fees: Credit card late fees, credit card cash advance fees, and interchange fees (specified credit card fees). Interchange fees are sometimes labeled merchant discount in certain private label credit card transactions.

Commenters requested that the final regulations provide that promotional discount, which also is sometimes labeled merchant discount, is not a specified fee. Promotional discount arises when a credit card issuer charges a fee to a merchant as compensation for accepting a below market interest rate on a credit card balance during a promotional period. Commenters explained that promotional discount is generally included in income over a promotional or similar period on a taxpayer's AFS and, despite possible alternative labeling, is, in substance, an adjustment to the yield of a debt instrument for AFS purposes. The Treasury Department and the IRS agree that any fee that adjusts the yield of a debt instrument for AFS purposes over the life of the instrument or another period should not be a specified fee. Therefore, the final regulations do not include the phrase ''over the life of the instrument'' in the definition of a specified fee but add the phrase ''spread over a period of time'' to clarify the definition. Thus, a fee that adjusts the yield of a debt instrument over a promotional or similar period for AFS purposes, such as promotional discount, is not a specified fee under the final regulations.

One commenter agreed that section 451(b) was not intended to affect the application of the general OID timing rules to OID other than for certain fees that are not treated as discount for AFS purposes, including the specified credit card fees. Accordingly, the commenter agreed with the rules in proposed § 1.451–3(i) and the inclusion of the general OID timing rules as a special method of accounting. Except as provided in the preceding paragraph, the definition of specified fees in the proposed regulations is adopted in the final regulations.

G. Proposed § 1.451–3(k): Cumulative Rule for Multi-Year Contracts

The proposed regulations provide that for a multi-year contract, a taxpayer must take into account the cumulative amounts included in income in prior taxable years on the contract in order to determine the amount to be included for the taxable years remaining in the contract. The proposed regulations contain two examples that illustrate this rule.

The final regulations clarify that if the item of gross income from a multi-year contract is from the sale of an item of inventory and the taxpayer uses the AFS cost offset method, the taxpayer must first determine the ''AFS inventory inclusion amount'' for the taxable year. The taxpayer determines the AFS inventory inclusion amount for the taxable year by first taking the greater of: (1) The cumulative amount of revenue from the item of inventory that satisfies the all events test under § 1.451–1(a) through the last day of the taxable year, less the portion of any advance payment received that is deferred to a subsequent taxable year under § 1.451–8, if applicable, or (2) the cumulative amount of revenue from the item of inventory that is treated as taken into account as AFS revenue through the last day of the taxable year and identifies the larger of the two amounts or if the two amounts are equal, the equal amount. The taxpayer then reduces such amount by the prior year AFS inventory inclusion amount for that item of inventory, if any, to determine the AFS inventory inclusion amount for the current taxable year. Lastly, the taxpayer reduces the AFS inventory inclusion amount for the taxable year by the cost of goods in progress offset for the taxable year (which generally equals the costs of goods in progress for the item of inventory as of the end of the year less the portion of such costs that were taken into account as a cost of goods in progress offset for a prior taxable year). This net amount is the amount required to be included in gross income in the taxable year. However, in the taxable year in which ownership of the item of inventory is transferred to the customer, the taxpayer performs the same ''greater of'' computation noted earlier, but rather than subtract the prior year AFS inventory inclusion amount for the item of inventory (which is gross of cost offsets) from the result of the ''greater of'' computation, the taxpayer subtracts all prior year gross income inclusions for the item of inventory from the result of the ''greater of'' computation. This net amount is the amount required to be included in gross income in the taxable year of ownership transfer. The effect of this computation is that any revenue reduced by a cost offset in a prior year is included in gross in the taxable year in which ownership of the item of inventory is transferred to the customer. Although no cost offset is permitted in such year, the taxpayer would recover costs capitalized and allocated to the item of inventory transferred as cost of goods sold in such year in accordance with sections 471 and 263A or any other applicable provision of the Code.

In the case of any other item of gross income from a multi-year contract, the taxpayer first compares the cumulative amount of the item of gross income that satisfies the all events test under § 1.451–1(a) through the last day of the taxable year with the cumulative amount of revenue from the item of gross income that is treated as taken into account as AFS revenue through the last day of the taxable year and identifies the larger of the two amounts (or, if the two amounts are equal, the equal amount). The taxpayer then reduces such amount by all prior year inclusion amounts attributable to the item of gross income, if any, to determine the amount required to be included in gross income in the current taxable year. Special coordination rules for applying § 1.451–8 are also provided to the extent certain payments received under a multi-year contract are advance payments. The analysis in the examples is updated to reflect the clarifications to the rule.

H. Proposed § 1.1275–2(l): OID Rule for Income Item Subject to Section 451(b)

Under proposed § 1.1275–2(l), 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 for a debt instrument is subject to the timing rules in proposed § 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. Commenters agree with these rules and note that these rules confirm that the current treatment of items other than specified fees will not be affected by section 451(b). The commenters also note that removing specified fees, including 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 OID rules, thereby reducing taxpayer compliance burdens. Accordingly, the Treasury Department and the IRS adopt the rules in proposed § 1.1275–2(l) in the final regulations.

I. Other Comments

1. Burial Plots and Interment Rights

Commenters request clarification on the treatment of income from contracts with customers for the sale of burial plots or interment rights, on a pre-need basis (pre-need contracts). The terms of the pre-need contracts typically require the customer to make an initial down payment and pay the balance of the sales price over several years. If the purchaser cancels or fails to perform under the contract before the entire purchase price is paid, commenters represent that, under every state law, the taxpayer's sole remedy is to keep all or a portion of the installment payments previously received from the customer as liquidated damages. Commenters highlighted that there may be an extended period of time between the date the pre-need contract is executed and the date the taxpayer collects the full sales price from the customer.

Commenters represented that ASC 606 requires the entire transaction price from a pre-need contract, net of costs, to be included in revenue in the year in which the parties execute the contract. However, for Federal income tax purposes, commenters requested that the final regulations clarify that taxpayers with pre-need contracts should not include the unpaid balance of the transaction price in income in the taxable year the contract is executed under the AFS Income Inclusion Rule. In commenters' view, the sale of a burial plot should not be treated as a completed sale for tax purposes until the entire sales price of the burial plot is paid by the customer and ownership rights in the burial plot are transferred. Further, the taxpayer does not have an enforceable right to payment for the entire transaction price of the plot if the customer cancels or fails to perform under the contract.

Commenters concluded that these taxpayers should be entitled to recover any allocable cost basis in the burial plot before including in gross income any of the installment payments received from the customer. Commenters viewed the sale of a burial plot as the sale of an interest in real property and assert that the basis recovery rules of sections 1016 and 1001 apply to prepayments for burial plots. Under this approach, prepayments for the purchase price of a burial plot before the sale of the plot first decrease the taxpayer's basis in the burial plot. See § 1.1016–2(a). When the prepayments exceed the taxpayer's basis in the burial plot, the taxpayer recognizes the excess amount as gain. See § 1.1001–1(c)(1). Accordingly, commenters requested that the final regulations clarify the application of sections 1001 and 1016 to the sale of pre-need burial plots.

Commenters also requested clarification on the income recognition treatment of pre-need contracts with customers for the sale of interment rights. Commenters noted that the ASC 606 treatment for pre-need contracts for the sale of interment rights resemble the treatment for pre-need contracts for the sale of burial rights. Commenters viewed the receipt of any installment payments prior to the transfer of those rights and prior to the payment of the entire transaction price to be controlled by sections 1001 and 1016, rather than by sections 451 and 471. Under this rationale, a taxpayer's treatment of the down payment and the installment payments from pre-need contracts in its AFS should not determine the timing of income for tax purposes. Instead, commenters suggested that the amounts received before the transfer of the interment rights should be viewed as a return of capital and a reduction in the taxpayer's basis in the interment space.

The IRS and the Treasury Department agree that the sale of burial plots and interment rights are governed by sections 1001 and 1016 but consider the determination of whether a sale has occurred to be a factual issue. If a sale has occurred under the facts and circumstances, any income resulting from the sale is realized under section 1001 and the right to the income is fixed, therefore the AFS Income Inclusion Rule does not result in the acceleration of AFS revenue. If the sale has not occurred, and the right to the future payments is extinguished if the customer cancels the contract, the AFS Income Inclusion Rule does not require acceleration because there is no enforceable right to the future payments if the contract is cancelled by the customer provided that the taxpayer is not using the alternative AFS revenue method in § 1.451–3(b)(2)(ii).

2. Book Percentage-of-Completion Method (Book PCM)

One commenter expressed interest in a Book PCM option as a special method of accounting that taxpayers with contracts accounted for using an over-time method of accounting for revenue under ASC 606 could elect to include the full amount of revenue reported on its AFS without regard to any offset or exception provided in these regulations, but with an offset for the allocable costs reported on its AFS, with some potential tax adjustments. Under ASC 606, the over-time method, where taxpayers recognize revenue over time (as opposed to at a point in time) is used for the following contracts where control over promised goods or services is transferred over time: (1) Where the customer controls the asset as it is created or enhanced by the entity's performance under the contract; (2) where the customer receives and consumes the benefits of the entity's performance as it performs under the contract; or (3) where the entity's performance creates or enhances an asset that has no alternative use to the entity, and the entity has the right to receive payment for work performed to date and expects to fulfill the contract as promised. An entity using an ''over-time method'' recognizes revenue using either: (1) An output method, which measures the value of the goods and services transferred to date to the customer (for example, units produced); or (2) an input method, which recognizes revenue based on the entity's efforts or inputs (for example, labor hours expended, costs incurred) as compared to the expected total costs to satisfy the performance obligation.

Other commenters expressed concern about allowing a Book PCM option. Some commenters suggested that limiting a Book PCM option to only taxpayers that must report revenue on a particular over-time basis, such as an input cost-incurred method, could create more complexity, not less. Other commenters suggested that, while a Book PCM option might achieve some book-tax conformity, they would still want the opportunity to take advantage of tax rules that provide more beneficial timing than available under Book PCM, such as additional first year depreciation. The Treasury Department and the IRS will continue studying the feasibility and efficacy of an optional Book PCM approach. At this time, however, the Treasury Department and the IRS decline to adopt the Book PCM option set forth by commenters because of the concerns raised regarding the complexity and the desire by some taxpayers to obtain more beneficial timing under tax rules when using a Book PCM method.

3. AFS Issues

No formal comments were received regarding the definition of AFS in proposed § 1.451–3(c)(1). Accordingly, the definition of AFS remains largely unchanged in these final regulations. See § 1.451–3(a)(5). One commenter questioned the statutory language in section 451(b) regarding financial statements prepared using international financial reporting standards (IFRS). Specifically, section 451(b)(3)(B) provides that a financial statement made on the basis of IFRS is an AFS for section 451(b) if the financial statement is filed with a foreign government agency that is equivalent to the United States Securities and Exchange Commission (SEC) and has financial reporting standards not less stringent than the standards imposed by the SEC. Proposed § 1.451–3(c)(1)(iii)(A) and the final regulations § 1.451–3(a)(5)(ii)(A) mirror the statutory language. The commenter questioned whether the requirement in section 451(b)(3)(B) that the financial reporting standards of a foreign agency or government be not less stringent than the standards required by the SEC, refers solely to reporting standards related to revenue or if it also refers to reporting standards for other items that are not related to revenue. The statutory language does not distinguish the reporting standards between revenue and other items that are not related to revenue. Additionally, Revenue Procedure 2004–34, which was the model for the definition of AFS in section 451(b)(3), did not have similar language. Accordingly, based on the plain language of the statute, if the financial reporting standard for any item is less stringent than SEC reporting standards, even if that standard does not relate to revenue reporting, the statement will not be an AFS under proposed § 1.451–3(c)(1)(iii)(A) or § 1.451–3(a)(5)(ii)(A) of the final regulations. However, the financial reporting standards relativity requirement does not prevent the IFRS financial statements from qualifying as an AFS under proposed § 1.451–3(c)(1)(iii)(B) or (C) or § 1.451–3(a)(5)(ii)(B) or (C) of the final regulations.

No formal comments were received regarding the AFS issues addressed in proposed § 1.451–3(h)(1). Accordingly, the rules regarding an AFS that covers a group of entities (consolidated AFS rules) and mismatched reporting periods remain largely unchanged in these final regulations. However, the Treasury Department and the IRS are aware of questions regarding the application of certain aspects of the consolidated AFS rules. Under proposed § 1.451–3(h)(1)(i), if a taxpayer's results are reported on the AFS for a group of entities, the taxpayer's AFS is the group's AFS. Proposed § 1.451–3(h)(3) provides that 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.

Under the proposed regulations, it was unclear whether the portion of the AFS revenue allocable to the taxpayer includes amounts that are subsequently eliminated in the group's AFS (consolidated AFS). Accordingly, the final regulations clarify that, if the consolidated AFS does not separately state items, the portion of the AFS revenue allocable to the taxpayer is determined by relying on the taxpayer's separate source documents used to create the consolidated AFS and includes amounts that are subsequently eliminated in the consolidated AFS.

III. Comments and Revisions Regarding § 1.451–8

A. Proposed § 1.451–8(b)(1)(i): Definition of Advance Payment

1. Prepayments for Pre-Need Burial Plots

Under section 451(c)(4)(A), the term advance payment means any payment that meets the following three requirements: (1) The full inclusion of the payment in gross income in the year of receipt is a permissible method of accounting; (2) any portion of the advance payment is included in revenue in an AFS for a subsequent tax year; and (3) the advance payment is for goods, services, or such other items that the Secretary has identified. Proposed § 1.451–8(b)(1)(i) largely mirrors the definition of an advance payment in section 4.01 of Revenue Procedure 2004–34, which expands upon the goods, services, and other items for which a payment can qualify as an advance payment.

One commenter requested that the Secretary exercise the authority to broaden the definition of advance payment to include prepayments for the sale of an interest in real property, including pre-need burial plots. If the comment is adopted, prepayments for pre-need burial plots would be eligible for the one-year deferral of income.

Commenters agreed that taxpayers in the death care industry uniformly treat the entire amount of the sales price for pre-need burial plots as income on an AFS in the year the pre-need contract is executed. To qualify as an advance payment, a portion of the prepayment must be included in revenue by the taxpayer in an AFS for a subsequent taxable year. Section 451(c)(4)(A)(ii). Since prepayments for pre-need burial plots cannot meet this requirement, these prepayments cannot qualify as advance payments. For this reason, the Treasury Department and the IRS decline to adopt this comment in the final regulations.

No other requests were received to expand the definition of advance payment. Accordingly, the list of items that are included in the definition of advance payment under proposed § 1.451–8(b)(1)(i) is unchanged.

2. Amount of Payment Included in AFS Revenue in a Subsequent Year

Under section 451(c)(4)(A) and proposed § 1.451–8(a)(1)(i), for a payment to qualify as an advance payment, a portion of the payment must be included in revenue in an AFS for a subsequent tax year. The final regulations clarify that to determine the amount of the payment that is taken into account as AFS revenue, the taxpayer must adjust AFS revenue for any amounts described in § 1.451–3(b)(2)(i)(A), (C), and (D). As a result, to the extent that AFS revenue in the taxable year of receipt reflects, for example, a reduction for liabilities that are required to be accounted for under provisions such as section 461 or amounts anticipated to be in dispute, AFS revenue in the taxable year of receipt must be increased by such amounts.

The final regulations make similar clarifying changes to the deferral method for taxpayers with an AFS in § 1.451–8(c). Under § 1.451–8(c), a taxpayer that uses the deferral method must include all or a portion of the advance payment in gross income in the taxable year of receipt to the extent ''taken into account as AFS revenue'' as of the end of the taxable year of receipt, and include the remaining portion of the advance payment in gross income in the following taxable year. To determine the extent that an advance payment is treated as ''taken into account as AFS revenue'' as of the end of the taxable year of receipt, the taxpayer must adjust AFS revenue by the amounts described in § 1.451–3(b)(2)(i)(A), (C), and (D). Accordingly, to the extent that AFS revenue reflects a reduction for liabilities that are accounted for under other provisions of the Code such as section 461 or amounts anticipated to be in dispute, AFS revenue is increased by such amounts. Further, if the transaction price, as defined in § 1.451–3(a)(14), was increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, then any AFS revenue attributable to such increase is disregarded.

B. Proposed § 1.451–8(b)(1)(ii)(H): Specified Good Exception

Proposed § 1.451–8(b)(1)(ii) lists exceptions to the definition of an advance payment. Specifically, proposed § 1.451–8(b)(1)(ii)(H) provides that an advance payment does not include a payment received in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery date for a specified good. Proposed § 1.451–8(b)(8) defines the ''contractual delivery date'' as the month and year of delivery listed in the written contract to the transaction. A ''specified good'' is defined in proposed § 1.451–8(b)(9) as a good for which: (1) The taxpayer does not have the goods of a substantially similar kind and in a sufficient quantity at the end of the taxable year the upfront payment is received; and (2) the taxpayer recognizes all of the revenue from the sale of the good in its AFS in the year of delivery. If the prepayment satisfies the specified good exception, the prepayment is analyzed under section 451(b) and § 1.451–1.

1. Contractual Delivery Date Requirement

Some commenters generally requested that the Treasury Department and the IRS re-examine the contractual delivery date requirement. One commenter requested that the definition of contractual delivery date be broadened to include contracts where the delivery date can be reasonably determined based on all the facts and circumstances as provided in the contract. Another commenter requested that the exception be modified to cover any contract for the sale or production of goods where, based on all of the facts and circumstances, it is reasonably certain that the taxpayer's performance to which the advance payment relates will in fact take place. The same commenter also suggested that if the definition of the contractual delivery date was broadened, the requirement regarding the period of time between when an advance payment is received and the delivery date for a specified good could be modified to require that the expected delivery date occur more than 24 months after the advance payment is received.

The Treasury Department and the IRS decline to adopt the comments to broaden the definition of contractual delivery date in the final regulations because the suggested approaches would decrease administrability and increase uncertainty for taxpayers and the potential for litigation. Therefore, the definition of contractual delivery date in the final regulations continues to be limited to situations where the written contract provides the month and year of delivery for the goods.

In addition, because the Treasury Department and the IRS are not broadening the definition of contractual delivery date, it is not necessary to limit the specified good exception to situations where there is more than 24 months between the date the advance payment is received and the contractual delivery date. The recommended rule is more restrictive than the rule in the proposed regulation which requires the payment to be received in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery date. Accordingly, the Treasury Department and the IRS decline to adopt this recommendation.

2. Requirement That AFS Revenue Must Be Recognized in the Year of Delivery

One commenter questioned why the specified good exception in the proposed section 451(c) regulations is restricted to situations where all the revenue from the sale of the good is recognized in the taxpayer's AFS in the year of delivery. The commenter requested that the exception be expanded to include situations where the taxpayer recognizes the revenue for Federal income tax purposes no later than the time when the revenue related to the production of the goods is recognized for financial accounting purposes. As a result, taxpayers using the over-time method to report revenue under ASC 606 could be eligible for the exception.

Payments that qualify for the specified good exception are subject to the general accrual method of accounting rules under section 451(a) and (b), including the all events test under section 451(b)(1)(C) and § 1.451–1(a) and the existing case law that addresses the all events test. The specified good exception was narrowly crafted to allow a taxpayer meeting the requirements to evaluate its treatment of qualifying payments under the all events test under section 451(b)(1)(C) and § 1.451–1(a) and the existing case law that addresses the all events test. Taxpayers that meet the specified good exception criteria, unlike those taxpayers that use the over-time method to report revenue from the sale of goods under ASC 606, are generally not required to test the payment for inclusion under the AFS income inclusion rule in section 451(b)(1)(A), as the payment is not taken into account as AFS revenue until the specified good is delivered to the customer, and is only required to analyze the payment for inclusion under the all events test in section 451(b)(1)(C). Additionally, taxpayers that use the over-time method under ASC 606 generally incur production costs as AFS revenue is recognized and can therefore benefit from the advance payment cost offset method under § 1.451–8(e). However, taxpayers that use the point-in-time method to report revenue from the sale of goods under ASC 606 and that meet the rest of the specified good exception criteria generally don't incur production costs until closer to the delivery date and may not be able to benefit from the advance payment cost offset method under § 1.451–8(e). For these reasons, the Treasury Department and the IRS decline to expand the specified good exception to situations where taxpayers are using the over-time method to report revenue under ASC 606.

For this reason, the Treasury Department and the IRS do not adopt this comment. Therefore, the definition of specified good in the final regulations retains the requirement that the taxpayer recognizes all of the revenue from the sale of the good in its AFS in the year of delivery.

3. Integral Services

A commenter requested that the definition of ''specified good'' in proposed § 1.451–8(b)(8) be expanded to include ''integral services'' furnished for the good. However, the commenter provided no definition of integral services, a term which could be broadly construed resulting in audit controversies. Moreover, the Conference Report expresses Congress' intent for section 451(c) to override former § 1.451–5, which defined an advance payment to include prepayments for services that were integral to the sale or disposition of goods. See H.R. Rep. No. 115–466, at 429 fn. 880 (2017) (Conf. Rep.). For these reasons, the Treasury Department and the IRS decline to accept this comment.

4. Reasonable Estimate of Unused Net Operating Loss (NOL)

One commenter requested that, if certain proposed changes to the specified good exception are not adopted, the Treasury Department and the IRS should include an exclusion to the definition of ''advance payment'' for prepayments where the taxpayer reasonably estimates, based on the facts at the time the agreement is entered into, that it will have a NOL that remains unused for the 5-year period after the year the prepayments received are included in the taxpayer's taxable income. The requested rule would be difficult to administer because it requires a taxpayer to estimate that it will have an NOL that remains unused for a 5-year period after the advance payments are included in gross income. Accordingly, the Treasury Department and the IRS decline to adopt this comment in the final regulations.

5. Tax Consequences of Meeting the Specified Good Exception

Several commenters provided examples in which payments that qualify for the specified good exception in proposed § 1.451–8(a)(1)(ii)(H) are deferred and included in gross income when the payment is recognized as revenue in the taxpayer's AFS in the year the good is delivered. As mentioned in part III.B.2 of this Summary of Comments and Explanation of Revisions and for additional clarification, payments that qualify for the specified good exception are subject to the general accrual method of accounting rules under section 451(a) and (b), including the all events test under section 451(b)(1)(C) and § 1.451–1 and the existing case law that addresses the all events test.

6. Method To Treat Prepayments Satisfying the Specified Good Exception as Advance Payments

One commenter asked that the specified good exception be made optional, particularly if meeting the specified good exception does not result in deferral of the prepayment to match the book timing of the payment. The commenter noted that some taxpayers may prefer the section 451(c) regime, especially if there is some uncertainty whether the contract meets the specified good exception. Further, some taxpayers that had the choice of a longer deferral under § 1.451–5 or a one-year deferral under Revenue Procedure 2004–34 still chose the 1-year deferral.

The Treasury Department and the IRS agree with this comment. Accordingly, the final regulations allow taxpayers to treat all prepayments that satisfy the specified good exception as advance payments subject to section 451(c), the ''specified good section 451(c) method.'' See § 1.451–8(f). The requested election provides flexibility for taxpayers. If the taxpayer does not use the specified good section 451(c) method, payments satisfying the specified good exception are not eligible for the deferral method provided in section 451(c) and § 1.451–8 but are subject to section 451(b) and § 1.451–1(a). If the taxpayer uses the specified good section 451(c) method, the prepayment is generally deferred for one year; however, if a taxpayer also uses the advance payment cost offset method under § 1.451–8(e) to account for such prepayments, a portion of the prepayment may be deferred until the year in which ownership of the good is transferred to the customer.

The specified good section 451(c) method is a method of accounting. The method applies to all payments that satisfy the specified good exception that are received by each trade or business that uses the method. The use of this method results in the adoption of, or a change in, a method of accounting under section 446. See § 1.451–8(g).

C. Proposed § 1.451–8(c)(2)(i)(B): Acceleration of Advance Payments

Under proposed § 1.451–8(c)(2)(i)(B), a taxpayer that uses the deferral method generally includes an advance payment in gross income when it satisfies its obligation for the advance payment. Example 11 of proposed § 1.451–8(c)(8)(xi) provides an example of a travel agent that received commission income when it purchased and delivered the ticket to the customer but did not include the commission in revenue in its AFS until the following year. The example concludes that the commission is not an advance payment because it was not earned by the taxpayer in a subsequent taxable year.

Example 11 incorrectly concludes that the payment for the commission is not an advance payment. The payment for the commission income is an advance payment because it meets the definition of an advance payment under section 451(c)(4), including the requirement that a portion of the payment is included in the taxpayer's revenue in an AFS for a subsequent taxable year. However, the commission income is included in income in the year of receipt because the taxpayer's obligation with respect to the advance payment was satisfied in that year. Accordingly, in the final regulations, this example has been moved and revised into an example of the rules on the acceleration of advance payments. In addition, the analysis has been changed to clarify that (1) the commission income is an advance payment, and (2) the taxpayer's satisfaction of its obligation for the advance payment caused the commission to be included in income in the year of receipt.

D. Proposed § 1.451–8(c)(5): Contracts With Multiple Performance Obligations

Section 451(c)(4) provides that for purposes of the rules for advance payments, rules similar to the rules in section 451(b)(4), which allocate transaction price among multiple performance obligations, apply. Proposed § 1.451–8(c)(5) provides rules for taxpayers with an AFS for allocating the transaction price when there is more than one performance obligation in a contract. Specifically, those taxpayers allocate the transaction price based on the method in proposed § 1.451–3(g), namely, using the allocation in the taxpayer's AFS. No formal comments were received on this provision.

Under the proposed regulations it was not clear whether the taxpayer was required to allocate the payment to multiple performance obligations based on their relative transaction price or based on the payment allocation used for AFS purposes. Accordingly, the final regulations clarify that advance payments received under a contract with multiple performance obligations are allocated to the corresponding item of gross income in the same manner that the payments are allocated to the performance obligations in the taxpayer's AFS. This rule is consistent with the requirement in section 451(c)(4)(D) that ''rules similar to the rules in [section 451](b)(4) shall apply,'' because it follows the manner in which the taxpayer allocates the payment for AFS purposes.

The rule for taxpayers without an AFS remains unchanged. See § 1.451–8(d)(4).

2. Proposed § 1.451–8(c)(6): Contracts With Advance Payments That Include Items Subject to a Special Method of Accounting

The proposed regulations requested comments on the allocation of a payment when the contract includes income subject to section 451(c) and income subject to section 460, but no comments were received.

Consistent with the objective criteria standard under Section 5.02(4) of Rev. Proc. 2004–34, the final regulations provide that if (1) a contract with a customer includes item(s) of gross income subject to a special method of accounting and item(s) of gross income described in § 1.451–8(a)(1)(i)(C), and (2) the taxpayer receives an allocable payment, then the taxpayer must determine the portion of the payment allocable to the items of gross income described in § 1.451–8(a)(1)(i)(C) based on objective criteria. The taxpayer is deemed to satisfy the objective criteria standard when it allocates the payment to each item of gross income in proportion to the amounts determined in § 1.451–3(d)(5) or as otherwise provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d)).

This rule is consistent with the requirement in section 451(c)(4)(D) that ''rules similar to the rules in [section 451](b)(4) shall apply.'' The final regulations also provide a similar allocation rule for taxpayers using the non-AFS deferral method.

E. Cost Offset for Advance Payments

The proposed regulations do not provide for a cost offset. The preamble to the proposed regulations explains the rationale for rejecting a cost offset and requests comments on this issue.

As they did with respect to the proposed section 451(b) regulations, commenters requested that the final regulations under section 451(c) provide a cost offset, such as a COGS offset for expected future costs against advance payments for the sale of goods. Commenters asserted that a COGS offset is supported by the definition of ''receipt'' in section 451(c)(4)(C), which refers to an ''item of gross income.'' Under section 61 and § 1.61–3(a), for the sale of goods, an item of gross income generally means total sales revenue minus the cost of goods sold. Commenters cited *Hagen Advertising Displays, Inc.* v. *Commissioner,* 407 F.2d 1105 (6th Cir. 1969), as support for this position. In *Hagen Advertising,* the Sixth Circuit Court of Appeals acknowledged that, to determine the proper amount of gross income for advance payments for the sale of goods to be delivered in the future, it would be appropriate for a taxpayer to reduce the amount of the advance payment by the estimated cost of the goods to be delivered. Otherwise, denying an offset for related COGS would tax the return of capital. *Id.* at 1110. Accordingly, commenters asserted that denying a COGS offset could result in an impermissible tax on gross receipts.

Commenters also asserted that not allowing a cost offset could result in a mismatch of revenue and costs and fails to clearly reflect income. According to commenters, a taxpayer would be required to report the full amount of an advance payment in income, in excess of the expected profit associated with that portion of the total contract price being reported. When the costs are actually incurred in subsequent years, the taxpayer would report losses with no associated revenue, which, in extreme cases where the losses cannot be used, could result in a permanent loss of the tax benefit of the cost. For a limited-life business, the acceleration of revenue recognition may result in NOLs that are permanently lost, as expenses trail income throughout the life cycle of the business. The commenters pointed out that this mismatch of income and associated costs does not reflect the reality of the overall amount of gross income realized by the taxpayer on the contract as a whole.

Further, commenters reasoned that allowing a cost offset under section 451(c) will not violate the economic performance requirement of section 461(h). Since the acceleration of advance payments under section 451(c) is a departure from accrual method accounting, the costs related to the payments should also depart from accrual method concepts. Commenters pointed out that the allowance of a cost offset for expected future COGS against substantial advance payments under former § 1.451–5(c), based on *Hagen Advertising,* coexisted with section 461(h) for over 33 years. In addition, the purpose of section 461(h) was not to eliminate an offset for estimated COGS for inventory to be delivered in the near future, but to defer a deduction for costs where the obligation was fixed but was going to be performed many years in the future. Here, commenters asserted that a COGS offset would help to determine the proper amount of gross income to be accelerated, which is not what the economic performance requirement was intended to prevent.

Commenters also reasoned that section 451(c) was not meant to codify all aspects of Revenue Procedure 2004–34, including the lack of a cost offset in Revenue Procedure 2004–34. Announcement 2004–48, 2004–1 C.B. 998, explains that a COGS offset was not permitted in Revenue Procedure 2004–34 because it was inconsistent with the simplification that the revenue procedure was meant to achieve, and taxpayers could still qualify for a COGS offset under former § 1.451–5(c). Commenters also found it significant that the term ''receipt'' in section 451(c) uses the specific term ''an item of gross income,'' while the definition of received in Revenue Procedure 2004–34 uses the general term ''income.''

The Treasury Department and the IRS have considered these comments and have determined that a cost offset based on estimates of future costs would be inappropriate. As discussed in the preamble to the proposed section 451(c) regulations, allowing a cost offset based on estimated costs would be inconsistent with sections 461, 263A, and 471, and the regulations under those sections of the Code and difficult for the IRS to administer. Additionally, allowing a cost offset based on estimated costs is inconsistent with Congress' intent to override former § 1.451–5(c). Former § 1.451–5(c) permitted a cost offset for both incurred and estimated costs against certain advance payments that were required to be included in gross income in a taxable year prior to the year in which ownership of the item of inventory was transferred to the customer, and was recently withdrawn in final regulations published in the **Federal Register** on July 15, 2019. See H.R. Rep. No. 115–466, at 429 fn. 880 (2017) (Conf. Rep.); see also, 84 FR 33691 (July 15, 2019). However, the Treasury Department and the IRS agree with comments suggesting that taxpayers should be afforded the flexibility of applying an offset for costs incurred against advance payments for the future sale of inventory. In this case, the final regulations provide that a taxpayer determines the amount of the advance payment that is included in gross income for the taxable year by reducing the amount that would otherwise be included in gross income for such taxable year under the taxpayer's full inclusion method or deferral method, as applicable (advance payment inventory inclusion amount) by the cost of goods related to the item of inventory, the ''cost of goods in progress offset.'' The method allows taxpayers to offset advance payments included in income under either the full inclusion method or under the deferral method. The portion of any advance payment that is offset by a cost of goods in progress offset for a taxable year is deferred and generally included in gross income in the taxable year in which ownership of the item of inventory is transferred to the customer.

Specifically, the final regulations provide that the cost of goods in progress offset for an item of inventory for each taxable year is calculated as the cost of goods incurred for such item through the last day of the taxable year, reduced by the cumulative cost of goods in progress offset amounts in prior taxable years, if any. However, the cost of goods in progress offset cannot reduce the advance payment inventory inclusion amount for the taxable year below zero. Further, the cost of goods in progress offset attributable to one item of inventory cannot reduce the advance payment inventory inclusion amount attributable to a separate item of inventory. Any incurred costs that were not used to offset the advance payment for the item of inventory because they were subject to limitation are considered when the taxpayer determines the cost of goods in progress offset in a subsequent taxable year. In addition, the cost of goods in progress offset does not apply to the advance payment inventory inclusion amount that is included in gross income as a result of the acceleration rules in § 1.451–8(c)(4), and any advance payments previously deferred by way of a cost of goods in progress offset in a prior year are accelerated under such rule.

The cost of goods in progress offset is determined by reference to the costs and expenditures related to items of inventory produced or acquired for resale, which costs have been incurred under section 461 and have been capitalized and included in inventory under sections 471 and 263A or any other applicable provision of the Code as of the end of the year. The taxpayer must be able to demonstrate that the costs are properly capitalizable under the Code to the items of inventory produced or acquired for resale under the contract to which the taxpayer is applying the cost of goods in progress offset. For a sale of a gift card or customer reward program points, this requirement cannot be met, and no cost of goods in progress offset is permitted. However, the cost of goods in progress offset does not reduce the costs that are capitalized to the items of inventory produced or acquired for resale by the taxpayer under the contract. That is, while the cost of goods in progress offset reduces the amount of the advance payment included in income, it does not affect how and when costs are capitalized to inventory under sections 471 and 263A or any other applicable provision of the Code or when those capitalized costs will be recovered.

The costs of goods comprising the cost of goods in progress offset must be determined by applying the taxpayer's inventory accounting methods. A taxpayer must calculate its cost of goods in progress offset by reference to all costs that the taxpayer has permissibly capitalized and allocated to items of inventory under its method of accounting for inventories for federal income tax purposes, but may not consider costs that are not properly capitalized under such method.

The Treasury Department and the IRS provided this cost offset method in the final regulations because it provides a reasonable matching of income from advance payments and incurred cost of goods, and more clearly reflects income. The advance payment cost offset method is a method of accounting that applies to all advance payments received by a trade or business for items of inventory that satisfy the criteria in § 1.451–8(e). If a taxpayer chooses to use the advance payment cost offset method for a trade or business, it must also use the AFS cost offset method in § 1.451–3(c) for that trade or business. See prior discussion regarding coordination between the AFS cost offset method and the advance payment cost offset method. Additional guidance on the cost offset method for advance payments may be provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d)).

F. Continued Application of Revenue Procedure 2004–32 and Revenue Procedure 79–38

Commenters requested clarification of whether Revenue Procedure 2004–32, 2004–1 C.B. 988, and Revenue Procedure 79–38, 1997–2 C.B. 501, remain in effect after the enactment of section 451(c). Revenue Procedure 2004–32 allows an accrual method taxpayer to account for income from credit card annual fees ratably over the period covered by the fees, as described in section 4 of Revenue Procedure 2004–32. Revenue Procedure 79–38 generally allows accrual method manufacturers, wholesalers, and retailers of motor vehicles or other durable goods to include a portion of an advance payment related to the sale of a multi-year service warranty contract in gross income over the life of the service warranty obligation. Revenue Procedure 2004–32 and Revenue Procedure 79–38 remain effective after the enactment of section 451(c) and may be relied upon after these regulations are finalized.

Effect on Other Documents

The preamble to proposed § 1.451–3 requested comments on the proposed obsolescence of Revenue Procedure 2004–33, 2004–1 C.B. 989 (relating to credit card late fees), Revenue Procedure 2005–47, 2005–2 C.B. 269 (relating to credit card cash advance fees), Revenue Procedure 2013–26, 2013–22 I.R.B. 1160 (relating to a safe harbor method of accounting for OID on a pool of credit card receivables), and Chief Counsel Notice CC–2010–018 (relating to interchange). Instead of obsoleting Revenue Procedure 2013–26, commenters recommended limiting the scope of Revenue Procedure 2013–26 to OID that is not subject to the timing rules in proposed § 1.451–3(i) and thus, not excluded from the OID rules under proposed § 1.1275–2(l). Commenters explained that retaining Revenue Procedure 2013–26 would allow taxpayers to continue to use the proportional method described in the revenue procedure as a safe harbor method of accounting for certain amounts that are not OID under section 1272, such as bond premium and market discount, as well as certain kinds of OID such as promotional discount. See discussion of promotional discount in part II.F. of the Summary of Comments and Explanation of Revisions. The Treasury Department and the IRS agree with the recommendations not to obsolete Revenue Procedure 2013–26. In addition, the Treasury Department and the IRS intend to modify Revenue Procedure 2013–26 to make clear that the safe harbor method does not apply to any specified fees, including the specified credit card fees. However, based on section 451(b) and the final regulations, Revenue Procedure 2004–33, Revenue Procedure 2005–47, and Chief Counsel Notice CC–2010–018 no longer provide current guidance on the treatment of the specified credit card fees. Accordingly, these items are obsolete as of January 1, 2021.

In addition, Revenue Procedure 2004–34, Revenue Procedure 2011–18, Revenue Procedure 2013–29 and Notice 2018–35 are obsolete for taxable years beginning on or after January 1, 2021. Taxpayers that relied on the now obsoleted guidance should determine whether a change in method of accounting occurs once they cease to use the obsoleted guidance.

Applicability Dates

In general, the rules in §§ 1.451–3 and 1.451–8 apply for taxable years beginning on or after January 1, 2021. However, the rules in § 1.451–3(j) for specified fees that are not specified credit card fees apply for taxable years beginning on or after January 6, 2022. Also, for a specified credit card fee as defined in § 1.451–3(j)(2), § 1.1275–2(l)(1) applies for taxable years beginning on or after January 1, 2021, and, for a specified fee that is not a specified credit card fee, § 1.1275–2(l)(1) applies for taxable years beginning on or after January 6, 2022.

However, pursuant to section 7805(b)(7), taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may apply the rules in these final regulations, in their entirety and in a consistent manner, to a taxable year beginning after December 31, 2017, and before January 1, 2021, provided that, once applied to such a taxable year, such rules are applied in their entirety and in a consistent manner to all subsequent taxable years. Notwithstanding the preceding sentence, pursuant to section 7805(b)(7), taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may apply the rules in these final regulations that apply to specified credit card fees in their entirety and in a consistent manner, to a taxable year beginning after December 31, 2018, and before January 1, 2021, provided that, once applied to such a taxable year, such rules are applied in their entirety and in a consistent manner to all subsequent taxable years. Taxpayers that choose to apply the rules in the final regulations to a taxable year beginning before January 1, 2021 must follow the rules for changes in method of accounting under section 446 and the applicable procedural guidance.

Alternatively, a taxpayer may rely on the proposed regulations for taxable years beginning after December 31, 2017 (or December 31, 2018, in the case of specified credit card fees) and before January 1, 2021.

In the case of a specified fee that is not a specified credit card fee, a taxpayer may neither choose to apply the final regulations to, nor rely on the proposed regulations for, a taxable year beginning after December 31, 2018, and before January 6, 2022.

Statement of Availability of IRS Documents

The IRS Notices, Revenue Rulings, and Revenue Procedures cited in this document 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*.

Special Analyses

I. Regulatory Planning and Review—Economic Analysis

Executive Orders 12866, 13563, and 13771 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, of reducing costs, of harmonizing rules, and of promoting flexibility. For purposes of E.O. 13771 this rule is regulatory.

These regulations have been designated as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations. The Office of Information and Regulatory Affairs has designated these regulations as economically significant under section 1(c) of the MOA. Accordingly, the OMB has reviewed these regulations.

A. Need for the Final Regulations

The Tax Cuts and Jobs Act (TCJA) substantially modified the statutory rules of section 451, which generally governs when income is recognized for Federal tax purposes. As a result of those changes, the Treasury Department and the IRS recognized that questions were likely to arise regarding the definitions and rules that taxpayers are required to apply in calculating a business's gross income. To provide greater specificity, the Treasury Department and the IRS previously issued separate proposed regulations related to section 451(b) and 451(c) on September 9, 2019.

The proposed regulations regarding section 451(b): (1) Clarify how section 451(b) applies to multi-year contracts; (2) provide rules for taxpayers whose financial results are included on an Applicable Financial Statement (AFS) covering a group of entities; (3) describe and clarify the definition of transaction price and revenue; (4) specify the allocation of a transaction price in the case of a contract which contains multiple performance obligations; and (5) specify rules for certain debt instruments.

The proposed regulations for section 451(c) describe the deferral rules for advance payments for taxpayers with and without an AFS; (2) provide acceleration rules for taxpayers that cease to exist; (3) clarify the treatment of financial statement adjustments for taxpayers with deferred advance payments; (4) provide rules relating to the treatment of short taxable years for taxpayers deferring advance payments; and (5) define and clarify the treatment of performance obligations. They also list items excluded from the definition of an advance payment. In response to taxpayer comments received during the development of the proposed regulations, that list includes goods for which (1) the taxpayer does not have goods of a substantially similar kind and in a sufficient quantity at the end of the taxable year the upfront payment is received; and (2) the taxpayer recognizes all of the revenue from the sale of the good in its AFS in the year of delivery.

Comments were received on the proposed regulations for 451(b) and 451(c) requesting further clarification of or changes to those regulations. Based on these comments, the Treasury Department and the IRS determined that final regulations are needed to bring clarity to instances where the statute may be subject to multiple interpretations in the absence of further guidance and to respond to comments received on the proposed regulations. Among other benefits, the final regulations provide greater certainty and consistency in the application of section 451 by taxpayers and the IRS.

B. Background and Overview of Final Regulations

Under section 451(a) of the Code, income is ''recognized'' (that is, included in gross income for tax purposes) in the year in which it is received by the taxpayer unless it is properly accounted for in a different period under the taxpayer's method of accounting. Because of this latter condition, the tax treatment of certain items of income depends on the method of accounting a taxpayer is using. For taxpayers using the accrual method of accounting, income is generally recognized in the year in which all events have occurred that fix the right to receive that income and the amount of income can be determined with reasonable accuracy (all events test).

The timing of income recognition on a firm's financial statement may deviate from these principles. Both the U.S. generally accepted accounting principles (GAAP) and the international financial reporting standards (IFRS) provide income recognition rules that differ from tax reporting rules under certain circumstances. For example, 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. New accounting standards released by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) in 2014 further accelerated the timing of income recognition for financial reporting purposes, widening the gap between financial and tax reporting.

The timing of income recognition for tax purposes may also deviate from the all-events test in certain circumstances. For instance, receipt of payment by the business satisfies the all events test. However, recognition of certain payments for goods or services not yet provided may be deferred to the year following receipt of payment, to the extent that recognition is also deferred on the taxpayer's AFS. Such payments are referred to as ''advance payments.''

Prior to the enactment of TCJA on December 22, 2017, taxpayers were generally permitted to defer the tax on these advance payments; in other words, advance payments could be recognized in a later taxable year. Under prior law, the period over which an advance payment was deferred varied depending on the alternative regulatory treatment chosen (Revenue Procedure 2004–34 or § 1.451–5) and, within § 1.451–5, the type of good for which an advance payment was accepted (inventoriable goods versus non-inventoriable goods).

Under Revenue Procedure 2004–34, a taxpayer who receives an advance payment includes the advance payment in taxable income in the year of receipt to the extent that the payment is earned (if the taxpayer does not have an AFS) or, if the taxpayer has an AFS, to the extent that the payment is included in revenues in the AFS. The taxpayer includes the remaining amount of the advance payment in taxable income in the next taxable year, unless the next taxable year is a short year of 92 days or less. In the event of such a short year, the taxpayer includes in taxable income the part of the advance payment included in revenue in the AFS for the short tax year or, in the case of a taxpayer that does not have an AFS, the part of the advance payment which is earned in the short tax year. The remaining balance of the advance payment is included in income for the taxable year following the short tax year. Revenue Procedure 2004–34 applies to numerous types of advance payments beyond advance payments for the provision of services and sales of goods. For example, it applies to advance payments for the use of intellectual property and software, the occupancy or use of property if the occupancy or use is ancillary to the provision of services, guaranty or warranty contracts, subscriptions, memberships in organizations, and eligible gift card sales.

Under § 1.451–5, advance payments were defined more narrowly than under Revenue Procedure 2004–34 to include payments received by an accrual-method taxpayer for the future sale of goods held by the taxpayer in the ordinary course of trade or business and as payments for the building, installing, constructing, or manufacturing of goods by the taxpayer in a future taxable year. Such advance payments were generally included in taxable income either in the year of receipt or in the year in which the payment was properly accruable under the taxpayer's method of accounting.

An exception to this general rule occurred in the case of certain advance payments for certain goods properly held in inventory by the taxpayer. In the case of such goods, the receipt of a substantial advance payment required that all previously unrecognized advance payments be included in taxable income by the end of the second taxable year following the taxable year in which the substantial advance payment was received. The taxpayer was considered to have received a substantial advance payment if the sum of the advance payment received in the current taxable year and prior taxable years for the same contract was greater than or equal to total inventoriable costs and expenditures.

The TCJA substantially amended section 451 providing, among other things, new rules addressing deviations from the all-events test. The amended section 451(b) more closely aligns when income is recognized for Federal tax purposes with when it is recognized on businesses' financial accounting statements. In particular, section 13221 of the TCJA amends section 451(b), such that an item of gross income must be included in gross income no later than the period when the item is included in revenue on an AFS. 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). For these taxpayers, income recognition is accelerated for tax purposes when income has been recognized for financial accounting purposes before the all events test has been satisfied.

The amendments made to section 451(b) only apply to taxpayers that use accrual accounting and have an AFS. Neither the statutory changes to 451(b) nor the final regulations regarding 451(b) change the time at which income is recognized for accrual method taxpayers without an AFS.

Section 451(c), added by the TCJA, allows accrual-method taxpayers to elect to recognize as income only a portion of an advance payment in the taxable year in which it is received, and then recognize the remainder in the following taxable year. Section 451(c) essentially codifies the deferral method of accounting for advance payments that was permitted in Revenue Procedure 2004–34. (Joint Committee on Taxation, *General Explanation of Public Law 115–97,* (Washington, U.S. Government Publishing Office, December 2018), at 167.) The new section 451(c), a subject of the final regulations, addresses how advance payments are defined and when they need to be recognized in a business's gross income.

C. Economic Analysis

1. Baseline

In this analysis, the Treasury Department and the IRS assess the benefits and costs of the final regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these final regulations.

2. Summary of Economic Effects

The final regulations provide certainty and consistency in the application of sections 451(b) and 451(c) by providing definitions and clarifications regarding the statute's terms and rules. In the absence of the guidance provided in these final regulations, the chance that different taxpayers might interpret the statute differently is exacerbated. For example, two similarly situated taxpayers might interpret the statutory provisions pertaining to the definition of advanced payments differently, with one taxpayer pursuing a project that another comparable taxpayer might decline because of a different interpretation of how the income may be treated under section 451(c). If this second taxpayer's activity is more profitable, an economic loss arises. Similar situations may arise under each of the provisions addressed by these regulations. Certainty and clarity over tax treatment generally also reduce compliance costs for taxpayers.

An economic loss might also arise if all taxpayers have similar interpretations under the baseline of the tax treatment of particular items of income but those interpretations differ slightly from the interpretation Congress intended for these income streams. For example, the final regulations may specify a tax treatment that few or no taxpayers would adopt in the absence of specific guidance but that nonetheless advances Congressional intent. In these cases, guidance provides value by bringing economic decisions closer in line with the intent and purpose of the statute.

While no guidance can curtail all differential or inaccurate interpretations of the statute, the final regulations significantly mitigate the chance for differential or inaccurate interpretations and thereby increase economic efficiency.

Because the final regulations clarify the tax treatment of items of gross income for certain taxpayers, there is the possibility that business decisions may change as a result of these regulations. The final regulations generally have the effect of delaying the timing of tax liability, thus reducing effective tax rates for affected taxpayers. This reduction in effective tax rates, viewed in isolation, will generally lead to an increase in economic activity by these taxpayers.

This delay in the timing of tax liability, viewed in isolation, will also decrease Federal tax revenue. A decrease in Federal tax revenue either increases the deficit or necessitates increases in other taxes or a reduction in spending. This revenue effect will be mitigated to some degree by improved economic performance (and accompanying tax revenues) under these regulations due to (i) the enhanced alignment in the timing of taxes on income and costs; (ii) the enhanced certainty and clarity provided by the final regulations as described previously; and (iii) enhanced economic activity due to lower effective tax rates for affected taxpayers.

The Treasury Department and the IRS have not estimated these effects relative to the no-action baseline or alternative regulatory approaches because they do not have readily available data or models that measure: (i) The volume of cost offsets allowed under the final regulations;[1] (ii) the effect on economic activity by affected taxpayers from the enhanced alignment of income and costs under the final regulations relative to the no-action baseline or alternative regulatory approaches; (iii) the tax positions that taxpayers would take on other provisions of the final regulations, relative to the no-action baseline or alternative regulatory approaches; or (iv) the economic activities that taxpayers would engage in under those tax positions.

The Treasury Department and the IRS have also not made projections of any change in compliance costs arising from the final regulations, relative to the no-action baseline. Treasury generally projects that compliance costs will be lower under the final regulations relative to the no-action baseline because enhanced clarity and certainty reduce compliance costs. The Treasury Department and the IRS recognize that some taxpayers may take advantage of favorable provisions in the final regulations and that this decision could increase their compliance costs. Taxpayers would not take advantage of these provisions, however, unless the overall treatment was beneficial to the taxpayer.

The proposed regulations noted that the economic analysis of the final regulations under section 451(c) would address the economic effects of regulatory guidance, if any, under sections 460 and 461(h) or other sections of the Code that interact with section 451(c), that was issued between the proposed and final regulations. Since the release of the proposed regulations on September 5, 2019, no such regulatory guidance has been issued.

The proposed regulations for 451(b) and 451(c) solicited comments on the economic effects of the proposed regulations. No such comments were received.

3. Number of Affected Taxpayers

The Treasury Department and the IRS estimate that between 174,000 and 299,000 entities are likely to be affected by the final regulations.

Section 451(b) and (c) and the regulations under § 1.451–3 affect only those business entities that (i) use an accrual method of accounting, and (ii) have an AFS. One provision in § 1.451–8 applies to accrual method taxpayers without an AFS. Regarding the accrual method of accounting, section 13102 of TCJA modified section 448 to expand the number of taxpayers eligible to use the cash receipts and disbursements method of accounting (cash method of accounting). In general, C corporations and partnerships with a C corporation

[1] Cost offsets are not reported on current tax returns and will not be separately reported on future tax returns.

partner are now permitted to use the cash method of accounting if average annual gross receipts are $25 million or less for taxable years beginning in 2018 (up from $5 million or less in 2017). This amount was adjusted for inflation for taxable years beginning after December 31, 2018. The amount was $26 million in taxable year 2019.

The statute and the regulations generally affect only those entities that also have an AFS although one provision in the regulations under § 1.451–8 applies to non-AFS taxpayers. The Treasury Department and the IRS do not have readily available data to measure the prevalence of these affected entities. 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. Schedule M–3 is required to be filed only by entities with at least $10 million of assets. This population is more likely to possess an AFS and, conversely, entities that do not file Schedule M–3 are less likely to possess an AFS or otherwise be affected by the regulations as owners and/or creditors of such smaller entities are less likely to require the entity to certify its financial results via a financial statement audit. Data are currently available only for electronic filers.

The Treasury Department and the IRS estimated the number of affected taxpayers separately for entities with gross receipts of $26 million or less and those with gross receipts above $26 million. For taxable year 2017, 89 percent of accrual-method entities filing Forms 1120, 1120–S, and 1065 with gross receipts of $26 million or less were filers of electronic tax forms. About 11 percent, or 288,000 returns, included a Schedule M–3. About 40 percent of the returns with Schedule M–3, or 113,000, indicated they had a certified audited income statement.[2] 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 127,000 (113,000/0.89) entities with gross receipts of $26 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 251,000 of these entities are potentially impacted by the final regulations.

For entities with gross receipts above $26 million and that are accrual method entities, the comparable calculations are that 95 percent of returns are e-filed and that 73 percent of those included a Schedule M–3. Based on the assumption that filers of paper tax forms have the same incidence as electronic filers and that entities that do not include a Schedule M–3 generally do not have an AFS, the Treasury Department and the IRS estimate that 47,000 (45,000/0.95) entities with gross receipts above $26 million 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 48,000 of these entities are potentially affected by these regulations.

Together, these calculations imply that between 174,000 and 299,000 entities are potentially affected by the final regulations.

CORPORATION AND PARTNERSHIP RETURNS USING AN ACCRUAL METHOD OF ACCOUNTING ***

[Taxable year 2017; thousands of returns]

	Entities with gross receipts not greater than $26 million			Entities with gross receipts greater than $26 million		
	E-filed	Paper-filed	Total	E-filed	Paper-filed	Total
Returns	2,503	307	2,810	73	4	77
Returns with a Schedule M–3	288	* 35	* 323	62	* 3	* 65
Returns with a Schedule M–3 and an audited income statement	113	* 14	* 127	45	* 2	* 47
Returns without a Schedule M–3	2,215	* 272	* 2,487	11	* 1	* 12
Returns without a Schedule M–3, but with an audited income statement (estimated)	** 111	** 13	** 124	** 1	** 0	** 1
Returns with an audited income statement	** 224	** 27	** 251	** 46	** 2	** 48

* 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 percent of returns without a Schedule M–3 have an audited income statement.

*** This table does not include sole proprietorships because the number of sole proprietorships with gross receipts above $26 million that used accrual accounting was statistically indistinguishable from zero in 2017. The number of sole proprietorships with gross receipts of $26 million or below that are affected by these regulations is projected to be minimal.

Source: Data compiled by the IRS Research, Applied Analytics and Statistics Division using data from the Compliance Data Warehouse. The total number of accrual method returns of corporations and partnerships may differ slightly from other estimates due to different data sources.

4. Economic Effects of Provisions Under Section 451(b)

a. Provisions Substantially Revised From the Proposed Section 451(b) Regulations

i. Cost Offset Under Section 451(b)

Section 451(b) as amended by TCJA addresses the timing of revenue recognition for tax purposes but makes no mention of the timing of cost recognition. The Treasury Department and the IRS considered three options for addressing the treatment of costs under section 451(b): (i) Do not allow a cost offset; (ii) allow a cost offset for incurred costs; and (iii) expand the allowance for incurred costs by further allowing a cost offset for projected costs. The proposed regulations did not provide a cost offset for the AFS income inclusion rule.

In the proposed section 451(b) regulations (in this part C.4, *proposed regulations*), the Treasury Department and the IRS argued that allowing a cost offset would be inconsistent with the economic performance rules under section 461 and inventory accounting rules under section 471. The proposed regulations further argued that Congress did not make clear any intention to alter those sections of the Code or their

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

associated regulations. The proposed regulations stated, however, that the subject was still under consideration and requested comments addressing appropriate cost offset rules.

In response to the comments received, the Treasury Department and the IRS have decided to include in the final regulations an offset for the cost of goods in progress (cost offset). This cost offset allows taxpayers to reduce the amount of revenue from the sale of inventory that is otherwise required to be included in gross income under the AFS income inclusion rule in a taxable year prior to the year in which ownership of the inventory is transferred to the customer and defer such revenue to the taxable year in which the ownership of the inventory is transferred to the customer. The amount of such reduction, or cost offset, is determined by reference to the inventoriable costs incurred to date. The offset applies only to incurred costs, not estimated or projected costs. Further, the cost offset cannot reduce the amount of revenue that is included in gross income under the AFS inclusion rule below zero. Any incurred costs subject to this limitation may be carried forward to determine the cost offset in subsequent taxable years.

The cost offset in the final regulations generally reduces the amount of revenue that is required to be included in gross income in a taxable year prior to the year in which ownership of inventory is transferred to the customer relative to the proposed regulations. An improved match of income and cost timing is generally held to provide a more accurate measure of economic activity and thus would lead to a more efficient tax system than under the proposed regulations, within the context of the statute and the overall Code.

This enhanced alignment in the tax treatment of revenue and costs can be expected to reduce financing costs for at least some projects and taxpayers. This reduction in financing costs relative to the proposed regulations may arise because in some cases under the proposed regulations, the inability of taxpayers to match the timing of revenue and cost associated with a project leads to a large, front-loaded tax liability, which may require a costly rebalancing of other assets, particularly for liquidity-constrained taxpayers. Taxpayers who experience a reduction in financing costs as a result of these final regulations, relative to the proposed regulations, may, as a result, increase other expenditures, including investment. The provision of the cost offset in the final regulations may further encourage longer-run projects relative to the proposed regulations.

The Treasury Department and the IRS considered expanding the cost offset to allow for projected costs, with several possible formats for how projected costs would be accounted for. Allowing an offset for projected costs would entail a higher administrative burden than the offset (only) for incurred costs and would not definitively improve the alignment of when income and costs are recognized for tax purposes relative to the offset for incurred costs. The Treasury Department and the IRS project that under an offset for projected costs, more disputes would likely arise over the projected costs because taxpayers would have an incentive to overstate projected costs in order to delay income recognition.

The Treasury Department and the IRS have not estimated the difference in compliance costs, administrative burden, or income-cost alignment (and any subsequent effects on economic activity) between the final regulations and alternative regulatory approaches using projected costs. The Treasury Department and the IRS have not undertaken this estimation because they do not have sufficiently detailed data or models that capture possible differences in cost offset formats that use incurred costs versus projected costs.

ii. Scope of the AFS Income Inclusion Rule

The final regulations also address concerns raised by commenters regarding recent changes to the financial accounting standards. The commenters suggested that the AFS inclusion rule is overly broad in light of these new standards, which generally accelerate AFS revenue recognition relative to the prior standards, and could cause taxpayers to incur a tax liability before they receive, or have a fixed right to receive, the money to pay the liability. Accordingly, the final regulations provide that under the AFS inclusion rule, amounts taken into account as AFS revenue include only those amounts that the taxpayer has an enforceable right to recover if the customer were to terminate the contract at the end of the taxable year.

The final regulations further provide, however, that a taxpayer may treat any amount reported as AFS revenue as being taken into account as AFS revenue regardless of whether the taxpayer has an enforceable right to recover such amounts. The Treasury Department and the IRS project that this option will lead to reduced compliance burden, reduced administrative burden, and to fewer taxpayer disputes relative to an alternative regulatory approach under which amounts taken into account as AFS revenue include only those amounts that the taxpayer has an enforceable right to recover if the customer were to terminate the contract at the end of the taxable year. Under this ''enforceable right'' approach, taxpayers would be required to analyze each contract to determine amounts for which the taxpayer has an enforceable right to recover if the customer were to terminate the contract at the end of the year; this analysis would be potentially costly.

The Treasury Department and the IRS also considered an alternative regulatory approach under which taxpayers would be permitted to defer ''increases'' in the transactions price that are taken into account as AFS revenue in a given year but to which a taxpayer's entitlement is contingent on a future event (contingent transaction price approach). This alternative regulatory approach was reflected in the proposed regulations. However, commenters expressed confusion as to what constitutes an ''increase'' in the transaction price and the types of contingencies that were intended to be included within the scope of the rule. Because of the uncertainties created by the contingent transaction price approach, and the potential for multiple interpretations, the Treasury Department and the IRS decided against this approach. The enforceable right standard adopted by the final regulations may accelerate income inclusion relative to the contingent transaction price approach, although the Treasury Department and the IRS recognize that the opposite result may hold for some taxpayers.

The Treasury Department and the IRS have not estimated the differences in income inclusion between the final regulations and this alternative regulatory approach because they do not have readily available data on the income inclusion timing differences under an enforceable right standard versus the contingent transactions price approach. Because of this lack of data, the Treasury Department and the IRS have further not estimated the difference in compliance costs between the final regulations and the alternative regulatory approach.

b. Provisions Not Substantially Revised From the Proposed Section 451(b) Regulations

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

The final 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 annual approach and (ii) a cumulative approach. Under an annual approach, for each taxable year under the contract a taxpayer would compare the amount of income taken into account as AFS revenue for that taxable year and the amount of income that meets the requirements for recognition under the all events test for that same taxable year to determine its gross income inclusion for that taxable year; that is, the taxpayer would include the larger of the two amounts. The total amount of gross income recognized under the contract through the end of such taxable year is not to exceed the total contract price.

In contrast, under a cumulative approach, in each taxable year a taxpayer would compare the cumulative amount of revenue included in its AFS up to and including that taxable year with the cumulative amount of income that meets the requirements for recognition under the all events test up to and including that taxable year. The taxpayer would then take the larger of the two amounts and reduce it for any prior taxable year income inclusions with respect to that item of gross income to determine the amount that is required to be included in gross income in the current taxable year.

The difference between the annual approach and the cumulative approach are illustrated by the following example. In 2021, D, an engineering services provider, enters into a non-severable contract with a customer to provide engineering services through 2024 for a total of $100x. Under the contract, D receives payments of $25x in each calendar year of the contract. For its AFS, D reports $50x, $0, $20x, and $30x of AFS revenue from the contract for 2021, 2022, 2023, and 2024, respectively. D has an enforceable right, as defined in § 1.451–3(a)(9), to recover all amounts reported as AFS revenue through the end of a given contract year if the customer were to terminate the contract on the last day of such year. The $25x payment received for 2023 is an advance payment, as defined in § 1.451–8(a)(1), because $5x of the $25x payment is reported as AFS revenue for 2024. D uses the full inclusion method for advance payments.

The accompanying table shows the treatment of gross income under the two approaches.

	2021	2022	2023	2024	Total
Payments	$25x	$25x	$25x	$25x	$100x
AFS Revenue	50x	0x	20x	30x	100x
Gross Income (cumulative approach)	50x	0x	25x	25x	100x
Gross Income (annual approach)	50x	25x	25x	0x	100x

An annual 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 2022 the fact that cumulative AFS revenue of $50x had been recognized as taxable gross income in 2021. Accordingly, the annual approach would require that an additional $25x of income be recognized in 2022, since a payment of that amount was received in that year. In effect, an annual approach would accelerate the recognition of $25x from 2023 to 2022 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 annual approach would be excessive relative to the cumulative approach when considered against the intent and purpose of the statute. The final regulations therefore adopt the cumulative approach.

The Treasury Department and the IRS have not estimated the difference in compliance costs, administrative burden, or economic activity between the final regulations and an alternative regulatory approach of using an annual comparison. The Treasury Department and the IRS have not undertaken this estimation because they do not have sufficiently detailed data or models that capture possible differences in taxpayers' income inclusions under these two alternative regulatory approaches.

ii. Applicable Financial Statement Covering a Group of Entities

The final 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 final 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 final 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 final regulations describe and clarify the definition of AFS revenue to broadly include amounts characterized as revenue in a taxpayer's AFS as well as amounts reported in other comprehensive income or retained earnings provided such amounts relate to an item of gross income that is subject to the rules under section 451(b) and (c). 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 final regulations is consistent with the current application of the all events test under § 1.451–1(a) and ensures that all relevant 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. 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 final 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 final 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 TCJA (see Conference Report, p. 276), the final regulations provide that credit card late fees, credit card cash advance fees, and interchange fees are subject to the AFS income inclusion rule. The final regulations further specify that if these credit card fees are subject to the AFS income inclusion rule, 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 final 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.

5. Economic Effects of Provisions Under 451(c)

a. Provisions Substantially Revised From the Proposed Section 451(c) Regulations

i. Cost Offset for Advance Payments

The Treasury Department and the IRS considered three options for addressing the treatment of costs under section 451(c): (i) No cost offset; (ii) a cost offset for incurred costs; and (iii) a cost offset that further allowed for projected costs. The proposed section 451(c) regulations (in this part C.5, *proposed regulations*) did not provide for a cost offset for advanced payments. At the time, the Treasury Department and the IRS argued that Congress intentionally simplified the rules for advance payments by limiting the deferral of advance payments for taxpayers with an AFS to a prescribed statutory method that (1) does not include an accelerated cost offset, (2) is consistent with Revenue Procedure 2004–34, and (3) overrides § 1.451–5. Taxpayers commenting on the proposed regulations were concerned that the failure to provide a cost offset rule in 451(c) would cause a mismatch of income and expenses and result in the taxation of gross receipts. For example, if a business has a multi-year contract to build or manufacture a highly customized good, it would report any advance payment in income in the year of receipt or in the following taxable year. If it uses the advance payment to purchase materials and to pay workers as part of the project, it would recover those costs only when the sale takes place. Under the proposed regulations, the statute would generate a tax on the total amount of the advance payment in the first years of the contract with all related costs being recovered later in the contract.

In response to these comments on the proposed regulations, the Treasury Department and the IRS have written the final regulations to include an offset for cost of goods in progress (cost offset). This cost offset allows taxpayers to reduce the amount of an advance payment for the future sale of inventory that is required to be included in gross income in a year prior to the year in which ownership of the inventory is transferred to the customer. The amount of such reduction, or cost offset, is equal to the inventoriable costs incurred as of the end of the taxable year in which the advance payment is required to be included in gross income under the taxpayer's method of accounting for advance payments. This provision of the final regulations allows taxpayers to offset advance payments included in income under either the full inclusion method or the deferral method. However, the cost of goods in progress offset cannot reduce the amount of the advance payment income inclusion below zero. Any incurred costs subject to this limitation may be carried forward to determine the cost of goods in progress in subsequent taxable years.

The cost offset in the final regulations generally reduces the amount of the advance payment that is required to be included in gross income in a taxable year prior to the year in which ownership of the inventory is transferred to the customer relative to the proposed regulations. An improved match of income and cost timing is generally held to provide a more accurate measure of economic activity and thus provide a more efficient tax system than under the proposed regulations. For further discussion of the economic effects of the cost offset for advance payments and for income more generally see 4.a.i.

The Treasury Department and the IRS considered expanding the cost offset to allow for projected costs, with several possible formats being considered for how projected costs would be treated. Allowing an offset for projected costs would entail a higher administrative burden than the offset for incurred costs and may not definitively improve the alignment of when income and costs are recognized for tax purposes relative to the offset for incurred costs.

The Treasury Department and the IRS have not estimated the difference in compliance costs, administrative burden, or income-cost alignment (and any subsequent effects on economic activity) between the final regulations and alternative regulatory approaches using projected costs associated with advance payments. The Treasury Department and the IRS have not undertaken this estimation because they do not have sufficiently detailed data or models that capture possible differences in cost offset formats that use incurred costs versus projected costs.

b. Provisions Not Substantially Revised From the Proposed Regulations

i. Deferral Methods Under Section 451(c)

The statute prescribes a particular deferral method for accrual-method taxpayers that have an AFS (AFS taxpayers) but does not explicitly describe a deferral method to be used by taxpayers that do not have an AFS (non-AFS taxpayers). To remedy this gap, the proposed and final regulations describe and clarify that a method similar to the deferral method available to non-AFS taxpayers under Revenue Procedure 2004–34 will be available to non-AFS taxpayers.

The Treasury Department and the IRS considered and rejected a narrow interpretation of section 451(c) that would have precluded non-AFS taxpayers from using a deferral method similar to that provided in Revenue Procedure 2004–34. Section 451(c) does not explicitly prohibit the use of such a method by non-AFS taxpayers, and the Treasury Department and IRS continue to have authority under the Code to prescribe a deferral method for such taxpayers. Precluding non-AFS taxpayers from using a deferral method similar to that of AFS taxpayers would treat AFS and non-AFS taxpayers quite differently regarding business decisions they might make that are otherwise similar. Such treatment would result in a less economically efficient tax system, which generally treats similar economic decisions similarly.

ii. Advance Payment Acceleration Provisions

If a taxpayer ceases to exist by the close of a taxable year in which an advance payment has been received and deferred, then issues may arise as to when or whether the remaining amount of the payment will be recognized as taxable income because there may not be a succeeding taxable year in which such income can be recognized.

Under the statute, if the taxpayer dies or ceases to exist by the close of the taxable year in which the advance payment was received, any remaining untaxed amounts of advance payments must be included in income in the year they were received. The final regulations extend this payment ''acceleration'' rule to situations in which a performance obligation is satisfied or otherwise ends in the taxable year of receipt or in a succeeding short taxable year, a treatment that is consistent with a similar rule in Revenue Procedure 2004–34.

The Treasury Department and the IRS considered not modifying or expanding the acceleration rule contained in section 451(c) but rejected this alternative because the remaining amount may never be included in income, thus risking a permanent exclusion of the amount from taxable income. The possibility of a permanent exclusion of income provides incentives for taxpayers to structure payments in ways that avoid tax liability, thus reducing Federal tax revenue without providing an accompanying general economic benefit. The proposed and final regulations treat the expanded set of accelerated transactions consistently with similar types of transactions based on the timing and structure of the payments involved.

iii. Advance Payments and Financial Statement Adjustments

Under the statute, if a taxpayer counts an advance payment as an item of deferred revenue, under certain conditions (for example, certain acquisitions of one corporation by another), the taxpayer may be required by its system of accounting to adjust that item on the balance sheet in a subsequent year. The item would then not be included in current earnings or AFS revenues. In this case, taxpayers might argue that they can exclude the amount deferred from taxable income because it is never ''earned'' nor included in revenue under their AFS. If this argument were upheld, taxpayers could convert an income ''deferral'' amount into an income ''exemption'' amount. To address this issue and avoid this possibility, the proposed and final regulations specify that such financial statement adjustments are to be treated as ''revenue.''

The Treasury Department and the IRS considered not providing clarity on the treatment of financial statement write-downs but rejected that approach because it would have risked an inappropriate permanent exclusion of income. The possibility of a permanent exclusion of income provides incentives for taxpayers to structure payments in ways that avoid tax liability, thus reducing Federal tax revenue without providing an accompanying general economic benefit.

iv. Short Taxable Years and the 92-Day Rule

Section 451(c) does not provide a rule relating to the treatment of short taxable years. In the absence of such a rule, it will be unclear to taxpayers how they should implement the deferral method provided in section 451(c) in the case of a short taxable year. To address this issue, the proposed and final regulations provide rules relating to the treatment of short taxable years for advance payments that are generally consistent with Revenue Procedure 2004–34. The Treasury Department and the IRS considered and rejected not providing short taxable year rules because such a decision would have created significant confusion among taxpayers, increased administrative costs for the IRS, and increased compliance costs for taxpayers.

v. Performance Obligations for Non-AFS Taxpayers

A performance obligation is generally a contractual arrangement with a customer to provide a good, service or a series of goods or services that are basically the same and have a routine pattern of transfer. Further, each performance obligation in a contract generally yields a separate item of gross income. The Treasury Department and the IRS interpret the statute as requiring taxpayers to allocate payments attributable to multiple items of gross income in the same manner as such payments are allocated to the corresponding performance obligations in the taxpayer's AFS. The statute does not, however, specify the allocation rules to be used by non-AFS taxpayers.

To address this issue, the proposed and final regulations provide allocation rules for non-AFS taxpayers consistent with a similar rule in Revenue Procedure 2004–34. That rule specifies that a payment that is attributable to multiple items of gross income is required to be allocated to such items in a manner that is based on objective criteria. The objective criteria standard will be satisfied if the allocation method is based on payments the taxpayer regularly receives for an item or items that are regularly sold or provided separately. The Treasury Department and the IRS considered not providing allocation rules for non-AFS taxpayers but rejected such an approach because it would have treated similarly situated taxpayers quite differently and would have led to increased administrative costs for the IRS and increased compliance costs for taxpayers relative to the rules provided in the final regulations. While the allocation rules for AFS taxpayers and non-AFS taxpayers differ to some degree under the final regulations, the chosen provision provides a rule upon which non-AFS taxpayers can rely, while minimizing the differences between AFS and non-AFS taxpayers in this regard within the constraints imposed by the statute.

vi. Specified Good Exception

Section 451(c) provides that certain items are excluded from the definition of an advance payment. Those items include rent; insurance premiums governed by subchapter L; payments with respect to financial instruments; payments with respect to certain warranty or guaranty contracts; payments subject to section 871(a), 881, 1441, or 1442; payments in property to which section 83 applies; and other payments identified by the Secretary. This list of items excluded from the definition of an advance payment is generally comparable to the list of items excluded from the definition of an advance payment in Revenue Procedure 2004–34.

Prior to release of the proposed regulations, several commenters requested that the list of excluded items be expanded to include certain goods that require a significant amount of capital to produce and that may require considerable time from development to delivery. Generally, for financial statement purposes, such manufacturers recognize revenue related to these goods when the product is completed and delivered and the title and risk of loss have transferred to the customer.

To address this issue, the proposed regulations crafted a narrow specified-goods exception for taxpayers who receive advance payments but do not perform the work or deliver the good for several years in the future. Specifically, an exclusion was introduced for certain goods for which a taxpayer requires a customer to make an upfront payment under the contract if (i) the contracted delivery month and year of the good occurs at least two taxable years after an upfront payment, (ii) the taxpayer does not have the good or a substantially similar good on hand at the end of the year the upfront payment is received, and (iii) the taxpayer recognizes all of the revenue from the sale of the good in its AFS in the year of delivery.

The final regulations make one minor modification to the specified good exception. In response to comments, the final regulations give taxpayers the option to treat upfront payments that satisfy the criteria for the specified good exception as a typical advance payment under section 451(c). In other words, taxpayers have the option of including the advance payment in gross income under the full inclusion method or the deferral method. This flexibility in the section 451(c) regime reduces uncertainty for taxpayers who may be unsure if a contract meets the specified good exception relative to the proposed regulations. It also allows taxpayers using the 1-year deferral under Revenue Procedure 2004–34 prior to the passage of the TCJA the option to continue to do so.

The Treasury Department and the IRS considered as an alternative not using the authority granted to the Secretary in section 451(c)(4)(B)(vii) to exclude certain payments. For manufacturers of highly customizable goods with a delivery date more than two years after the upfront payment, the one-year deferral period has the potential to increase book-tax accounting differences relative to the final regulations. For some companies, a one-year deferral period may require the creation of separate records to track advance payments for accounting and tax purposes. Thus, for these taxpayers, the final regulations may provide greater conformity between accounting (book) income and taxable income to the extent that applicable case law would defer the inclusion of income related to the specified goods exception.

II. Paperwork Reduction Act

These regulations do not impose any additional information collection requirements in the form of reporting, recordkeeping requirements or third-party disclosure requirements related to tax compliance. Instead, because section 451(b) and section 451(c) and these regulations provide various methods of accounting affecting the timing of income inclusion, taxpayers without an existing method of accounting for these items may initially adopt such method without the consent of the Commissioner. However, the consent of the Commissioner under section 446(e) and the accompanying regulations is required before implementing method changes from one method to another method. See §§ 1.451–3(l) and 1.451–8(g). Some of the methods of accounting referenced by and discussed in these regulations are represented in the following chart.

Section	Brief description of method
§ 1.451–3(b)(2)(i)	Application of AFS income inclusion rule by making all AFS revenue adjustments.
§ 1.451–3(b)(2)(ii)	Application of AFS income inclusion rule by making certain AFS revenue adjustments (Alternative AFS Revenue method).
§ 1.451–3(c)	AFS cost offset method.
§ 1.451–3(i)(4)	Computing revenue when the AFS and taxable years are mismatched.
§ 1.451–3(l)	Change in the method of recognizing revenue in an AFS.
§ 1.451–8(c)	Deferral method for taxpayers with an AFS.
§ 1.451–8(d)	Deferral method for taxpayer without an AFS.
§ 1.451–8(e)	Advance payment cost offset method.
§ 1.451–8(f)	Election for the specified goods exception to not apply.
§ 1.451–8(g)	Change in the method for recognizing advance payments on an AFS.

Taxpayers request consent to use a method in these regulations by filing Form 3115, *Application for Change in Accounting Method* (Parts I, II, IV and Schedule B). Filing of Form 3115 and any statements attached thereto (for taxpayers who are required to do so or who elect certain methods of accounting described in the regulations) is the sole collection of information requirement imposed by the statute and the regulations.

For the Paperwork Reduction Act (PRA), the reporting burden associated with the collections of information in these regulations will be reflected in the IRS Form 3115 PRA Submissions (OMB control numbers 1545–0074 for individual filers, 1545–0123 for business filers, and 1545–2070 for all other types of filers).

In 2018, the IRS released and invited comment on a draft of Form 3115 to give the public the opportunity to benefit from certain specific revisions 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. Form 3115 applies to changes of accounting methods generally and is therefore broader than section 451(b).

On November 25, 2019, the Treasury Department and the IRS published Revenue Procedure 2019–43, 2019–28 I.R.B. 1107, which updated Revenue Procedure 2018–31, and provides a global list of automatic method change procedures, including procedures for taxpayers to comply with various provisions in section 451(b) and (c) and the proposed regulations. Under the procedures, taxpayers can request permission to change to a method of accounting to comply with the various provisions in section 451(b) and (c) and the proposed regulations 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.

The current status of the PRA submissions that will be revised as a result of the information collections in these regulations is provided in the accompanying table. As described earlier, the reporting burdens associated with the information collections in these 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 filers subject to Revenue Procedure 2018–31). The overall burden estimates associated with the OMB control numbers identified later 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 these regulations. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by these 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 TCJA.

No burden estimates specific to the forms affected by these 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 these 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 TCJA and those that arise out of discretionary authority exercised in these regulations 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 these regulations, including estimates for how much time it would take to comply with the paperwork burdens described earlier 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.

Form/revenue procedure	Type of filer	OMB no.(s)	Status
Form 3115	All other Filers (mainly trusts and estates) (Legacy system).	1545–2070	Published in the **Federal Register** on 2/15/17. Public comment period closed on 4/17/17.
	Link: *https://www.federalregister.gov/documents/2017/02/15/2017-02985/proposed-information-collection-comment-request*.		
	Business (NEW Model)	1545–0123	Published in the **Federal Register** on 10/8/18. Public comment period closed on 12/10/18.
	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*.		
	Individual (NEW Model)	1545–0074	Limited scope submission (1040 only) on 10/11/18 at OIRA for review. Full ICR submission for all forms in 2019.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031*.		
Revenue Procedure 2018–31	IRS Research estimates	1545–0123	Published in the **Federal Register** on 9/30/19. Public Comment period closed on 12/23/19.
	Link: *https://www.federalregister.gov/documents/2019/10/22/2019–23009/proposed-collection-comment-request-for-rev-proc-2018-31.*		

III. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), 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 (small entities). This certification can be made because the Treasury Department and the IRS have determined that the regulations may affect a substantial number of small entities but have also concluded that the economic effect on small entities as a result of these regulations is not expected to be significant. Section 451(b) 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 AFS. Due to the revised financial accounting standards for calculating revenue in an AFS under ASC 606, the result of section 451(b) generally will be to move the recognition of income forward by a year or two compared to previous law. Section 451(c) provides rules regarding the treatment of advance payments. These regulations provide general guidance on the rules, including the scope of the rules, exceptions to the rules, definitions of key terms, and examples demonstrating applicability of the rules.

The Treasury Department and the IRS have estimated the number of small business entities that may be affected by the statute and these regulations. Section 451(b) and (c) and the regulations under § 1.451–3 affect only those business entities that (i) use an accrual method of accounting, and (ii) have an AFS. One provision in § 1.451–8 applies to accrual method taxpayers without an AFS. The remaining provisions in § 1.451–8 apply to accrual method taxpayers with an AFS.

Regarding the accrual method of accounting, section 13102 of TCJA modified section 448 to expand the number of taxpayers eligible to use the cash receipts and disbursements method of accounting (cash method of accounting). In general, C corporations and partnerships with a C corporation partner are now permitted to use the cash method of accounting if average annual gross receipts are $25 million or less for taxable years beginning in 2018 (up from $5 million or less in 2017). The $25 million figure is considered for adjustment for inflation annually. This amount was adjusted for inflation for taxable years beginning after December 31, 2018. The amount was $26 million for taxable year 2019. The Treasury Department and the IRS estimate that approximately 3,128,000 business entities with gross receipts of $26 million or less used an accrual method of accounting in taxable year 2017, which represents approximately 8.5 percent of all business entities with gross receipts of $26 million or less. The Treasury Department and the IRS project that in future years, the number of entities with gross receipts not greater than $26 million that will be using the accrual method will be less than 8.5 percent of all entities with gross receipts of $26 million or less.

Many small business entities use the cash method of accounting, as opposed to an accrual method, and thus are not subject to these regulations. The percent of returns that use an accrual method of accounting, by entity types and for entities with gross receipts not greater than $26 million, is shown in the accompanying table.

TOTAL RETURNS AND RETURNS USING ACCRUAL METHOD OF ACCOUNTING

[Taxable year 2017]

Entities with gross receipts not greater than $26 million			
Entity	Total returns (thousands)	Returns using an accrual method of accounting (thousands)	Percent of returns using accrual method of accounting
C corporations	1,570	691	44
S corporations	4,684	1,146	24
Partnerships	3,884	912	23
Sole proprietors and LLCs	26,425	379	1
All entities	36,425	3,128	8.5

Source: Internal Revenue Service, RAAS, KDA.

The Treasury Department and the IRS next examined the second condition, that entities with an AFS are affected by section 451(b) and the regulations. The Treasury Department and the IRS do not have readily available data to measure the prevalence of entities with an AFS, as defined in the statute and in § 1.451–3(b)(1). 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. The Schedule M–3 is required to be filed only by entities with at least $10 million of assets. This population is more likely to possess an AFS and, conversely, entities that do not file Schedule M–3 are less likely to possess an AFS as owners and/or creditors of such smaller entities are less likely to require the entity to certify its financial results via a financial statement audit. Data is currently available only for electronic filers.

For taxable year 2017, approximately 89 percent of accrual-method entities filing Forms 1120, 1120–S, and 1065 with gross receipts of $26 million or less were filers of electronic tax forms. About 11 percent, or 288,000 returns, included a Schedule M–3. About 40 percent of the returns with Schedule M–3, or 113,000, indicated they had a certified audited income statement. 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 127,000 (113,000/0.89) entities with gross receipts of $26 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 224,000 entities with gross receipts of $26 million or less are potentially affected by these 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 2017

[Thousands of returns]

Entities with gross receipts not greater than $26 million			
	E-filed returns	Paper-filed returns	Total returns
Returns	2,503	307	2,810
Returns with a Schedule M–3	288	** 35*	** 323*
Returns with a Schedule M–3 and an audited income statement	113	** 14*	** 127*
Returns without a Schedule M–3	2,215	** 272*	** 2,487*
Returns without a Schedule M–3, but with an audited income statement	*** 111*	*** 13*	*** 124*

CORPORATION AND PARTNERSHIP RETURNS USING AN ACCRUAL METHOD OF ACCOUNTING—TAXABLE YEAR 2017—Continued

[Thousands of returns]

Entities with gross receipts not greater than $26 million			
	E-filed returns	Paper-filed returns	Total returns
Returns with an audited income statement	** *224*	** *27*	** *251*

* 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 Research, Applied Analytics and Statistics KDA Division using data from the Compliance Data Warehouse. The total number of accrual method returns of corporations and partnerships differs slightly from that reported in the earlier table 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 regulations are reflected in modest reporting activities. Taxpayers needing to make method changes pursuant to these 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 (c), and plan to provide streamlined procedures for such taxpayers to change to the methods of accounting described in these regulations. Under the streamlined procedures, eligible taxpayers would either complete only a portion of the Form 3115 or would not complete the Form 3115 at all to comply with the guidance. 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. In addition, contemporaneous with these regulations, the Treasury Department and the IRS are issuing a streamlined procedure 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.

The estimated cumulative annual reporting and/or recordkeeping burden for the statutory method changes relating to the streamlined procedures used to be described under OMB control number 1545–1551. In 2019, OMB number 1545–1551 was merged into OMB number 1545–0123. The estimated number of respondents, after taking into account the streamlined procedures that are being issued is 28,046 respondents, and a total annual reporting and/or recordkeeping burden of 34,279 hours. The estimated annual burden per respondent/recordkeeper under OMB control number 1545–0123 before publication of this revenue procedure varies from 1⁄6 hour to 8½ hours, depending on individual circumstances, with an estimated average of 1½ hours. The estimated monetized burden for compliance is $95 per hour. The estimated cumulative annual reporting and/or recordkeeping burden for the method changes described under OMB control number 1545–0123 after the revenue procedure is accounted for is 28,046 respondents, and a total annual reporting and/or recordkeeping burden is 34,279 hours. These burdens are essentially unaffected by these regulations.

Accordingly, the Secretary certifies that the rule will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), the notice of proposed rulemaking preceding this final rule was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business. No comments on the notice were received from the Chief Counsel for the Office of Advocacy of the Small Business Administration.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain 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 section, of $100 million in 1995 dollars, update annually for inflation. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private section 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 final 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.

VI. Congressional Review Act

The Administrator of the Office of Information and Regulatory Affairs of the Office of Management and Budget has determined that this is a major rule for purposes of the Congressional Review Act (5 U.S.C. 801 *et seq.*). Under 5 U.S.C. 801(a)(3), a major rule takes effect 60 days after the rule is published in the **Federal Register**.

Notwithstanding this requirement, 5 U.S.C. 808(2) allows agencies to dispense with the requirements of 5 U.S.C. 801 when the agency for good cause finds that such procedure would be impracticable, unnecessary, or contrary to the public interest and the rule shall take effect at such time as the agency promulgating the rule determines. Pursuant to 5 U.S.C. 808(2), the Treasury Department and the IRS find, for good cause, that a 60-day delay in the effective date is contrary to the public interest.

Following the amendments to section 451(b) and (c) by the TCJA, the Treasury Department and the IRS published the proposed regulations to provide certainty to taxpayers. In particular, as demonstrated by the wide variety of public comments in response to the proposed regulations received, taxpayers continue to express uncertainty regarding the proper application of the statutory rules under section 451(b) and (c). This is especially the case for taxpayers in the manufacturing and retail industries producing or reselling inventoriable goods because the final regulations allow such taxpayers to more clearly reflect their income for Federal income tax purposes compared to the approach of the proposed regulations. An earlier effective date will allow taxpayers to implement the final regulations earlier to take advantage of certain provisions in the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116–136 (March 27, 2020) that were designed to enhance liquidity, such as the 5-year net operating loss carryback provisions. Consistent with Executive Order 13924 (May 19, 2020), the Treasury Department and the IRS have therefore determined that an expedited effective date of the final regulations would more appropriately provide such critical businesses greater liquidity needed to remain open or ''re-open by providing guidance on what the law requires.'' 85 FR 31353–54. Accordingly, the Treasury Department and the IRS have determined that the rules in this Treasury decision will take effect on the date of filing for public inspection in the **Federal Register**.

Drafting Information

The principal author of these regulations is Jo Lynn Ricks (Office of the Associate Chief Counsel (Income Tax and Accounting)). Other personnel from the Treasury Department and the IRS, including Kate Abdoo, John Aramburu, James Beatty (formerly Income Tax and Accounting), David Christensen, Alexa Dubert, Sean Dwyer, Peter Ford, Christina Glendening, Anna Gleysteen, Charlie Gorham, Evan Hewitt, William Jackson, Doug Kim, Tom McElroy, and Karla Meola, Office of the Associate Chief Counsel (Income Tax and Accounting); and William E. Blanchard, Charles Culmer, and Deepan Patel, Office of the Associate Chief Counsel (Financial Institutions and Products), participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding entries in numerical order for §§ 1.451–3 and 1.451–8 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), (b)(3)(C) and 461(h).

Section 1.451–8 also issued under 26 U.S.C. 451(c)(2)(A), (3), (4)(A)(iii), (4)(b)(vii), and 461(h).

* * * * *

■ **Par. 2.** Section 1.446–1 is amended by adding a parenthetical sentence between the first and second sentences of paragraph (c)(1)(ii)(A) to read as follows:

§ 1.446–1 General rule for methods of accounting.

* * * * *

(c) * * *

(1) * * *

(ii) * * *

(A) * * * (See § 1.451–1 for rules relating to the taxable year of inclusion.) * * *

■ **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 ''; or'' in its place, and adding paragraph (a)(2)(i)(G) to read as follows:

§ 1.446–2 Method of accounting for interest.

(a) * * *

(2) * * *

(i) * * *

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

* * * * *

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

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

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

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

The additions read as follows:

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

* * * * *

(b) *Timing of income inclusion for accrual method taxpayers with an applicable financial statement.* For the timing of income inclusion for taxpayers that have an applicable financial statement, as defined in § 1.451–3(b)(1), and that use an accrual method of accounting, see section 451(b) and § 1.451–3.

(c) *Special rule for timing of income inclusion from advance payments.* For the timing of income inclusion for taxpayers that receive advance payments, as defined in § 1.451–8(a)(1), and that use an accrual method of accounting, see section 451(c) and § 1.451–8.

* * * * *

■ **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) *Definitions.* The following definitions apply for this section:

(1) *AFS income inclusion amount.* The term *AFS income inclusion amount means the amount* of an item of gross income that is required to be included in gross income under the AFS income inclusion rule in paragraph (b)(1) of this section.

(2) *AFS income inclusion rule.* The term *AFS income inclusion rule* has the meaning provided in paragraph (b)(1) of this section.

(3) *AFS inventory inclusion amount.* The term *AFS inventory inclusion amount* has the meaning provided in paragraph (c)(2)(i)(A) of this section.

(4) *AFS revenue.* The term *AFS revenue* means revenue reported in the taxpayer's AFS. The characterization of an amount in the AFS is not determinative of whether the amount is AFS revenue. For example, AFS revenue can include amounts reported as other comprehensive income or adjustments to retained earnings in an AFS. See paragraph (b) of this section for adjustments to AFS revenue that may need to be made to apply the rules of this section.

(5) *Applicable financial statement (AFS).* Subject to the rules in paragraph (a)(5)(iv) of this section, the terms *applicable financial statement* and *AFS* are synonymous and mean the taxpayer's financial statement listed in paragraph (a)(5)(i) through (iii) of this section that has the highest priority, including priority within paragraphs (a)(5)(i)(B) and (a)(5)(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 United States 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 (IRS);

(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 financial 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, Federal agency, a foreign government, or agency of a foreign government, other than the SEC, IRS, or an agency that is equivalent to the SEC or the IRS; 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 including, for example, a financial statement filed with a state agency that regulates insurance companies or the Financial Industry Regulatory Authority. Additional financial statements beyond those included in this paragraph (a)(5)(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 AFS revenue for a taxable year prior to the date that the taxpayer files its Federal income tax return for such taxable year, the restated AFS must be used instead of the original AFS. If using the restated AFS revenue results in a change in method of accounting, the preceding sentence applies only if the taxpayer receives permission to change its method of accounting to use the restated AFS revenue. In addition, if a taxpayer with different financial accounting and taxable years is required to file both annual financial statements and periodic financial statements covering less than a year with a government or government agency, the taxpayer must prioritize the annual financial statement in accordance with this paragraph (a)(5).

(6) *Cost of goods.* The term *cost of goods* means the costs that are properly capitalized and included in inventory under sections 471 and 263A or any other applicable provision of the Internal Revenue Code (Code) and that are allocable to an item of inventory for which an AFS inventory inclusion amount is calculated. See paragraph (c)(5)(iii) of this section for specific rules for taxpayers using simplified methods under section 263A.

(7) *Cost of goods in progress offset.* The term *cost of goods in progress offset* has the meaning provided in paragraph (c)(3) of this section.

(8) *Cumulative cost of goods in progress offset.* The term *cumulative cost of goods in progress offset* means the cumulative cost of goods in progress offset amounts under paragraph (c) of this section for a specific item of inventory that have reduced an AFS inventory inclusion amount attributable to such item of inventory in prior taxable years.

(9) *Enforceable right.* The term *enforceable right* means any right that a taxpayer has under the terms of a contract or under applicable Federal, state, or international law, including rights to amounts recoverable in equity and liquidated damages. A contract can include, but is not limited to, a statement of work, purchase order, or invoice.

(10) *Equity method.* The term *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.

(11) *Performance obligation.* The term *performance obligation* means a promise in a contract with a customer to transfer to the customer a distinct good, service, or right; or a series of distinct goods, services, or rights, or a combination thereof, that are substantially the same and that have the same pattern of transfer to the customer. A performance obligation includes a promise to grant or transfer a right to use or access intangible property. Performance obligations in a contract are identified by applying the accounting standards the taxpayer uses to prepare its AFS. Additionally, to the extent the contract with the customer provides the taxpayer with an enforceable right to payment, the revenue from which is not allocated to a performance obligation described in the first two sentences of this paragraph (a)(11) in the taxpayer's AFS but is accounted for as a separate source of revenue in the taxpayer's AFS, such right shall be treated as a separate performance obligation under this section. A fee described in paragraph (j)(2) of this section is an example of an enforceable right that is treated as a separate performance obligation.

(12) *Prior income inclusion amounts.* The term *prior income inclusion amounts* means amounts of an item of gross income that were required to be included in the taxpayer's gross income under this section or § 1.451–8 in prior taxable years.

(13) *Special method of accounting.* The term *special method of accounting* means a method of accounting expressly permitted or required under any provision of the Code, the regulations in this part, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter) under which the time for taking an item of gross income into account in a taxable year is not determined under the all events test in § 1.451–1(a). See, however, paragraph (j) of this section relating to certain items of income for debt instruments. The term special method of accounting does not include any method of accounting expressly permitted or required under this section. The following are examples of special methods of accounting to which the AFS income inclusion rule 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 notional principal contracts under § 1.446–3;

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

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

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

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

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

(ix) 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;

(x) Except as otherwise provided in paragraph (j) of this section, timing rules for original issue discount (OID) under section 811(b)(3) or 1272 (and the regulations in this part under section 1272 of the Code), 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;

(xi) 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));

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

(xiii) Timing rules for short-term obligations under sections 1281 through 1283;

(xiv) Timing rules for stripped bonds under section 1286; and

(xv) 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.

(14) *Transaction price amount.* The term *transaction price amount* means the total amount of consideration to which a taxpayer is, or expects to be, entitled from all performance obligations under a contract. The transaction price amount is determined under the standards the taxpayer uses to prepare its AFS.

(b) *AFS income inclusion rule*—(1) *In general.* Except as otherwise provided in this section, if a taxpayer uses an accrual method of accounting for Federal income tax purposes and has an AFS, the all events test under § 1.451–1(a) for any item of gross income, or portion thereof, is met no later than when that item, or portion thereof, is taken into account as AFS revenue (AFS income inclusion rule). See paragraph (b)(2) of this section for rules regarding when an item of gross income, or portion thereof, is treated as *taken into account as AFS revenue* under the AFS income inclusion rule. See paragraph (c) of this section for optional rules to determine the AFS income inclusion amount for an item of gross income from the sale of inventory. See paragraph (d) of this section for rules regarding the allocation of the transaction price amount to multiple items of gross income. See paragraph (e) of this section for rules to determine the AFS income inclusion amount for an item of gross income from a multi-year contract. See paragraphs (f) and (g) of this section for limitations of the AFS income inclusion rule. See paragraph (h) of this section for special rules that may affect the determination of AFS revenue under the AFS income inclusion rule. See paragraph (j) of this section for special ordering rules for certain items of income with respect to debt instruments.

(2) *Amounts taken into account as AFS revenue*—(i) *General rule.* Unless the taxpayer uses the alternative AFS revenue method described in paragraph (b)(2)(ii) of this section, the amount of the item of gross income that is treated as *taken into account as AFS revenue* under paragraph (b)(1) of this section is determined by making adjustments to AFS revenue for the amounts described in paragraphs (b)(2)(i)(A) through (D) of this section.

(A) If AFS revenue reflects a reduction for amounts described in paragraph (b)(2)(i)(A)(*1*) or (*2*) of this section, AFS revenue is increased by the amount of the reduction.

(*1*) Cost of goods sold and liabilities that are required to be accounted for under other provisions of the Code such as section 461, including liabilities for allowances, rebates, chargebacks, rewards issued in credit card transactions and other reward programs, and refunds, regardless of when any amount described in this paragraph (b)(2)(i)(A)(*1*) is incurred.

(*2*) Amounts anticipated to be in dispute or anticipated to be uncollectable.

(B) If AFS revenue includes an amount the taxpayer does not have an enforceable right to recover if the customer were to terminate the contract on the last day of the taxable year (regardless of whether the customer actually terminates the contract), AFS revenue is reduced by such amount.

(C) If the transaction price was increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, then any AFS revenue attributable to such increase is disregarded.

(D) AFS revenue may be increased or reduced by additional amounts as provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter).

(ii) *Alternative AFS revenue method.* A taxpayer that chooses to apply the AFS income inclusion rule by using the alternative AFS revenue method described in this paragraph (b)(2)(ii) in lieu of the rules in paragraph (b)(2)(i) of this section, determines the amount of the item of gross income that is treated as *taken into account as AFS revenue* under paragraph (b)(1) of this section by making adjustments to AFS revenue for only the amounts described in paragraphs (b)(2)(i)(A), (C), and (D) of this section. A taxpayer that uses the alternative AFS revenue method for a trade or business must apply the method to all items of gross income in the trade or business that are subject to the AFS income inclusion rule.

(3) *Exceptions.* The AFS income inclusion rule in paragraph (b)(1) of this section does not apply to:

(i) Any item of gross income, or portion thereof, if the timing of income inclusion for that item, or portion thereof, is determined using a special method of accounting;

(ii) Any item of gross income, or portion thereof, in connection with a mortgage servicing contract; or

(iii) Any taxable year that is not covered for the entire year by one or more AFS.

(4) *Examples.* The following examples illustrate the provisions of paragraph (b) of this section. Unless the facts specifically state otherwise, the taxpayer has an AFS, is on a calendar year for Federal income tax purposes and AFS purposes, and uses an accrual method of accounting for Federal income tax purposes. Further, the taxpayer does not use the alternative AFS revenue method under paragraph (b)(2)(ii) of this section or the AFS cost offset method under paragraph (d) of this section, and does not use a special method of accounting:

(i) *Example 1: Provision of installation services*—(A) *Facts.* In 2021, B enters into a 2-year service contract with a customer to install the customer's manufacturing equipment for $100,000. Throughout the term of the contract, the customer retains control of the equipment. B begins providing the installation services in 2021 and completes the installation services in 2022. Under the contract, B bills the customer $55,000 in 2021 when installation begins, but does not have a fixed right to receive the remaining $45,000 until installation is complete and approved by the customer. However, if the customer were to terminate the contract prior to completion, B would have an enforceable right to payment for all services performed prior to the termination date. For its AFS, B reports $60,000 of AFS revenue for 2021 and $40,000 of AFS revenue for 2022, in accordance with the services performed in each respective year.

(B) *Analysis.* Under the all events test in § 1.451–1(a), B is required to include $55,000 in gross income in 2021 as B has a fixed right to receive $55,000 as of the end of 2021. However, under the AFS income inclusion rule, because B has an enforceable right to recover the entire $60,000 that was reported in AFS revenue for 2021 had the customer terminated the contract on the last day of 2021, the entire $60,000 is treated as taken into account as AFS revenue in 2021. Accordingly, the all events test is met for the $60,000 of gross income no later than the end of 2021 and B is required to include $60,000 in gross income in 2021.

(ii) *Example 2: Provision of goods included in AFS with enforceable right*—(A) *Facts.* In November 2021, 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, the contract provides that C has an enforceable right to be paid for work performed to date if the customer were to terminate the contract prior to delivery. C produces and ships all of the computers in 2021. In 2022, the customer accepts delivery of the computers and C bills the customer. For its AFS, C reports $80,000 of AFS revenue for 2021.

(B) *Analysis.* Under the all events test in § 1.451–1(a), C does not have a fixed right to receive the $80,000 until the customer accepts delivery of the computers in 2022. However, under the AFS income inclusion rule, because C has an enforceable right to recover the entire $80,000 of AFS revenue that was reported for 2021 had the customer terminated the contract on the last day of 2021, the entire $80,000 is treated as ''taken into account as AFS revenue'' in 2021. Accordingly, the all events test is met for the $80,000 no later than in 2021 and C is required to include $80,000 in gross income in 2021.

(iii) *Example 3: Provision of services included in AFS with enforceable right*—(A) *Facts.* In 2021, D, an engineering services provider, enters into a 4-year contract with a customer to provide services for a total of $100x. Under the contract, D bills and receives $25x for each year of the contract. If the customer were to terminate the contract prior to completion, D has an enforceable right to only the billed amounts. For its AFS, D reports $60x, $0, $20x, and $20x of AFS revenue from the contract for 2021, 2022, 2023, and 2024, respectively.

(B) *Analysis.* Under the all events test in § 1.451–1(a), D is required to include $25x in gross income in 2021 as D has a fixed right to receive $25x as of the end of 2021. Although D reports $60x of AFS revenue from the provision of services for 2021, D has an enforceable right to recover only $25x if the customer were to terminate the contract on the last day of 2021. Accordingly, pursuant to paragraph (b)(2)(i)(B) of this section, of the $60x of AFS revenue reported for 2021, only $25x is treated as ''taken into account as AFS revenue'' under the AFS income inclusion rule. As a result, D is required to include only $25x in gross income in 2021. Similarly, in 2022, 2023 and 2024, D includes in gross income only the yearly $25x contract payments under the all events test as only the billed amounts are treated as ''taken into account as AFS revenue'' under the AFS income inclusion rule.

(iv) *Example 4: Sale of good under cost-plus contract*—(A) *Facts.* In 2021, E, a manufacturer, enters into a contract with Fire Department for the manufacture and delivery of a fire truck. The fire truck takes 10 months to manufacture at an estimated cost of $60,000. The contract provides E with an enforceable right to recover costs incurred in manufacturing the fire truck regardless of whether the Fire Department accepts delivery of the fire truck or terminates the contract, and an enforceable right to an additional $20,000 if the fire truck is accepted by the Fire Department. E does not have an enforceable right to recover any portion of the additional $20,000 if the Fire Department were to terminate the contract before it accepts the fire truck. E has an obligation to cure any defects if the customer rejects the fire truck. In August 2021, E begins manufacturing the fire truck ordered by Fire Department and incurs $30,000 of costs for materials and labor for the contract. For its AFS, E reports $40,000 of AFS revenue for 2021 ($30,000 costs plus $10,000 expected profit on the sale of the fire truck).

(B) *Analysis for 2021 taxable year.* Under the all events test in § 1.451–1(a), E is required to include $30,000 in gross income in 2021 as E has a fixed right to receive $30,000 as of the end of 2021. Although E reports $40,000 of AFS revenue for 2021, E has an enforceable right to recover only $30,000 if the Fire Department were to terminate the contract on the last day of 2021. Accordingly, pursuant to paragraph (b)(2)(i)(B) of this section, of the $40,000 of AFS revenue reported for 2021, only $30,000 is treated as ''taken into account as AFS revenue'' under the AFS income inclusion rule. As a result, E is required to include only $30,000 in gross income in 2021.

(v) *Example 5: Sale of goods with AFS revenue adjustments*—(A) *Facts.* In July 2021, F, a manufacturer of automobile parts, enters into a contract to sell 1,000 parts to a customer for $10 per part, for a total of $10,000 (1,000 × $10). The contract also provides that F will receive a $200 bonus if it delivers all the parts to the customer by February 1, 2022. F delivers 500 non-defective parts to the customer on December 31, 2021 and schedules the remaining 500 parts for delivery to the customer on January 1, 2022. F does not have an enforceable right to recover any portion of the $200 bonus if the customer were to terminate the contract before all 1,000 parts are delivered. F expects to earn the $200 bonus and have 5% of the non-defective parts returned. For its AFS, F reports $4,850 ($5,000 + $100 − $250) of AFS revenue for 2021, which includes a $100 (50% × $200) adjustment to increase AFS revenue for the expected bonus and a $250 (5% × $5,000) adjustment to decrease AFS revenue for anticipated returns.

(B) *Analysis.* Under the all events test in § 1.451–1(a), F is required to include $5,000, less the corresponding cost of goods sold under sections 263A and 471 as applicable, in gross income in 2021 as F has a fixed right to receive $5,000 from the delivery of 500 parts to the customer in 2021. However, F does not have a fixed right to receive any portion of the $200 delivery bonus as of the end of 2021 as the remaining 500 parts had yet to be delivered. Under the AFS income inclusion rule and, specifically, paragraphs (b)(2)(i)(A)(*1*) and (b)(2)(i)(B) of this section, the amount treated as ''taken into account as AFS revenue'' for 2021 is also $5,000, calculated as $4,850 of AFS revenue that was reported for 2021, decreased by $100 for the expected delivery bonus that F does not have an enforceable right to recover if the customer were to terminate the contract as of the end of 2021 and increased by $250 for anticipated return liabilities that are accounted for under section 461 ($4,850 − $100 + $250 = $5,000). Accordingly, F is required to include $5,000, less the corresponding cost of goods sold determined under sections 263A and 471 as applicable, in gross income in 2021.

(vi) *Example 6: Chargebacks*—(A) *Facts.* In November 2021, G, a pharmaceutical manufacturer, enters into a contract to sell 1,000 units to W, a wholesaler, for $10 per unit, totaling $10,000 (1,000 × $10). The contract also provides that G will credit or pay W $4 per unit (a 40% ''chargeback'') for sales W makes to certain qualifying customers. G delivers 600 units to W on December 31, 2021, and bills W $6,000 under the contract. W does not make any sales to qualifying customers in 2021. For its AFS, G reports $3,600 ($6,000 − $2,400) of AFS revenue for 2021, which includes a reduction of the $6,000 of sales revenue by $2,400 (40% × $6,000) for anticipated chargebacks.

(B) *Analysis.* Under the all events test in § 1.451–1(a), G is required to include $6,000, less the corresponding cost of goods sold under sections 263A and 471 as applicable, in gross income in 2021 as G has a fixed right to receive $6,000 from the delivery of 600 units to W in 2021. The anticipated chargebacks are liabilities that are accounted for under section 461. Under the AFS income inclusion rule and, specifically, paragraph (b)(2)(i)(A)(*1*) of this section, the amount treated as ''taken into account as AFS revenue'' for 2021 is also $6,000, calculated as $3,600 of AFS revenue reported for 2021, increased by $2,400 of anticipated chargeback liabilities that are accounted for under section 461 ($3,600 + $2,400 = $6,000). Accordingly, G is required to include $6,000, less the corresponding cost of goods sold under sections 263A and 471 as applicable, in gross income in 2021.

(vii) *Example 7: Sale of property using a special method of accounting.* In 2021, H, a financial services provider, sells a building for $100,000, payable in five annual payments of $20,000 together with adequate stated interest, starting in 2021. For its AFS, H reports $100,000 of AFS revenue for 2021 from the sale of the building. For Federal income tax purposes, H uses the installment method under section 453 for the sale of the building. Because the installment method under section 453 is a special method of accounting under paragraphs (a)(13)(ii) and (b)(3)(i) of this section, the AFS income inclusion rule does not apply to H's sale of the building. Accordingly, the gain from the sale is included in income as prescribed in section 453.

(viii) *Example 8: Insurance contract renewals*—(A) *Facts.* J, an insurance agent, is engaged by an insurance carrier to sell insurance. Pursuant to the contract between J and the insurance carrier, J is entitled to receive a $50 commission from the insurance carrier at the time a policy is sold to a customer. The contract also provides that J is entitled to receive an additional $25 commission each time a policy is renewed. J does not have an enforceable right to a renewal commission if the insurance carrier terminates the contract before a policy is renewed. J sells 1,000 one-year policies in 2021, of which 800 are expected to be renewed in 2022 and 700 are expected to be renewed in 2023. J does not have any ongoing obligation to provide additional services to the insurance carrier or the customers after the initial sale of the policy. For its AFS, J reports $87,500 of AFS revenue for 2021, which includes $50,000 ($50 × 1,000) of commission income for policies sold in 2021 and an estimate of $37,500 ($25 × 1,500) of commission income for the policies expected to be renewed in 2022 and 2023.

(B) *Analysis.* Under the all events test in § 1.451–1(a), J is required to include $50,000 in gross income in 2021 as J has a fixed right to receive $50,000 of commission income for the policies it sold during 2021. However, as of the end of 2021, J does not have a fixed right to receive any commission income from anticipated policy renewals. Under the AFS income inclusion rule, although J reports $87,500 of AFS revenue for 2021, J does not have an enforceable right to recover the $37,500 of anticipated commission income from future policy renewals if the insurance carrier were to terminate the contract on the last day of 2021. Accordingly, pursuant to paragraph (b)(2)(i)(B) of this section, of the $87,500 of AFS revenue reported for 2021, only $50,000 is treated as ''taken into account as AFS revenue'' under the AFS income inclusion rule. As a result, J is required to include $50,000 in gross income in 2021. Alternatively, if J uses the alternative AFS revenue method in paragraph (b)(2)(ii) of this section, all $87,500 of AFS revenue reported for 2021 would be treated as ''taken into account as AFS revenue'' under the AFS income inclusion rule and J would be required to include $87,500 of commission income in gross income in 2021.

(ix) *Example 9: Escalating rents*—(A) *Facts.* (*1*) K is a landlord in the business of leasing office space. On January 1, 2021, K enters into a 5-year lease with a tenant that provides for annual rent of $30,000 for 2021 and increases by 5% each year over the lease term. The annual rents are due at the end of each year. Accordingly, the rent for each year (rounded to the nearest dollar) is as follows:

TABLE 1 TO PARAGRAPH (b)(4)(ix)(A)

Year	Calculation	Total rent
2021	$30,000	$30,000
2022	30,000 * 1.05	31,500
2023	31,500 * 1.05	33,075
2024	33,075 * 1.05	34,729
2025	34,729 * 1.05	36,465
Total Rent for Five Years		165,769

(*2*) The lease is not a section 467 rental agreement as defined under section 467(d). If the tenant terminates the lease early, the tenant must pay K the balance of the rent due for the remainder of the termination year. On its AFS, K reports AFS revenue from rents on a straight-line basis over the term of the lease, or approximately $33,154 per year ($165,769 total rent/5 years). Accordingly, for its AFS, K reports $33,154 of AFS revenue for 2021.

(B) *Analysis.* Under the all events test in § 1.451–1(a), K is required to include $30,000 in gross income in 2021 as K has a fixed right to receive $30,000 for the 2021 rental period under the terms of the lease agreement. Under the AFS income inclusion rule, although K reports $33,154 of AFS revenue for 2021, K has an enforceable right to recover only $30,000 if the tenant were to cancel the lease on the last day of 2021. Accordingly, pursuant to paragraph (b)(2)(i)(B) of this section, of the $33,154 of AFS revenue reported for 2021, only $30,000 is treated as ''taken into account in AFS revenue'' under the AFS income inclusion rule. As a result, K is required to include $30,000 in gross income in 2021.

(x) *Example 10: Licensing income from digital services*—(A) *Facts.* M is engaged in the business of licensing media entertainment content packages. M licenses content packages to customers by entering into subscription plans with customers. In January 2021, M enters into a two-year subscription plan with Customer. M charges Customer $40 per month billed monthly in arrears. If Customer terminates the plan prior to the two-year term, it must pay the balance of the subscription fee for the remaining term of the contract. For its AFS, M reports $960 ($40 × 24 months) of AFS revenue for 2021.

(B) *Analysis.* Under the all events test in § 1.451–1(a), M is required to include $480 in gross income in 2021 as M has a fixed right to receive $480 ($40 × 12) for the 12 months of media content licensed to Customer in 2021. M does not have a fixed right to receive any portion of the 2022 subscription fee as of the end of 2021 as such fee is not due under the terms of the subscription agreement until 2022 and M has yet to provide the media content for the 2022 subscription period. However, under the AFS income inclusion rule, because M has an enforceable right to recover all $960 of AFS revenue reported for 2021 if Customer were to terminate the contract at the end of 2021, all $960 is treated as ''taken into account as AFS revenue'' in 2021. Accordingly, M is required to include $960 in gross income in 2021.

(c) *Cost offsets*—(1) *In general.* This paragraph (c) provides an optional method of accounting that may be used to determine the AFS income inclusion amount for an item of gross income from the sale of inventory (AFS cost offset method). A taxpayer that uses the AFS cost offset method for a trade or business must apply this method to all items of gross income in the trade or business that meet the criteria in this paragraph (c). Additionally, a taxpayer that uses this method for a trade or business must also use the advance payment cost offset method described in § 1.451–8(e) to account for all advance payments received by such trade or business that meet the criteria in § 1.451–8(e), if applicable. A taxpayer that uses the AFS cost offset method to account for gross income from the sale of an item of inventory, but not the advance payment cost offset method because it does not receive any advance payments for such item, determines the corresponding AFS income inclusion amount for a taxable year by following the rules in paragraph (c)(2) of this section. A taxpayer that uses the AFS cost offset method and the advance payment cost offset method to account for gross income, including advance payments, from the sale of an item of inventory, determines the corresponding AFS income inclusion amount and the advance payment income inclusion amount, as defined in § 1.451–8(a)(2), for a taxable year by following the rules in paragraph (c)(2) of this section rather than the rules under § 1.451–8(e). However, if all payments received for the sale of an item of inventory meet the definition of an advance payment under § 1.451–8(a)(1), a taxpayer that uses the advance payment cost offset method determines the corresponding advance payment income inclusion amount for a taxable year by following the rules in § 1.451–8(e).

(2) *AFS cost offset method.* A taxpayer that uses the AFS cost offset method and, if applicable, the advance payment cost offset method, to account for gross income from the sale of an item of inventory determines the AFS income inclusion amount, or, if applicable, the advance payment income inclusion amount, for a taxable year prior to the taxable year in which ownership of the item of inventory is transferred to the customer by following the rules in paragraph (c)(2)(i) of this section, subject to the additional rules and limitations in paragraphs (c)(4) through (6) of this section. Such taxpayer determines the AFS income inclusion amount or, if applicable, the advance payment income inclusion amount, for the taxable year in which ownership of the item of inventory is transferred to the customer by following the rules in paragraph (c)(2)(ii) of this section. A taxpayer described in this paragraph (c)(2) that receives advance payments for the sale of the item of inventory may be required to include in gross income for a taxable year an amount that is comprised of both an AFS income inclusion amount and an advance payment income inclusion amount. In such case, it is not necessary to determine the portion of the total inclusion that is comprised of the AFS income inclusion amount and the portion of the total inclusion that is comprised of the advance payment income inclusion amount.

(i) *Determining gross income for a year prior to the year of sale.* To determine the amount required to be included in gross income from the sale of an item of inventory for a taxable year prior to the taxable year in which ownership of the item of inventory is transferred to the customer, a taxpayer must first determine the AFS inventory inclusion amount for such item for such year by applying the steps in paragraph (c)(2)(i)(A) of this section. This AFS inventory inclusion amount is then reduced by the cost of goods in progress offset for the taxable year, as determined under paragraphs (c)(3) through (5) of this section. This net amount is required to be included in gross income for the taxable year.

(A) *AFS inventory inclusion amount for a taxable year.* To determine the AFS inventory inclusion amount for an item of inventory for a taxable year:

(*1*) The taxpayer first takes the greater of the amount described in paragraph (c)(2)(i)(A)(*1*)(*i*) of this section, or the amount described in paragraph (c)(2)(i)(A)(*1*)(*ii*) of this section (or if the two amounts are equal, the equal amount).

(*i*) The cumulative amount of revenue from the item of inventory that satisfies the all events test under § 1.451–1(a) through the last day of the taxable year, less any advance payment inventory inclusion amount, as defined in § 1.451–8(a)(3), with respect to a subsequent taxable year.

(*ii*) The cumulative amount of revenue from the item of inventory that is treated as ''taken into account as AFS revenue'' under paragraph (b)(2) of this section through the last day of the taxable year.

(*2*) The taxpayer then reduces the amount determined under paragraph (c)(2)(i)(A)(*1*) of this section by the amount computed under paragraph (c)(2)(i)(A)(*1*) of this section for that item of inventory for the immediately preceding taxable year.

(B) [Reserved]

(ii) *Determining the gross income for the year of sale.* To determine the amount required to be included in gross income from the sale of an item of inventory for the taxable year in which ownership of the item of inventory is transferred to the customer:

(A) The taxpayer first takes the greater of the amount described in paragraph (c)(2)(ii)(A)(*1*) of this section, or the amount described in paragraph (c)(2)(ii)(A)(*2*) of this section (or if the two amounts are equal, the equal amount).

(*1*) The cumulative amount of revenue from the item of inventory that satisfies the all events test under § 1.451–1(a) through the last day of the taxable year, including the full amount of any advance payment received for the item of inventory.

(*2*) The cumulative amount of revenue from the item of inventory that is treated as ''taken into account as AFS revenue'' under paragraph (b)(2) of this section through the last day of the taxable year.

(B) The taxpayer then reduces such amount by any prior income inclusion amounts with respect to such item of inventory. This net amount is required to be included in gross income for the taxable year. The taxpayer does not further reduce such amount by a cost of goods in progress offset under paragraph (c)(3) of this section. However, the taxpayer is entitled to recover the costs capitalized to the item of inventory as cost of goods sold in accordance with sections 471 and 263A or any other applicable provision of the Internal Revenue Code. See § 1.61–3.

(3) *Cost of goods in progress offset for a taxable year.* The cost of goods in progress offset for the taxable year is calculated as:

(i) The cost of goods allocable to the item of inventory through the last day of the taxable year; reduced by

(ii) The cumulative cost of goods in progress offset attributable to the item of inventory, if any.

(4) *Limitations to the cost of goods in progress offset.* The cost of goods in progress offset is determined separately for each item of inventory. Further, the cost of goods in progress offset attributable to one item of inventory cannot reduce the AFS inventory inclusion amount attributable to a separate item of inventory. The cost of goods in progress offset cannot reduce the AFS inventory inclusion amount for the taxable year below zero.

(5) *Inventory methods*—(i) *Inventory costs not affected by cost of goods in progress offset.* The cost of goods comprising the cost of goods in progress offset does not reduce the costs that are capitalized to the items of inventory produced or items of inventory acquired for resale by the taxpayer. While the cost of goods in progress offset reduces the AFS inventory inclusion amount, the cost of goods in progress offset does not affect how and when costs are capitalized to inventory under sections 471 and 263A or any other applicable provision of the Internal Revenue Code or when those capitalized costs will be recovered.

(ii) *Consistency between inventory methods and AFS cost offset method.* The costs of goods comprising the cost of goods in progress offset must be determined by applying the taxpayer's method of accounting for inventory for Federal income tax purposes. A taxpayer using the AFS cost offset method and, if applicable, the advance payment cost offset method must calculate its cost of goods in progress offset by reference to all costs that the taxpayer has permissibly capitalized and allocated to items of inventory under its method of accounting for inventory for Federal income tax purposes, but including no more costs than what the taxpayer has permissibly capitalized and allocated to items of inventory.

(iii) *Allocation of ''additional section 263A costs'' for taxpayers using simplified methods.* If a taxpayer uses the simplified production method as defined under § 1.263A–2(b), the modified simplified production method as defined under § 1.263A–2(c), or the simplified resale method as defined under § 1.263A–3(d) to determine the amount of its *additional section 263A costs,* as defined under § 1.263A–1(d)(3), to be included in ending inventory, then solely to compute the cost of goods in progress offset, the taxpayer must determine the portion of additional section 263A costs allocable to an item of inventory by multiplying its total additional section 263A costs accounted for under the simplified method for all items of inventory subject to the simplified method by the following ratio:

Section 471 costs allocable to the specific item of inventory

Total section 471 costs for all items of inventory subject to the simplified method

(6) *Acceleration of gross income.* A taxpayer that uses the AFS cost offset method or the advance payment cost offset method must include in gross income for a taxable year prior to the taxable year in which an item of inventory is transferred to the customer, all payments received for the item of inventory that were not previously included in gross income:

(i) If, in that taxable year, the taxpayer either dies or ceases to exist in a transaction other than a transaction to which section 381(a) applies; or

(ii) If, and to the extent that, in that taxable year, the taxpayer's obligation to the customer with respect to the item of inventory ends other than in:

(A) A transaction to which section 381(a) applies; or

(B) A section 351(a) transfer that is part of a section 351 transaction in which:

(*1*) Substantially all assets of the trade or business, including the item of inventory, are transferred;

(*2*) The transferee adopts or uses, in the year of the transfer, the same methods of accounting for the item of inventory under this section and § 1.451–8 as those used by the transferor; and

(*3*) The transferee and the transferor are members of the same consolidated group, as defined in § 1.1502–1(h).

(7) *Additional procedural guidance.* The IRS may publish procedural guidance in the Internal Revenue Bulletin (see § 601.601(d) of this chapter) that provides alternative procedures for complying with the rules under this paragraph (c), including alternative methods of accounting for cost offsets.

(8) *Examples.* The following examples illustrate the AFS cost offset method. Unless the facts specifically state otherwise, the taxpayer has an AFS, is on a calendar year for both Federal income tax purposes and AFS purposes, uses an accrual method of accounting for Federal income tax purposes, and does not use a special method of accounting. Further, the taxpayer properly applies its inventory accounting method, uses the AFS cost offset method under paragraph (c) of this section, and, except as otherwise provided, does not receive advance payments. Lastly, the taxpayer does not produce unique items, as described in § 1.460–2(a)(1) and (b), or any item that normally requires more than 12 calendar months to complete, as determined under § 1.460–2(a)(2) and (c). Any production period that exceeds 12 calendar months is due to unforeseen production delays.

(i) *Example 1*—(A) *Facts.* During 2021, A enters into a contract with Customer to manufacture and deliver a good with a total contract price of $100x. The costs to produce the good are required to be capitalized under sections 471 and 263A as the good is inventory in the hands of A. Ownership of the good is transferred from A to Customer upon its delivery in 2022. A determines, under paragraph (c)(2)(i)(A) of this section, that its AFS inventory inclusion amount for 2021 is $20x. A incurs $12x of costs in 2021, and $48x of costs in 2022 ($60x in total) that are permissibly capitalized and allocated to the produced good under sections 471 and 263A. A has a fixed right to receive the $100x contract price when it delivers the good in 2022. A does not receive any payments from Customer prior to delivery. Further, all $100x is treated as ''taken into account as AFS revenue'' as of the last day of 2022.

(B) *Analysis for 2021.* For 2021, A's AFS income inclusion amount, as determined under paragraph (c)(2)(i) of this section, is $8x ($20x AFS inventory inclusion amount less $12x cost of goods in progress offset, which is the cost of goods incurred through December 31, 2021).

(C) *Analysis for 2022.* During 2022, ownership of the good is transferred to Customer. Accordingly, pursuant to paragraph (c)(2)(ii) of this section, A determines the AFS income inclusion amount for 2022 by:

(*1*) First taking the greater of:

(*i*) The cumulative amount of revenue that satisfies the all events test under § 1.451–1(a) through the last day of 2022 ($100x); or

(ii) The cumulative amount of revenue that is treated as ''taken into account as AFS revenue'' through the last day of 2022 ($100x) (or if the two amounts are equal, the equal amount).

(*2*) Then subtracting from such amount ($100x) the prior income inclusion amounts attributable to the transferred good ($8x). This net amount of $92x is the AFS income inclusion amount for 2022. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the $60x of costs capitalized to the good as cost of goods sold in 2022 in accordance with sections 471 and 263A. See § 1.61–3. Accordingly, A's gross income for 2022 is $32x.

(ii) *Example 2*—(A) *Facts.* In December of 2021, A enters into a contract with Customer to manufacture and deliver 10 items of inventory at a price of $10x per item by the end of 2023. A determines, under paragraph (c)(2)(i)(A) of this section, that the AFS inventory inclusion amount attributable to each item of inventory under the contract is $3x for 2021. A also incurs $10x of inventory costs during 2021. Such costs are permissibly capitalized and allocated under sections 471 and 263A and are allocated equally to each item of inventory under the contract ($1x per item). During 2022, the taxpayer incurs $18x of costs to finish manufacturing 6 of the 10 items and delivers such items to Customer in October of 2022. Such costs are permissibly capitalized and allocated under sections 471 and 263A and are allocated equally to each of the 6 items delivered in October of 2022 ($3x per item). Upon delivering the 6 items, ownership of the delivered items transfers to Customer, A has a fixed right to receive $60x of the total contract price, and all $60x is treated as ''taken into account as AFS revenue.'' A does not incur any inventory costs during 2022 that are allocable to the 4 remaining undelivered items, nor does the taxpayer have an AFS inventory inclusion amount attributable to such items for 2022. During 2023, A incurs $12x of costs to finish manufacturing the 4 remaining items and delivers such items to Customer. Such costs are permissibly capitalized and allocated under sections 471 and 263A and are allocated equally to each of the 4 items delivered in 2023 ($3x per item). Upon delivering the 4 remaining items, ownership of the items transfers to Customer, A has a fixed right to receive the remaining $40x contract price, and all $40x is treated as ''taken into account as AFS revenue.''

(B) *Analysis for 2021* A's AFS income inclusion amount for 2021 is $2x per item ($3x AFS inventory inclusion amount per item less $1x cost of goods in progress offset per item, which is the cost of goods as of December 31, 2021). Accordingly, A's total gross income inclusion for 2021 is $20x.

(C) *Analysis for 2022.* During 2022, ownership of 6 of the 10 items is transferred to Customer. Accordingly, pursuant to paragraph (c)(2)(ii) of this section, A determines the AFS income inclusion amount for 2022 by:

(*1*) First taking the greater of:

(*i*) The cumulative amount of revenue that satisfies the all events test under § 1.451–1(a) through the last day of 2022 ($10x per item); or

(*ii*) The cumulative amount of revenue that is treated as taken into account as AFS revenue through the last day of 2022 ($10x per item) (or if the two amounts are equal, the equal amount).

(*2*) Then subtracting from such amount ($10x per item) the prior income inclusion amounts attributable to each transferred item ($2x per item). This net amount of $8x per item is the AFS income inclusion amount for each transferred item for 2022. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the $4x of costs capitalized to each item delivered as cost of goods sold in 2022 in accordance with sections 471 and 263A. Accordingly, on an aggregate basis, A's gross income for 2022 is $24x (aggregate AFS income inclusion amount for the 6 items delivered in 2022 of $ 48x less aggregate cost of goods sold of $24x). A does not include any amounts in gross income for 2022 with respect to the 4 items of inventory that were not delivered to Customer until 2023 as A does not have an AFS inventory inclusion amount attributable to such items for 2022.

(D) *Analysis for 2023.* During 2023, ownership of the 4 remaining items are transferred to Customer. Based on the facts, A did not have an AFS inventory inclusion amount attributable to the 4 remaining items for 2022, nor did it incur any cost for such items in 2022 so the analysis for the 4 remaining items for 2023 is similar to the analysis for the 6 items transferred to the customer in 2022 on a per item basis. Pursuant to paragraph (c)(2)(ii) of this section, A determines the AFS income inclusion amount for 2023 by:

(*1*) First taking the greater of:

(*i*) The cumulative amount of revenue that satisfies the all events test under § 1.451–1(a) through the last day of 2023 ($10x per item); or

(ii) The cumulative amount of revenue that is treated as taken into account as AFS revenue through the last day of 2023 ($10x per item) (or if the two amounts are equal, the equal amount).

(*2*) Then subtracting from such amount ($10x per item) the prior income inclusion amounts attributable to each transferred item ($2x per item). This net amount of $8x per item is the AFS income inclusion amount for each transferred item for 2023. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the $4x of costs capitalized to each item delivered as cost of goods sold in 2023 in accordance with sections 471 and 263A. On an aggregate basis, A's gross income for 2023 is $16x (aggregate AFS income inclusion amount for the 4 items delivered in 2023 of $32x less aggregate cost of goods sold of $16x).

(iii) *Example 3*—(A) *Facts.* In December of 2021, A enters into a contract with Customer to manufacture and deliver a good with a total contract price of $100x. The costs to produce the good are required to be capitalized under sections 471 and 263A as the good is inventory in the hands of the taxpayer. Ownership of the good is transferred from A to Customer upon its delivery in January of 2023. A determines, under paragraph (c)(2)(i)(A) of this section, that its AFS inventory inclusion amount for 2021 and 2022 is $40x per year. A incurs $25x of costs each year ($75x in total) that are permissibly capitalized and allocated to the manufactured good under sections 471 and 263A. A has a fixed right to receive the $100x contract price when it delivers the good in January of 2023. A does not receive any payments from Customer prior to delivery. Further, all $100x is treated as ''taken into account as AFS revenue'' as of the last day of 2023.

(B) *Analysis for 2021 and 2022.* For 2021, A's AFS income inclusion amount, as determined under paragraph (c)(2)(i) of this section, is $15x ($40x AFS inventory inclusion amount for 2021 less the $25x cost of goods in progress offset for 2021, which is equal to the cost of goods as of December 31, 2021). For 2022, A's AFS income inclusion amount is $15x ($40x AFS inventory inclusion amount for 2022 less the $25x cost of goods in progress offset for 2022, which is the $50x cost of goods as of December 31, 2022 less the 25x cumulative cost of goods in progress offset amount taken into account in 2021).

(C) *Analysis for 2023.* During 2023, ownership of the good is transferred to Customer. Accordingly, pursuant to paragraph (c)(2)(ii) of this section, A determines the AFS income inclusion amount for 2023 by:

(*1*) First taking the greater of:

(*i*) The cumulative amount of revenue that satisfies the all events test under § 1.451–1(a) through the last day of 2023 ($100x); or

(*ii*) The cumulative amount of revenue that is treated as ''taken into account as AFS revenue'' through the last day of 2023 ($100x) (or if the two amounts are equal, the equal amount).

(*2*) Then subtracting from such amount ($100x) the prior income inclusion amounts attributable to the transferred good of $30x ($15x for 2021 and $15x for 2022). This net amount of $70x is the AFS income inclusion amount for 2023. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the $75x of costs capitalized to the good as cost of goods sold in 2023 in accordance with sections 471 and 263A. See § 1.61–3. Accordingly, A's gross income for 2025 is −$5x.

(iv) *Example 4*—(A) *Facts.* In December 2021, A enters into a contract with Customer to manufacture and deliver a good with a total contract price of $100x. A reports $5x of AFS revenue for 2021, $90x of cumulative AFS revenue through the end of 2022, and $100x of cumulative AFS revenue through the end of 2023. A has an enforceable right to recover all AFS revenue reported through the end of each contract year if Customer were to terminate the contract on the last day of each year. Under the terms of the contract, A is entitled to and receives a payment of $40x in 2021 and a payment of $60x when Customer accepts delivery of the good in 2023, which is also when ownership of the good transfers to Customer. The costs to produce the good are required to be capitalized under sections 471 and 263A as the good is inventory in the hands of A. A incurs $10x of costs in 2021, $55x of costs in 2022, and $5x of costs in 2023 ($70x in total). Such costs are permissibly capitalized and allocated to the produced good under sections 471 and 263A. A uses the AFS cost offset method under paragraph (c) of this section and accounts for advance payments, as defined in § 1.451–8(a)(1), under the deferral method and advance payment cost offset method under § 1.451–8(c) and (e), respectively.

(B) *Analysis for 2021.* The $40x payment A receives in 2021 meets the definition of an advance payment under § 1.451–8(a)(1) as the full inclusion of $40x in gross income in the year of receipt is a permissible method of accounting, a portion of the payment ($35x) is ''taken into account as AFS revenue'' in a subsequent year, and the payment is for a good. Pursuant to § 1.451–8(a)(3), A's advance payment inventory inclusion amount for 2022 is $35x (the portion of the payment deferred for AFS purposes). Pursuant to paragraph (c)(2)(i) of this section, A must first determine the AFS inventory inclusion amount for 2021 by applying the rules in paragraph (c)(2)(i)(A) of this section. A then reduces such amount by the cost of goods in progress offset for 2021, as determined under paragraphs (c)(3) through (5) of this section.

(*1*) Pursuant to paragraph (c)(2)(i)(A)(*1*) of this section, A first takes the greater of:

(*i*) The cumulative amount of revenue that satisfies the all events test under § 1.451–1(a) through the last day of 2021, less any advance payment inventory inclusion amount attributable to a subsequent year ($5x, determined as the $40x under the all events test, less the $35x of advance payment inventory inclusion amount attributable to 2022); or

(*ii*) The cumulative amount of revenue that is treated as ''taken into account as AFS revenue'' through the last day of 2021 ($5x) (or if the two amounts are equal, the equal amount).

(*2*) Pursuant to paragraph (c)(2)(i)(A)(*2*) of this section, A then subtracts from such amount ($5x) the amount determined under paragraph (c)(2)(i)(A)(*1*) of this section for the item of inventory for the immediately preceding year ($0). This net amount of $5x is the AFS inventory inclusion amount for 2021.

(*3*) Pursuant to paragraph (c)(2)(i) of this section, A reduces this $5x AFS inventory inclusion amount by the cost of goods in progress offset for 2021 of $5x, determined as the cost of goods as of December 31, 2021 of $10x, less the cumulative cost of goods in progress offset taken into account in prior years of $0, less 5x for the AFS inventory inclusion amount limitation under paragraph (c)(4) of this section. Accordingly, A is required to include $0 in gross income for 2021.

(C) *Analysis for 2022.* Pursuant to paragraph (c)(2)(i) of this section, A must first determine the AFS inventory inclusion amount for 2022 by applying the rules in paragraph (c)(2)(i)(A) of this section. A then reduces such amount by the cost of goods in progress offset for 2022, as determined under paragraphs (c)(3) through (5) of this section.

(*1*) Pursuant to paragraph (c)(2)(i)(A)(*1*) of this section, A first takes the greater of:

(*i*) The cumulative amount of revenue that satisfies the all events test under § 1.451–1(a) through the last day of 2022 ($40x); or

(*ii*) The cumulative amount of revenue that is treated as ''taken into account as AFS revenue'' through the last day of 2022 ($90x).

(*2*) Pursuant to (c)(2)(i)(A)(*2*) of this section, A then subtracts from such amount ($90x) the amount determined under paragraph (c)(2)(i)(A)(*1*) of this section for the item of inventory for 2021 ($5x). This net amount of $85x is the AFS inventory inclusion amount for 2022.

(*3*) Pursuant to paragraph (c)(2)(i) of this section, A reduces this $85x AFS inventory inclusion amount by the cost of goods in progress offset for 2022 of $60x, determined as the cost of goods as of December 31, 2022 of $65x, less the cumulative cost of goods in progress offset taken into account in prior years of $5x. Accordingly, A is required to include $25x in gross income for 2022.

(D) *Analysis for 2023.* During 2023, ownership of the good is transferred to Customer. Accordingly, pursuant to paragraph (c)(2)(ii) of this section, A determines its gross income inclusion for 2023 by:

(*1*) First taking the greater of:

(*i*) The cumulative amount of revenue that satisfies the all events test under § 1.451–1(a) through the last day of 2023 ($100x); or

(*ii*) The cumulative amount of revenue that is treated as ''taken into account as AFS revenue'' through the last day of 2023 ($100x) (or if the two amounts are equal, the equal amount).

(*2*) Then subtracting from such amount ($100x) the prior income inclusion amounts attributable to the transferred good of $25x ($0 for 2021 plus $25x for 2022). A is required to include this net amount of $75x in gross income for 2023. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the $70x of costs capitalized to the good as cost of goods sold in 2023 in accordance with sections 471 and 263A. See § 1.61–3. Accordingly, A's gross income for 2023 is $5x.

(v) *Example 5—(A) Facts.* The same facts as in paragraph (c)(8)(iv) of this section (*Example 4*) apply, except that in 2022, A's obligation to Customer with respect to the good ends other than in a transaction to which section 381(a) applies, or a section 351 transaction described in paragraph (c)(6)(ii)(B) of this section. A does not receive any additional payments in 2022.

(B) *Analysis for 2021.* The analysis for 2021 is the same as in paragraph (c)(8)(iv) of this section (*Example 4*).

(C) *Analysis for 2022.* Because, in 2022, A's obligation to Customer with respect to the good ends in a transaction other than a transaction described in paragraph (c)(6)(ii)(A) or (B) of this section, A is required to apply the acceleration rules in paragraph (c)(6) of this section. Accordingly, because A received $40x of payments as of the date of the transaction, but did not include any portion of such payments in gross income in prior years, A is required to include the remaining $40x of the payments received in gross income in 2022 pursuant to paragraph (c)(6) of this section. A is not permitted to further reduce the $40x income inclusion by a cost of goods in progress offset under this paragraph (c).

(vi) *Example 6*—(A) *Facts.* In 2021, A enters into a contract with Customer to produce and deliver a good. The contract provides that A will receive payments equal to AFS costs plus a 100% mark-up, however, A can only bill the customer on December 31, 2022 and, if the good is not delivered by December 31, 2022, A can also bill Customer upon delivery of the good, for the AFS costs (plus markup) incurred to date, less any amounts previously billed. A recognizes AFS revenue based on a percentage of completion (cost to cost) method. A recognizes AFS revenue of $100 through the last day of 2021, $150 through the last day of 2022, and $300 through the last day of 2023, and has an enforceable right to all AFS revenue reported as of the end of each year if the customer were to terminate the contract on the last day of the year. A bills the customer $150 on December 31 of 2022 and $150 in 2023 when A delivers the good and ownership transfers to Customer. The costs to produce the good are required to be capitalized under sections 471 and 263A as the good is inventory in the hands of the taxpayer. A incurs the following costs each year that are permissibly capitalized and allocated to the produced good under sections 471 and 263A: $125 in 2021; $0 in 2022; and $25 in year 2023.

(B) *Analysis for taxable year 2021.* Pursuant to paragraph (c)(2)(i) of this section, A must first determine the AFS inventory inclusion amount for 2021 by applying the rules in paragraph (c)(2)(i)(A) of this section. A then reduces such amount by the cost of goods in progress offset for 2021, as determined under paragraphs (c)(3) through (5) of this section.

(*1*) Pursuant to paragraph (c)(2)(i)(A)(*1*) of this section, A first takes the greater of:

(*i*) The cumulative amount of revenue that satisfies the all events test under § 1.451–1(a) through the last day of 2021 ($0); or

(*ii*) The cumulative amount of revenue that is treated as ''taken into account as AFS revenue'' through the last day of 2021 ($100).

(*2*) Pursuant to paragraph (c)(2)(i)(A)(*2*) of this section, A then subtracts from such amount ($100) the amount determined under paragraph (c)(2)(i)(A)(*1*) of this section for the item of inventory for the immediately preceding year ($0). This net amount of $100 is the AFS inventory inclusion amount for 2021.

(*3*) Pursuant to paragraph (c)(2)(i) of this section, A reduces this $100 AFS inventory inclusion amount by the cost of goods in progress offset for 2021 of $100. Although A's cost of goods in progress as of the end of 2021 is $125, the cost of goods in progress offset is limited to $100, the amount of A's AFS inventory inclusion amount for 2021. Accordingly, A is required to include $0 in gross income in 2021.

(C) *Analysis for taxable year 2022.* Pursuant to paragraph (c)(2)(i) of this section, A must first determine the AFS inventory inclusion amount for 2022 by applying the rules in paragraph (c)(2)(i)(A) of this section. A then reduces such amount by the cost of goods in progress offset for 2022, as determined under paragraphs (c)(3) through (5) of this section.

(*1*) Pursuant to paragraph (c)(2)(i)(A)(*1*) of this section, A first takes the greater of:

(*i*) The cumulative amount of revenue that satisfies the all events test under § 1.451–1(a) through the last day of 2022 ($150 due under the terms of the contract); or

(*ii*) The cumulative amount of revenue that is treated as ''taken into account as AFS revenue'' through the last day of 2022 ($150) (or if the two amounts are equal, the equal amount).

(*2*) Pursuant to paragraph (c)(2)(i)(A)(*2*) of this section, A then subtracts from such amount ($150) the amount determined under paragraph (c)(2)(i)(A)(*1*) of this section for the item of inventory for the immediately preceding year ($100). This net amount of $50 is the AFS inventory inclusion amount for 2022.

(*3*) Pursuant to paragraph (c)(2)(i) of this section, A reduces this $50 AFS inventory inclusion amount by the cost of goods in progress offset for 2022 of $25, determined as $125 cost of goods as of December 31, 2022 minus $100 cumulative cost of goods in progress offset amount taken into account in 2021. Accordingly, A is required to include $25 in gross income for 2022.

(D) *Analysis for taxable year 2023.* During 2023, ownership of the good is transferred to the customer. Accordingly, pursuant to paragraph (c)(2)(ii) of this section, A determines its gross income inclusion for 2023 by:

(*1*) First taking the greater of:

(*i*) The cumulative amount of revenue that satisfies the all events test under § 1.451–1(a) through the last day of 2023 ($300x); or

(*ii*) The cumulative amount of revenue that is treated as ''taken into account as AFS revenue'' through the last day of 2025 ($300x) (or if the two amounts are equal, the equal amount).

(*2*) Then subtracting from such amount ($300x) the prior income inclusion amounts attributable to the transferred good of $25 ($0 for 2021 plus $25 for 2022). This net amount of $275 is the AFS income inclusion amount for 2023. Although A does not reduce such amount by a cost of goods in progress offset under this paragraph (c), A is entitled to recover the $150 of costs capitalized to the good as cost of goods sold in 2023 in accordance with sections 471 and 263A. See § 1.61–3. Accordingly, A's gross income for 2023 is $125 ($275 AFS income inclusion amount less $150 cost of goods sold).

(d) *Contracts with multiple performance obligations*—(1) *In general.* Each performance obligation generally yields a corresponding item of gross income that must be accounted for separately under the AFS income inclusion rule in paragraph (b)(1) of this section. Except as provided in paragraph (d)(5) of this section, if a contract contains more than one performance obligation, and thus yields more than one corresponding item of gross income, the transaction price amount shall be allocated to each corresponding item of gross income in accordance with the transaction price amount allocated to each performance obligation for AFS purposes, subject to the adjustments to the transaction price amount and special allocation rules in paragraph (d)(3) of this section.

(2) *Single performance obligation with more than one item of gross income.* If a single performance obligation yields more than one corresponding item of gross income, the transaction price amount allocated to the single performance obligation for AFS purposes must be further allocated among the corresponding items of gross income using any reasonable method.

(3) *Adjustments to transaction price amount and special allocation rules*—(i) *Increases to transaction price amount.* If the transaction price amount includes a reduction for amounts described in paragraph (b)(2)(i)(A)(*1*) or (*2*) of this section, or has been reduced because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, the taxpayer must determine the specific performance obligation to which such reduction relates and increase the transaction price amount allocable to the corresponding item of gross income by the amount of such reduction (specific identification approach). If it is impracticable from the taxpayer's records to use the specific identification approach, the taxpayer may use any reasonable method to allocate the reduction amount to the items of gross income in the contract. A pro-rata allocation of the reduction amount across all items of gross income under the contract based on the relative

transaction price amounts allocated to such items under paragraph (d)(1) of this section is a reasonable method.

(ii) *Decrease to transaction price amount.* If the transaction price amount has been increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, the taxpayer must determine the specific performance obligation to which such amount relates and decrease the transaction price amount allocable to the corresponding item of gross income by such amount (specific identification approach). If it is impracticable from the taxpayer's records to use the specific identification approach, the taxpayer may use any reasonable method to allocate such amount to the items of gross income in the contract. A pro-rata allocation of such amount across all items of gross income under the contract based on the relative transaction price amounts allocated to such items under paragraph (d)(1) of this section is a reasonable method.

(4) *Examples.* The following examples illustrate the rules of paragraph (d)(1) through (3) of this section. Unless the facts specifically state otherwise, the taxpayer has an AFS, is on a calendar year for Federal income tax purposes and AFS purposes, and uses an accrual method of accounting for Federal income tax purposes.

(i) *Example 1*—(A) *Facts.* On November 1, 2021, A, a software developer, enters into a contract with a customer to transfer a software license, perform software installation services, and provide technical support for a two-year period for $100x. The installation service does not significantly modify the software and the software remains functional without the technical support. A receives an additional $10x bonus if the installation service is performed before February 1, 2022, which A expects to receive. Further, the customer is entitled to a refund of $2x if technical support does not meet performance standards set forth in the contract, which A expects it will pay to the customer. For its AFS, A identifies three performance obligations in the contract:

(*1*)(*i*) The software license;

(*ii*) The installation service; and

(*iii*) Technical support.

(*2*) Also, for its AFS, A determines that the transaction price amount is $108x, determined as $100x contract price plus $10x bonus for installation services minus $2x customer refund. Finally, for its AFS, A allocates the $108x transaction price amount to the three performance obligations as follows: $60x to the software license; $40x to the installation service ($30x + $10x bonus); and $8x to technical support ($10x − $2x refund).

(B) *Analysis.* Pursuant to paragraph (d)(1) of this section, A's contract with the customer has three performance obligations, and each performance obligation yields a corresponding item of gross income that is accounted for separately. Pursuant to paragraph (d)(1) of this section, A is required to allocate the $108x transaction price amount to each corresponding item of gross income in accordance with the transaction price amount allocated to each respective performance obligation for AFS purposes. Accordingly, A initially allocates $60x to the software license item, $40x to the installation service item, and $8 to the technical support item. However, because the transaction price amount was reduced by the anticipated refund of $2x, which relates specifically to the technical support item, A must increase the transaction price allocable to that item of gross income pursuant to the specific identification approach in paragraph (d)(3) of this section. Accordingly, the amount allocated to the item of gross income related to technical support is $10x.

(ii) *Example 2*—(A) *Facts.* In 2021, B, a manufacturer and servicer of airplane parts, enters into a contract with a customer to sell airplane parts in 2021 and to service those parts, as necessary, in 2021, 2022, and 2023 for $100x. B regularly sells the airline parts and the services separately. For its AFS, B identifies two performance obligations in the contract:

(*1*)(*i*) The sale of airplane parts; and

(*ii*) The services for those parts.

(*2*) The customer receives a refund of $5x if it does not require a specified level of service for the parts, which B expects it will pay to the customer. Also, for its AFS, B determines that the transaction price amount is $95x, determined as the $100x contract price minus the $5x refund that it expects to pay the customer. Finally, for its AFS, B allocates the $95x transaction price amount to the two performance obligations as follows: $40x to the sale of parts and $55x to the provision of services ($60x − $5x refund).

(B) *Analysis.* Pursuant to paragraph (d)(1) of this section, B's contract with the customer has two performance obligations, and each performance obligation yields a corresponding item of gross income that is accounted for separately. Pursuant to paragraph (d)(1) of this section, B is required to allocate the $95x transaction price amount to each corresponding item of gross income in accordance with the transaction price amount allocated to each respective performance obligation for AFS purposes. Accordingly, B initially allocates $40x to the sale of parts item and $55x to the provision of services item. However, because the transaction price amount was reduced by the anticipated refund of $5x, which relates specifically to provision of services item, B must increase the transaction price allocable to that item of gross income pursuant to the specific identification approach in paragraph (d)(3) of this section. Accordingly, the amount allocated to the item of gross income related to servicing the parts is $60x.

(iii) *Example 3: Reward points*—(A) *Facts.* On December 31, 2021, U, in the business of selling consumer electronics, sells a new TV for $1,000 and gives the customer 50 reward points. Each reward point is redeemable for a $1 discount on any future purchase of U's products. For its AFS, U identifies two performance obligations from the transaction:

(*1*)(*i*) The sale of the TV; and

(*ii*) The provision of rewards points.

(*2*) Also, for its AFS, U allocates $950 of transaction price amount to the sale of the TV and the remaining $50 of the transaction price amount to the reward points.

(B) *Analysis.* Pursuant to paragraph (d)(1) of this section, U's contract with the customer has two performance obligations, and each performance obligation yields a corresponding item of gross income that is accounted for separately. Pursuant to paragraph (d)(1) of this section, U is required to allocate the $1,000 transaction price amount to each corresponding item of gross income in accordance with the transaction price amount allocated to each respective performance obligation for AFS purposes. Accordingly, U allocates the transaction price amount as follows: $950 to the TV sale item and $50 to the reward points item. If U reports any portion of the $50 payment allocated to the reward points as AFS revenue for 2022, or later, the payment is an advance payment, as defined in § 1.451–8(a)(1), and may be accounted for under the deferral method if U satisfies the criteria in § 1.451–8(c).

(iv) *Example 4: Airline reward miles*—(A) *Facts.* On January 1, 2021, W, a passenger airline company, sells a customer a $700 airline ticket to fly roundtrip in 2021. As part of the purchase, the customer receives 7,000 points (air miles) from W to be redeemed for future air travel. For its AFS, W identifies two performance obligations in the contract:

(*1*)(*i*) The sale of the airline ticket; and (*ii*) The provision of air miles.

(*2*) W also anticipates that it will issue a rebate to the customer for $10. Also, for its AFS, W determines that the transaction price amount is $690, determined as the $700 ticket price minus the anticipated $10 rebate. Finally, for its AFS, W allocates the $690 transaction price amount to the separate performance obligations as follows: $660 to the ticket ($670 − $10 rebate = $660) and $30 to the air miles.

(B) *Analysis.* Pursuant to paragraph (d)(1) of this section, W's contract with the customer has two performance obligations, and each performance obligation yields a corresponding item of gross income that is accounted for separately. Pursuant to paragraph (d)(1) of this section, W must allocate the $690 transaction price amount to each corresponding item of gross income in accordance with the transaction price amount allocated to each respective performance obligation for AFS purposes. Accordingly, W initially allocates $660 to the ticket sale item and $30 to the air miles item. However, because the transaction price amount was reduced by the anticipated rebate of $10x, which relates to the ticket sale item, W must increase the transaction price allocable to that item of gross income pursuant to paragraph (d)(3) of this section. Accordingly, the amount allocated to the item of gross income related to the ticket sale is $670. If W reports any portion of the $30 payment allocated to the air miles item as AFS revenue for 2022, or later, the payment is an advance payment, as defined in § 1.451–8(a)(1), and may be accounted for under the deferral method if W satisfies the criteria in § 1.451–8(c).

(v) *Example 5: Contract with significant financing component amounts*—(A) *Facts.* On January 1, 2021, C, a manufacturer and servicer of airline parts, enters into a contract with a customer to sell airline parts in December 2022, and to service those parts, as necessary, through 2024. The contract contains two alternative payment options: payment of $5,000 in December 2022 when the customer obtains control of the parts or payment of $4,000 when the contract is signed. The customer pays $4,000 when the contract is signed, which reflects an implicit interest rate of 11.8% and is C's incremental borrowing rate. C regularly sells the airline parts and the services separately. For its AFS, C identifies two performance obligations in the contract:

(*1*)(*i*) The sale of airplane parts; and

(*ii*) The services for those parts.

(*2*) Also, for its AFS, although the contract only requires the customer to pay $4,000, the transaction price is increased by $1,000 to $5,000 because the customer is deemed to provide financing to C under the standards C uses to prepare its AFS. The $1,000 increase is attributable to a significant financing component. Finally, for its AFS, C allocates the $5,000 transaction price amount to the separate performance obligations as follows: $3,750 to the sale of parts ($3,000 upfront payment plus $750 financing component) and $1,250 ($1,000 upfront payment plus $250 financing component) to the provision of services.

(B) *Analysis.* Pursuant to paragraph (d)(1) of this section, C's contract with the customer has two performance obligations, and each performance obligation yields a corresponding item of gross income that is accounted for separately. Pursuant to paragraph (d)(1) of this section, C must allocate the $5,000 transaction price amount to each corresponding item of gross income in accordance with the transaction price amount allocated to each respective performance obligation for AFS purposes. Accordingly, C initially allocates $3,750 to the sale of the parts item and $1,250 to the provision of services item. However, because the transaction price was increased by a significant financing component of $1,000, $750 of which was allocated to sale of the parts item and $250 of which was allocated to the provision of services item, pursuant to paragraph (d)(3) of this section, C must decrease the transaction price amount allocable to the sale of parts item from $3,750 to $3,000 and must decrease the transaction price allocable to the provision of services from $1,250 to $1,000.

(5) *Contracts accounted for in part under this section and in part under a special method of accounting*—(i) *In general.* If a taxpayer has a contract with a customer that includes one or more items of gross income that are subject to a special method of accounting and one or more items of gross income that are subject to this section (*special method/451 contract*), the transaction price allocation rule in paragraph (d)(1) of this section does not apply to determine the amount of each item of gross income that is subject to a special method of accounting. For purposes of this paragraph (d)(5)(i), a special method of accounting has the meaning set forth in paragraph (a)(13) of this section, except as otherwise provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter). For special method/451 contracts, paragraphs (d)(5)(ii) and (iii) of this section apply to determine the transaction price amount and the portion of such amount that is allocated to each item of gross income that is subject to this section.

(ii) *Transaction price adjustments.* If the transaction price amount for the special method/451 contract includes a reduction for amounts described in paragraph (b)(2)(i)(A)(*1*) or (*2*) of this section, or has been reduced because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, the taxpayer must increase the transaction price amount by the amount of such reduction. If the transaction price amount for the special method/451 contract has been increased because a significant financing component is deemed to exist under the standards the taxpayer uses to prepare its AFS, the taxpayer must decrease the transaction price amount by the amount of such increase.

(iii) *Transaction price allocation.* After the taxpayer determines the adjusted transaction price amount for the special method/451 contract under paragraph (d)(5)(ii) of this section, the taxpayer first allocates such amount to the item(s) of gross income subject to a special method of accounting and then allocates the remainder (residual amount) to the item(s) of gross income that are subject to this section. If the contract contains more than one item of gross income that is subject to this section, the taxpayer allocates the residual amount to such items in proportion to the amounts allocated to the corresponding performance obligations for AFS purposes or as otherwise provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter).

(iv) *Example*—(1) *Facts.* B is a calendar-year accrual method taxpayer with an AFS. In 2020, B enters into a $100x contract to design, build, operate and maintain a toll road. The contract meets the definition of a long-term contract under § 1.460–1(b)(1). B determines that the obligations to design and build the toll road are long-term contract activities under § 1.460–1(d)(1) and accounts for the gross income from these activities under section 460 and the regulations in this part under section 460 of the Code. In addition, B determines that the obligations to operate and maintain the toll road are non-long-term contract activities under § 1.460–1(d)(2) and that the gross income attributable to these activities is required to be accounted for under this section. B determines that of the $100x transaction price amount, $60x is properly allocable to the items of gross income that are subject to section 460 and the regulations in this part under section 460 of the Code. However, for its AFS, B allocates $55x of the transaction price amount to performance obligations that are long-term contract activities, $30x to the toll road operation performance obligation and $15x to the toll road maintenance performance obligation.

(2) *Analysis.* A method of accounting under section 460 is a special method of accounting that is within the scope of paragraph (d)(5) of this section. Pursuant to paragraph (d)(5) of this section, B first allocates $60x of the transaction price amount to the items of gross income that are subject to section 460 and the regulations in this part under section 460 of the Code and then allocates the residual amount of $40x to the two items of gross income that are required to be accounted for under this section in proportion to the amounts allocated to the corresponding performance obligations for AFS purposes. Accordingly, B allocates $26.7 × ($30x/$45x × $40x residual amount) to the toll road operations item of gross income and $13.3x ($15x/$45x × $40x residual amount) to the toll road maintenance item of gross income.

(e) *Cumulative rule for multi-year contracts*—(1) *In general.* In the case of an item of gross income from a multi-year contract, a taxpayer determines the AFS income inclusion amount for a taxable year by applying the steps in paragraph (e)(1)(i) or (ii) of this section. For this paragraph (e), the term *multi-year contract* means a contract that spans more than one taxable year.

(i) *Inventory items.* If the item of gross income is from the sale of an item of inventory and the taxpayer uses the cost offset method under paragraph (c) of this section, see paragraph (c) of this section.

(ii) *Other items of gross income.* For all other items of gross income, the taxpayer first compares the cumulative amount of the item of gross income that satisfies the all events test under § 1.451–1(a) through the last day of the taxable year, including the full amount of any advance payment received for such item in a prior taxable year, with the cumulative amount of the item of gross income that is treated as ''taken into account as AFS revenue'' under paragraph (b)(2) of this section through the last day of the taxable year and identifies the larger of the two amounts (or, if the two amounts are equal, the equal amount). The taxpayer then reduces such amount by all prior year inclusion amounts attributable to the item of gross income, if any, to determine the AFS income inclusion amount for the current taxable year. If, however, the taxpayer receives an advance payment, as defined in § 1.451–8(a)(1), that is allocable to an item of gross income from a multi-year contract, the taxpayer applies the applicable rules in § 1.451–8, rather than the rules in this paragraph (e)(1)(ii), to determine the amount of the item of gross income that is required to be included in gross income in the taxable year in which such advance payment is received, or, if applicable, in a short taxable year described in § 1.451–8(c)(6).

(2) *Examples.* The following examples illustrate the rules of paragraph (e)(1) of this section. Unless the facts specifically state otherwise, the taxpayer has an AFS, is on a calendar year for both Federal income tax purposes and AFS purposes and uses an accrual method of accounting for Federal income tax purposes. Further, the taxpayer does not use a special method of accounting.

(i) *Example 1: Provision of services included in AFS revenue with full inclusion method for advance payments*—(A) *Facts.* In 2021, D, an engineering services provider, enters into a nonseverable contract with a customer to provide engineering services through 2024 for a total of $100x. Under the contract, D receives payments of $25x in each calendar year of the contract. For its AFS, D reports $50x, $0, $20x, and $30x of AFS revenue from the contract for 2021, 2022, 2023, and 2024, respectively. D has an enforceable right to recover all amounts reported as AFS revenue through the end of a given contract year if the customer were to terminate the contract on the last day of such year. The $25x payment received in 2023 is an advance payment, as defined in § 1.451–8(a)(1), because $5x of the $25x payment is reported as AFS revenue for 2024. D uses the full inclusion method for advance payments.

(B) *Taxable year 2021.* Under the all events test in § 1.451–1(a), D is required to include $25x in gross income in 2021 as $25x is due under the terms of the contract and received by D during 2021. D does not have a fixed right to receive any portion of the remaining $75 as such amount is not due under the terms of the contract until future years and is also contingent on D's completion of the nonseverable services. Under the AFS income inclusion rule, because D has an enforceable right to recover all $50x reported as AFS revenue for 2021 if the customer were to terminate the contract on the last day of such year, all $50x is treated as ''taken into account as AFS revenue'' in 2021. Accordingly, D is required to include $50x in gross income in 2021.

(C) *Taxable year 2022.* Under the all events test in § 1.451–1(a), D is required to include $50x in gross income through the end of 2022 as $50x is due under the terms of the contract and received by D as of the end of 2022. D does not have a fixed right to receive any portion of the remaining $50 as such amount is not due under the terms of the contract until future years and is also contingent on D's completion of the nonseverable services. Under the AFS income inclusion rule, because D has an enforceable right to recover all $50x reported as AFS revenue through the end of 2022 if the customer were to terminate the contract on the last day of such year, all $50x is treated as ''taken into account as AFS revenue'' as of the last day of 2022. Under the cumulative rule in paragraph (e)(1)(ii) of this section, D compares the cumulative all events test amount of $50x with the cumulative AFS revenue amount of $50x and selects the larger of the two amounts (or if the two amounts are equal, the equal amount). From this equal amount of $50x, D subtracts the prior income inclusion amount of $50x. Accordingly, under the cumulative rule D is not required to include any amount in gross income in 2022.

(D) *Taxable year 2023.* The payment received during 2023 meets the definition of an advance payment under § 1.451–8(a)(1). Accordingly, pursuant to paragraph (e)(1)(ii) of this section, D must determine the amount that is required to be included in gross income in 2023 under the rules in § 1.451–8. Because D uses the full inclusion method under § 1.451–8(b), D is required to include the $25x that was due and received during 2023 in gross income in 2023.

(E) *Taxable year 2024.* Under the all events test in § 1.451–1(a), D is required to include $100x in gross income through the end of 2024 as $100x is due under the terms of the contract and received by D as of the end of 2024. Under the AFS income inclusion rule, because D has an enforceable right to recover all $100x reported as AFS revenue through the end of 2024 if the customer were to terminate the contract on the last day of such year, all $100x is treated as ''taken into account as AFS revenue'' through the last day of 2024. Under the cumulative rule in paragraph (e)(1)(ii) of this section, D compares the cumulative all events test amount of $100x with the cumulative AFS revenue amount of $100x and selects the larger of the two amounts (or, if the two amounts are equal, the equal amount). From this equal amount of $100x, D subtracts the prior income inclusion amount of $75x ($50x from 2021 plus

$0x from 2022 plus $25x from 2023). Accordingly, under the cumulative rule D is required to include $25 in gross income in 2024. The example in this paragraph (e)(2)(i)(E) is summarized in the following table:

TABLE 2 TO PARAGAPH (e)(2)(i)(E)

	2021	2022	2023	2024	Total
All Events/Full Inclusion Income	$25x	$25x	$25x	$25x	$100x
AFS Revenue	50x	0	20x	30x	100x
Cumulative rule income	50x	0	25x	25x	100x

(ii) *Example 2: Provision of services included in AFS revenue with deferral method for advance payments*—(A) *Facts.* The facts are the same as in paragraph (e)(2)(i) of this section (*Example 1*), except D elects to use the deferral method under § 1.451–8(c) to account for advance payments.

(B) *Taxable years 2021 and 2022.* The analysis for tax years 2021 and 2022 is the same as in paragraph (e)(2)(i) of this section (*Example 1*).

(C) *Taxable year 2023.* The payment received during 2023 meets the definition of an advance payment under § 1.451–8(a)(1). Accordingly, pursuant to paragraph (e)(1)(ii) of this section, D must determine the amount that is required to be included in gross income in 2023 under the rules in § 1.451–8. Because D uses the deferral method under § 1.451–8(b), D is required to include $20x of the $25x payment in gross income in 2023 as $20x of such payment was treated as ''taken into account as AFS revenue'' as of the end of 2023.

(D) *Taxable year 2024.* Under the all events test in § 1.451–1(a), D is required to include $100x in gross income through the end of 2024. Under the AFS income inclusion rule, because D has an enforceable right to recover all $100x reported as AFS revenue through the end of 2024 if the customer were to terminate the contract on the last day of such year, all $100x is treated as ''taken into account as AFS revenue'' through the last day of 2024. Under the cumulative rule in paragraph (e)(1)(ii) of this section, D compares the cumulative all events test amount of $100x, which includes the full amount of the $25 advance payment received in 2023, with the cumulative AFS revenue amount of $100x and selects the larger of the two amounts (or, if the two amounts are equal, the equal amount). From this equal amount of $100x, D subtracts the prior income inclusion amount of $70x ($50x from 2021 plus $0x from 2022 plus $20x from 2023). Accordingly, under the cumulative rule D is required to include $30x in gross income in 2024. The example in this paragraph (e)(2)(ii)(D) is summarized in the following table:

TABLE 3 TO PARAGRAPH (e)(2)(ii)(D)

	2021	2022	2023	2024	Total
All Events Test/Deferral Method Income	$25x	$25x	[1] $20x	$30x	$100x
AFS Revenue amount	50x	0	20x	30x	100x
Cumulative rule income	50x	0	20x	30x	100x

[1] $5x of the advance payment in 2023 is deferred and taken into income in 2024.

(f) *No change in the treatment of a transaction.* Except as provided in paragraph (j) of this section and § 1.1275–2(l), the AFS income inclusion rule does not change the treatment of a transaction or the character of an item for Federal income tax purposes. The following are examples of transactions where the treatment or character for AFS purposes does not change the treatment of the transaction or character of the item 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 or instrument 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, return of capital, or conduit payment that is not gross income for Federal income tax purposes that is treated as AFS revenue.

(g) *No change to exclusion provisions and the treatment of non-recognition transactions*—(1) *In general.* The AFS income inclusion rule accelerates the time at which the all events test under § 1.451–1(a) is treated as satisfied, and therefore does not change the applicability of any exclusion provision, or the treatment of non-recognition transactions, in the Code, the regulations in this part, 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:

(i) Any non-recognition transaction, within the meaning of section 7701(a)(45), including, 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

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

(2) *Example: Non-recognition provisions not changed for Federal income tax purposes*—(i) *Facts.* Taxpayer (Distributing) is a calendar-year accrual method C corporation with an AFS. On December 31, 2021, Distributing:

(A)(*1*) Contributes assets to a wholly owned subsidiary (Controlled) in exchange for Controlled stock and $100x; and

(*2*) Distributes all the Controlled stock pro rata to its shareholders.

(B) 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, 2022, 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 2021 AFS, Distributing recognizes revenue of $150x related to the D reorganization.

(ii) *Analysis.* For Federal income tax purposes, under section 361, Distributing does not recognize gain on Distributing's:

(A)(*1*) Contribution of assets to Controlled;

(*2*) Receipt of Controlled stock and cash; and

(*3*) Distribution of Controlled stock and cash to Distributing's shareholders.

(B) Pursuant to paragraph (g) of this section, the AFS income inclusion rule does not change the result of this paragraph (g)(2).

(h) *Additional AFS issues*—(1) *AFS covering groups of entities*—(i) *In general.* If a taxpayer's financial results are reported on the AFS for a group of entities (consolidated AFS), the taxpayer's AFS is the consolidated AFS. However, if the taxpayer's financial results are also reported on a separate AFS that is of equal or higher priority to the consolidated AFS under paragraph (a)(5) 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 2021, B's financial results are included in P's consolidated financial statement, which is certified as being prepared in accordance with GAAP, and is a Form 10–K filed with the SEC. B also has a separate audited financial statement prepared in accordance with GAAP that is used for credit purposes. B must use its parent corporation's consolidated Form 10–K as its AFS.

(2) *Separately listed items.* If a consolidated AFS is treated as the taxpayer's AFS, the taxpayer must include the amount of any items listed separately in the consolidated AFS, including any notes or other supplementary data that is considered part of the consolidated AFS, in determining the amount of AFS revenue allocated to the taxpayer.

(3) *Non-separately listed items.* If a consolidated AFS does not separately list items for the taxpayer, the portion of the AFS revenue allocable to the taxpayer is determined by relying on the taxpayer's separate source documents that were used to create the consolidated AFS and includes amounts subsequently eliminated in the consolidated AFS. Whether a taxpayer that changes the source documents it uses for this purpose from one taxable year to another taxable year has changed its method of accounting is determined under the rules of section 446.

(4) *Computation of AFS revenue for the taxable year 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 following permissible methods of accounting described in paragraph (h)(4)(i)(A) through (C) of this section to determine the AFS income inclusion amount for the taxable year:

(A) The taxpayer computes AFS revenue as if its financial reporting period is the same as its taxable year by conducting an interim closing of its books using the accounting principles it uses to prepare its AFS.

(B) The taxpayer computes AFS revenue by including a pro rata portion of AFS 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 AFS 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 AFS revenue for the taxable year based on the AFS revenue reported on the AFS prepared for the financial accounting year ending within the taxpayer's taxable year. For this paragraph (h)(4)(i)(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.

(ii) *Examples.* The following examples illustrate the principles of paragraph (j)(4) of this section.

(A) *Example 1: Interim closing of the books.* A is a calendar year taxpayer. For its AFS, A's financial results are reported on a June 30 fiscal year. Using the method described in paragraph (h)(4)(i)(A) of this section, for the taxable year 2021, A uses the financial results reported on its June 30, 2021 AFS to determine whether an item of gross income is treated as ''taken into account as AFS revenue'' from January 1, 2021, through June 30, 2021, and uses financial data and accounting procedures from its June 30, 2022 AFS to prepare an interim closing of the books as of December 31, 2021 to determine whether an item of gross income is treated as ''taken into account as AFS revenue'' from July 1, 2021, through December 31, 2021.

(B) *Example 2: Pro rata approach.* A is a calendar year taxpayer. For its AFS, A's financial results are reported on a June 30 fiscal year. Using the method described in paragraph (h)(4)(i)(B) of this section, for the taxable year 2021, A computes AFS revenue for the 2021 tax year by taking the AFS revenue for the financial accounting year ending June 30, 2021 and multiplying it by a ratio equal to the number of days in the financial accounting year that are part of the 2021 tax year/365 and then adding to that amount the AFS revenue for the financial accounting year ending June 30, 2022 multiplied by the number of days in the financial accounting year that are part of the 2021 tax year/365.

(C) *Example 3: AFS revenue for the taxable year based on AFS ending in taxpayer's taxable year.* The same facts as in paragraph (h)(4)(ii)(B) of this section (*Example 2*) apply, except that A uses the method described in paragraph (h)(4)(i)(C) of this section. For the taxable year 2021, A uses the financial results reported on its June 30, 2021 AFS to determine whether an item of gross income is treated as ''taken into account as AFS revenue'' as of the end of its 2021 taxable year. Accordingly, any AFS revenue reported on the taxpayer's June 30, 2022 AFS is disregarded when determining whether an item of gross income is treated as ''taken into account as AFS revenue'' as of the end of the 2021 taxable year.

(i) [Reserved]

(j) *Special ordering rule for certain items of income for debt instruments*—(1) *In general.* If an item of income, or portion thereof, with respect to a debt instrument is described in paragraph (j)(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 (j)(2) of this section may not be included in income later than when that item, or portion thereof, is treated as *taken into account as AFS revenue,* as determined under paragraph (b)(2) of this section, 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 (j)(2) of this section under the OID rules.

(2) *Specified fees.* Paragraph (j)(1) of this section applies to fees (specified fees) that are not spread over a period of time as discount or as an adjustment to the yield of a debt instrument (such as points) in the taxpayer's AFS and, but for paragraph (j) 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 (j)(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.* C, a credit card issuer, is a calendar-year accrual method taxpayer with a calendar year AFS. In 2021, 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). For its AFS, C reports the $2 of interchange fees as AFS revenue for 2021. C's $2 of interchange fees is described in paragraph (j)(2)(iii) of this section. Under paragraph (j)(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 gross income in 2021, the year it is treated as ''taken into account as AFS revenue.'' Under paragraph (b)(2)(i)(A) 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 2021 ($2 of interchange fee minus $1 reward liability), under paragraph (b)(2)(i)(A) of this section, C includes $2 of interchange revenue in gross income in 2021. See sections 162 and 461(h) for the treatment of the reward by C.

(k) *Treatment of adjustments to deferred revenue in an AFS*—(1) *In general.* If a taxpayer treats an item of gross 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, AFS revenue for that subsequent taxable year is increased or decreased, as applicable by the amount of that item, or portion thereof, that is written down or adjusted. See § 1.451–8(c)(5).

(2) *Example*—(i) *Facts.* D, a remanufacturer of industrial equipment, is a calendar-year, accrual method taxpayer with a calendar year AFS. On January 1, 2021, D enters into a contract with a customer and receives a payment of $100x to remanufacture equipment in 2021 and 2022. The contract is not a long-term contract under section 460. For its AFS 2021, D performs remanufacturing services and reports $40x of the $100x payment as AFS revenue for 2021, and treats $60x of the $100x payment as deferred revenue.

(ii) *Facts for taxable year 2022.* On January 1, 2022, all of the stock of D is acquired by an unrelated third party and D adjusts deferred AFS revenue to $50x (the expected cost to provide the services) by charging $10x ($60x − $50× = $10x) to retained earnings. In addition, for 2022, D performs remanufacturing services and reports $50x of the deferred revenue as AFS revenue.

(iii) *Analysis for taxable year 2022.* Under paragraph (k)(1) of this section, D's $10x write down to deferred revenue for 2022 is treated as ''taken into account as AFS revenue'' for 2022.

(l) *Methods of accounting*—(1) *In general.* Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations in this part under sections 446 and 481 of the Code apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with § 1.446–1(e) and follow the administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method. For example, the use of the AFS income inclusion rule under paragraph (b)(1) of this section under which the taxpayer determines the amount of the item of gross income that is treated as ''taken into account as AFS revenue'' by making the adjustments provided in paragraph (b)(2)(i) of this section, the use of the AFS income inclusion rule under paragraph (b)(1) of this section under which the taxpayer determines the amount of the item of gross income that is treated as ''taken into account as AFS revenue'' by making only the adjustments provided in paragraph (b)(2)(ii) of this section (the alternative AFS revenue method), the AFS cost offset method under paragraph (c) of this section, the use of a method of determining AFS revenue under paragraph (i)(4) of this section, are methods of accounting under section 446 and the regulations in this part under section 446 of the Code. In addition, a change in the manner of recognizing revenue in an AFS that changes or could change the timing of the inclusion of income for Federal income tax purposes is generally a change in method of accounting under section 446 and the regulations in this part under section 446 of the Code. However, a change resulting from the restatement of AFS revenue may not always constitute a change in method of accounting under section 446 and the regulations in this part under section 446 of the Code. For example, a restatement of AFS revenue to correct an error described in § 1.446–1(e)(2)(ii)(b) does not constitute a change in method of accounting under section 446.

(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 of accounting initiated by the taxpayer under section 481(a)(2). A taxpayer obtains the consent of the Commissioner to make the change in method of accounting by using the applicable administrative procedures that govern changes in method of accounting under section 446(e). See § 1.446–1(e)(3).

(ii) *Special rules for OID and specified credit card fees.* The rules of paragraph (l)(2)(i) of this section apply to a qualified change in method of accounting 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 (j)(2) of this section. For paragraph (l) of this section, the section 481(a) adjustment period for any adjustment under section 481(a) for a change in method of accounting described in the preceding sentence is six taxable years.

(iii) *Qualified change in method of accounting.* For 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 Public Law 115–97, 131 Stat. 2054 (2017) (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) *Applicability date*—(1) *In general.* Except as provided in paragraph (m)(2) of this section, this section applies for taxable years beginning on or after January 1, 2021.

(2) *Delayed application with respect to certain fees.* Notwithstanding paragraph (m)(1) of this section, paragraph (j) of this section applies to specified fees (as defined in paragraph (j)(2) of this section) that are not specified credit card fees (as defined in paragraph (j)(2) of this section) for taxable years beginning on or after January 6, 2022.

(3) *Early application of this section*—(i) *In general.* Except as provided in paragraph (m)(3)(ii) of this section, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may apply both the rules in this section and, to the extent relevant, the rules in § 1.451–8, in their entirety and in a consistent manner, to a taxable year beginning after December 31, 2017, and before January 1, 2021, provided that, once applied to a taxable year, the rules in this section and, to the extent relevant, the rules in § 1.451–8, are applied in their entirety and in a consistent manner to all subsequent taxable years. See section 7508(b)(7) and § 1.451–8(h).

(ii) *Certain fees*—(A) *Specified credit card fees.* In the case of specified credit card fees, a taxpayer and its related parties, within the meaning of sections 267(b) and 707(b), may apply both the rules in this section and the rules in § 1.1275–2(l), in their entirety and in a consistent manner, to a taxable year beginning after December 31, 2018, and before January 1, 2021, provided that, once applied to a taxable year, the rules in this section and § 1.1275–2(l) that apply to specified credit card fees are applied in their entirety and in a consistent manner to all subsequent taxable years (other than the rules applicable to specified fees that are not specified credit card fees). See section 7508(b)(7) and § 1.1275–2(l)(2).

(B) *Specified fees.* Paragraphs (m)(3)(i) and (m)(3)(ii)(A) of this section do not apply to specified fees that are not specified credit card fees.

■ **Par. 6.** Section 1.451–8 is added to read as follows:

§ 1.451–8 Advance payments for goods, services, and certain other items.

(a) *Definitions.* Except as otherwise provided in this section, the following definitions apply for this section:

(1) *Advance payment*—(i) *In general.* An *advance payment* is a payment received by a taxpayer if:

(A) The full inclusion of the payment in the gross income of the taxpayer for the taxable year of receipt is a permissible method of accounting, without regard to this section;

(B) Any portion of the payment is taken into account as AFS revenue for a subsequent taxable year, or, if the taxpayer does not have an applicable financial statement any portion of the payment is earned by the taxpayer in a subsequent taxable year. To determine the amount of the payment that is treated as ''taken into account as AFS revenue,'' the taxpayer must adjust AFS revenue for any amounts described in § 1.451–3(b)(2)(i)(A), (C), and (D);

(C) The payment is for:

(*1*) Services;

(*2*) The sale of goods;

(*3*) The use, including by license or lease, of intellectual property, including copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights, such as franchise rights and arena naming rights;

(*4*) The occupancy or use of property if the occupancy or use is ancillary to the provision of services, for example, advance payments for the use of rooms or other quarters in a hotel, booth space at a trade show, campsite space at a mobile home park, and recreational or banquet facilities, or other uses of property, so long as the use is ancillary to the provision of services to the property user;

(*5*) The sale, lease, or license of computer software;

(*6*) Guaranty or warranty contracts ancillary to an item or items described in paragraph (a)(1)(i)(C)(*1*), (*2*), (*3*), (*4*), or (*5*) of this section;

(*7*) Subscriptions in tangible or intangible format. Subscriptions for which an election under section 455 is in effect is not included in this paragraph (a)(1)(i)(C)(*7*);

(*8*) Memberships in an organization. Memberships for which an election under section 456 is in effect are not included in this paragraph (a)(1)(i)(C)(*8*);

(*9*) An eligible gift card sale;

(*10*) Any other payment identified by the Secretary of the Treasury or his delegate (Secretary) under section 451(c)(4)(A)(iii), including in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter); or

(*11*) Any combination of items described in paragraphs (a)(1)(i)(C)(*1*) through (*10*) of this section.

(ii) *Exclusions from the definition of advance payment.* An advance payment does not include:

(A) Rent, except for amounts paid for an item or items described in paragraph (a)(1)(i)(C)(*3*), (*4*), or (*5*) of this section;

(B) Insurance premiums, to the extent the inclusion of those premiums is governed by Subchapter L of the Internal Revenue Code;

(C) Payments with respect to financial instruments (for example, debt instruments, deposits, letters of credit, notional principal contracts, options, forward contracts, futures contracts, foreign currency contracts, credit card agreements (including rewards or loyalty points under such agreements), financial derivatives, or similar items), including purported prepayments of interest;

(D) Payments with respect to service warranty contracts for which the taxpayer uses the accounting method provided in Revenue Procedure 97–38, 1997–2 C.B. 479 (see § 601.601(d)(2) of this chapter);

(E) Payments with respect to warranty and guaranty contracts under which a third party is the primary obligor;

(F) Payments subject to section 871(a), 881, 1441, or 1442;

(G) Payments in property to which section 83 applies;

(H) Payments received in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery date for a specified good (specified good exception) unless the taxpayer uses the method under paragraph (f) of this section;

(I) Any other payment identified by the Secretary under section 451(c)(4)(B)(vii), including in guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter); and

(J) Any combination of items described in paragraphs (a)(1)(ii)(A) through (I) of this section.

(2) *Advance payment income inclusion amount.* The term *advance payment income inclusion amount* means the amount of the advance payment that is required to be included in gross income for the taxable year under the applicable rules in this section.

(3) *Advance payment inventory inclusion amount.* The term *advance payment inventory inclusion amount* means the amount of the advance payment from the sale of an item of

inventory that, but for the cost of goods in progress offset, would be includable in gross income under paragraph (b), (c), or (d) of this section, as applicable, for the taxable year.

(4) *AFS revenue.* The term *AFS revenue* has the same meaning as provided in § 1.451–3(a)(4).

(5) *Applicable financial statement.* The term *applicable financial statement* (AFS) has the same meaning as provided in § 1.451–3(a)(5).

(6) *Contractual delivery date.* The term *contractual delivery date* means the month and year of delivery listed in the original written contract to the transaction entered into between the parties prior to initial receipt of any payments.

(7) *Cost of goods.* The term *cost of goods* means the costs that are properly capitalized and included in inventory under sections 471 and 263A or any other applicable provision of the Internal Revenue Code and that are allocable to an item of inventory for which an advance payment inventory inclusion amount is calculated. See paragraph (e)(6) of this section for specific rules for a taxpayer using the simplified methods under section 263A.

(8) *Cost of goods in progress offset.* The term *cost of goods in progress offset* has the meaning provided in paragraph (e)(4) of this section.

(9) *Cumulative cost of goods in progress offset.* The term *cumulative cost of goods in progress offset* means the cumulative cost of goods in progress offset amounts under paragraph (e) of this section for a specific item of inventory that have reduced an advance payment inventory inclusion amount attributable to such item of inventory in prior taxable years.

(10) *Eligible gift card sale.* The term *eligible gift card sale* means the sale of a gift card or gift certificate if:

(i) The taxpayer is primarily liable to the customer, or holder of the gift card, for the value of the card until redemption or expiration; and

(ii) The gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer as payment for items listed in paragraphs (a)(1)(i)(C)(*1*) through (*11*) of this section.

(11) *Enforceable right.* The term *enforceable right* has the same meaning as provided in § 1.451–3(a)(9).

(12) *Performance obligation.* The term *performance obligation* has the same meaning as provided in § 1.451–3(a)(11).

(13) *Prior income inclusion amounts.* The term *prior income inclusion amounts* means the amount of an item of gross income that was included in the taxpayer's gross income under this section or § 1.451–3 in a prior taxable year.

(14) *Received.* An item of gross income is *received* by the taxpayer if it is actually or constructively received, or if it is due and payable to the taxpayer.

(15) *Specified good.* The term *specified good* means a good for which:

(i) During the taxable year a payment is received, the taxpayer does not have on hand, or available to it in such year through its normal source of supply, goods of a substantially similar kind and in a sufficient quantity to satisfy the contract to transfer the good to the customer; and

(ii) All the revenue from the sale of the good is recognized in the taxpayer's AFS in the year of delivery.

(16) *Transaction price.* The term *transaction price* has the same meaning as provided in § 1.451–3(a)(14).

(b) *In general.* Except as provided in paragraph (c) or (d) of this section, an accrual method taxpayer shall include an advance payment in gross income no later than in the taxable year in which the taxpayer receives the advance payment.

(c) *Deferral method for taxpayers with an applicable financial statement (AFS)*—(1) *In general.* An accrual method taxpayer with an AFS that receives an advance payment may elect the deferral method described in this paragraph (c) if the taxpayer can determine the extent to which the advance payment is taken into account as AFS revenue as of the end of the taxable year of receipt and, if applicable, a short taxable year described in paragraph (c)(6) of this section. Except as otherwise provided in this section, a taxpayer that uses the deferral method described in this paragraph (c) must:

(i) Include the advance payment, or any portion thereof, in gross income in the taxable year of receipt to the extent *taken into account as AFS revenue* as of the end of such taxable year, as determined under paragraph (c)(2) of this section; and

(ii) Include the remaining portion of such advance payment in gross income in the taxable year following the taxable year in which such payment is received (next succeeding year).

(2) *Adjustments to AFS revenue.* The amount of an advance payment that is treated as ''taken into account as AFS revenue'' as of the end of the taxable year of receipt under paragraph (c)(1)(i) of this section is determined by adjusting AFS revenue by amounts described in § 1.451–3(b)(2)(i)(A), (C), and (D), as applicable.

(3) *Examples.* The following examples demonstrate the rules in paragraphs (c)(1) and (2) of this section.

(i) *Example 1: Gift cards not eligible for deferral method.* E, a hair styling salon, receives advance payments for gift cards that may later be redeemed at the salon for hair styling services or hair care products at the face value of the gift card. The gift cards may not be redeemed for cash and have no expiration date. E does not track the sale date of the gift cards and includes advance payments for gift cards in AFS revenue when redeemed. Because E is unable to determine the extent to which advance payments are taken into account as AFS revenue for the taxable year of receipt, E cannot use the deferral method for these advance payments.

(ii) *Example 2: Gift cards eligible for deferral method.* The same facts as in paragraph (c)(3)(i) of this section (*Example 1*) apply, except that the gift cards have an expiration date 12 months from the date of sale, E does not accept expired gift cards, and E includes unredeemed gift cards in AFS revenue for the taxable year in which the cards expire. Because E tracks the sale date and the expiration date of the gift cards for its AFS, E can determine the extent to which advance payments are taken into account as AFS revenue for the taxable year of receipt. Therefore, E meets the requirement of paragraph (c)(1) of this section and may elect the deferral method for these advance payments.

(4) *Acceleration of advance payments*—(i) *In general.* A taxpayer that uses the deferral method described in this paragraph (c) must include in gross income for the taxable year, all advance payments not previously included in gross income:

(A) If, in that taxable year, the taxpayer either dies or ceases to exist in a transaction other than a transaction to which section 381(a) applies; or

(B) If, and to the extent that, in that taxable year, the taxpayer's obligation for the advance payments is satisfied or otherwise ends other than in:

(*1*) A transaction to which section 381(a) applies; or

(*2*) A section 351(a) transfer that is part of a section 351 transaction in which:

(*i*) Substantially all assets of the trade or business, including advance payments, are transferred;

(*ii*) The transferee adopts or uses the deferral method in the year of transfer; and

(*iii*) The transferee and the transferor are members of the same consolidated group, as defined in § 1.1502–1(h).

(ii) *Examples.* The following examples illustrate the rules in paragraph (c)(4) of this section. In each of the following examples, the taxpayer is a C corporation, uses an accrual method of accounting for Federal income tax purposes and files its returns on a calendar year basis. In addition, the taxpayer has an AFS and uses the deferral method in paragraph (c) of this section.

(A) *Example 1: Ceasing to exist.* A is in the business of selling and licensing off the shelf, fully customized, and semi-customized computer software and providing customer support. On July 1, 2021, A enters into a 2-year software maintenance contract and receives an advance payment. Under the contract, A will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. A ceases to exist on December 1, 2021, in a transaction that does not involve a section 351(a) transfer described in paragraph (c)(4)(i)(B)(*2*) of this section and is not a transaction to which section 381(a) applies. For Federal income tax purposes, A must include the entire advance payment in gross income in its 2021 taxable year.

(B) *Example 2: Satisfaction of obligation*—(*1*) *Facts.* On November 1, 2021, J, a travel agent, receives payment from a customer for an airline flight that will take place in April 2022. J purchases and delivers the airline ticket to the customer on November 14, 2021. J retains the excess of the customer's payment over the cost of the airline ticket as its commission. The customer may cancel the flight and receive a refund from J only to the extent the airline itself provides refunds. In its AFS, J includes its commission in revenue for 2022.

(*2*) *Analysis.* The payment for commission income is an advance payment. Because J is not required to provide any services after the ticket is delivered to the customer on November 14, 2021, J satisfies its obligation to the customer for its commission when the airline ticket is delivered. Thus, for Federal income tax purposes, J must include the commission in gross income for 2021.

(5) *Financial statement adjustments*—(i) *In general.* If a taxpayer treats an advance payment as an item of deferred revenue in its AFS and writes-down or adjusts that item, or portion thereof, to an equity account such as retained earnings, or otherwise writes-down or adjusts that item of deferred revenue in a subsequent taxable year, AFS revenue for that subsequent taxable year is increased or decreased, as applicable, by the amount that is written down or adjusted. See § 1.451–3(k).

(ii) *Examples.* The following examples illustrate the rules in paragraph (c)(5) of this section. In each of the following examples, the taxpayer is a C corporation, uses an accrual method of accounting for Federal income tax purposes and files its returns on a calendar year basis. In addition, the taxpayer has an AFS and uses the deferral method in paragraph (c) of this section.

(A) *Example 1*—(*1*) *Facts.* On May 1, 2021, A received $100 as an advance payment for a 2-year contract to provide services. For financial accounting purposes, A recorded $100 as a deferred revenue liability in its AFS, expecting to report ¼ ($25) of the advance payment in AFS revenue for 2021, ½ ($50) for 2022, and ¼ ($25) for 2023. On August 31, 2021, C, an unrelated corporation that files its Federal income tax return on a calendar year basis and that is a member of a consolidated group, acquired all of the stock of A, and A joined C's consolidated group. A's short taxable year ended on August 31, 2021, and, as of that date, A had included ¼ ($25) of the advance payment in AFS revenue. On September 1, 2021, after the stock acquisition, and in accordance with purchase accounting rules, C wrote down A's deferred revenue liability to its fair value of $10 as of the date of the acquisition. The $10 is included in revenue on A's AFS in accordance with the method of accounting A uses for financial accounting purposes.

(*2*) *Analysis.* For Federal income tax purposes, A must take ¼ ($25) of the advance payment into income for its short taxable year ending August 31, 2021 and must include the remainder of the advance payment ($75) ($65 write down + $10 future financial statement revenue) in income for its next succeeding taxable year.

(B) *Example 2*—(*1*) *Facts.* On May 1, 2021, B received $100 as an advance payment for a contract to be performed in 2021, 2022, and 2023. On August 31, 2021, D, a corporation that is not a member of a consolidated group for Federal income tax purposes, acquired all of the stock of B. Before the stock acquisition, for 2021, B included $40 of the advance payment in AFS revenue, and $60 as a deferred revenue liability. On September 1, 2021, after the stock acquisition and in accordance with purchase accounting rules, B, at D's direction, wrote down its $60 deferred revenue liability to $10 (its fair value) as of the date of the acquisition. After the acquisition, B does not take into account as AFS revenue any of the $10 deferred revenue liability in its 2021 AFS. B does include $5 in revenue in 2022, and $5 in revenue in 2023.

(*2*) *Analysis.* For Federal income tax purposes, B must include $40 of the advance payment into income in 2021 and must include the remainder of the advance payment ($60) ($50 write down plus $10 future financial statement revenue) in income for the 2022 taxable year.

(6) *Short taxable year rule*—(i) *In general.* If the taxpayer's next succeeding taxable year is a short taxable year, other than a taxable year in which the taxpayer dies or ceases to exist in a transaction other than a transaction to which section 381(a) applies, and the short taxable year consists of 92 days or less, a taxpayer using the deferral method must include the portion of the advance payment not included in the taxable year of receipt in gross income for the short taxable year to the extent taken into account as AFS revenue as of the end of such taxable year, as determined under paragraph (c)(2) of this section. Any amount of the advance payment not included in gross income in the taxable year of receipt or the short taxable year, must be included in gross income for the taxable year immediately following the short taxable year.

(ii) *Example 1*—(A) *Facts.* A is a calendar year taxpayer and is in the business of selling and licensing off the shelf, fully customized, and semi-customized computer software and providing customer support. On July 1, 2021, A enters into a 2-year software maintenance contract and receives an advance payment of $240 under the contract. Under the contract, A will provide software updates if it develops an update within the contract period, as well as provides online and telephone customer support. A changes its taxable period to a fiscal year ending March 31. As a result, A has a short taxable year beginning January 1, 2022, and ending March 31, 2022. In its AFS, A includes 6/24 ($60) of the payment in revenue for the taxable year ending December 31, 2021 to account for the six-month period July 1 through December 31, 2021; 3/24 ($30) in revenue for the short taxable year ending March 31, 2022 to account for the three-month period January 1 through March 31, 2022; 12/24 ($120) in revenue for the taxable year ending March 31, 2023; and 3/24 ($30) in revenue for the taxable year ending March 31, 2024.

(B) *Analysis.* Because the taxable year ending March 31, 2021, is 92 days or less, A must include 6/24 ($60) of the payment in gross income for the taxable year ending December 31, 2021, 3/24 ($30) in gross income for the short taxable year ending March 31, 2022, and 15/24 ($150), the remaining amount, in gross income for the taxable year ending March 31, 2023.

(iii) *Example 2*—(A) *Facts.* On May 1, 2021, B received $100 as an advance payment for a contract to be performed in 2021, 2022, and 2023. On October 31, 2021, C, an unrelated corporation that files its federal income tax return on a calendar year basis and that is a member of a consolidated group, acquired all the stock of B and B joined C's consolidated group. Before the stock acquisition, for 2021, B included $40 of the advance payment in AFS revenue, and $60 as a deferred revenue liability. On November 1, 2021, after the stock acquisition and in accordance with purchase accounting rules, C wrote down B's $60 deferred revenue liability to $10 (its fair value) as of the date of the acquisition. After the acquisition, B does not include in revenue any of the $10 deferred revenue liability in its 2021 AFS. B includes $5 in revenue in 2022, and $5 in revenue in 2023.

(B) *Analysis.* For Federal income tax purposes, B must take $40 of the advance payment into income in its short tax year ending October 31, 2021. B's subsequent tax year, the short tax year ending December 31, 2021, is a tax year that is 92 days or less. Therefore, under paragraph (c)(6)(i) of this section, B generally will include the portion of the advance payment not included in the taxable year of receipt in gross income for this short taxable year to the extent taken into account as AFS revenue. Although for AFS purposes, no amount is recognized in revenue for the short period beginning November 1, 2021 and ending on December 31, 2021, under paragraph (c)(5)(i) of this section, B must treat the amount of the write-down as AFS revenue in the taxable year in which the write-down occurs. Therefore, B must include $50 of the advance payment into income in the short tax year ending December 31, 2021 (equal to the $50 write down plus $0 recognized in B's AFS for the period beginning on November 1, 2021 and ending December 31, 2021), and must include the remainder of the advance payment ($10) in income for the 2022 taxable year.

(7) *Financial statement conformity requirement.* A taxpayer that uses an AFS to apply the rules under § 1.451–3 must use the same AFS and, if applicable, the same method of accounting under § 1.451–3(h)(4), to apply the deferral method in paragraph (c) of this section. Additionally, the AFS rules under § 1.451–3(h) also apply for purposes of this section.

(8) *Contracts with multiple performance obligations*—(i) *General rule.* If a taxpayer is using the deferral method under this paragraph (c) and the taxpayer's contract with a customer has more than one performance obligation, then any payments received under the contract are allocated to the corresponding item of gross income in the same manner as such payments are allocated to the performance obligations in the taxpayer's AFS.

(ii) *Example: Computer software subscription with multiple performance obligations*—(A) *Facts.* P is in the business of licensing off the shelf, fully customized, and semi-customized computer software and providing customer support. P uses an accrual method of accounting for Federal income tax purposes, files its returns on a calendar year basis, and has an AFS. On July 1, 2021, P receives an advance payment of $100 for a 2-year software subscription comprised of:

(*1*)(*i*) A 1-year ''software maintenance contract'' under which P will provide software updates within the contract period; and

(*ii*) A ''customer support agreement'' for online and telephone customer support.

(*2*) P reflects the software maintenance contract and the customer support agreement as two separate performance obligations in its AFS and allocates $80 of the payment to the software maintenance contract and $20 to the customer support agreement. P includes the $80 allocable to the software maintenance payment in AFS revenue as follows: ¼ ($20) in AFS revenue for 2021; ½ ($40) in AFS revenue for 2022; and the remaining ¼ ($20) in AFS revenue for 2023. Regarding the $20 allocable to the customer support payment, P includes ½ ($10) in AFS revenue for 2021, and the remaining ½ ($10) in AFS revenue for 2022 regardless of when P provides the customer support.

(B) *Analysis.* Since the software maintenance contract and the customer support agreement are two separate performance obligations, each yielding a separate item of gross income, paragraph (c)(8) of this section requires P to allocate the $100 payment to each item of gross income in the same manner as the payment is allocated to each performance obligation in P's AFS. For Federal income tax purposes, P must include $30 in gross income for 2021 ($20 allocable to the software maintenance contract and $10 allocable to the customer support agreement) and the remaining $70 is included in gross income for 2022.

(iii) *Contracts with advance payments that include items subject to a special method of accounting*—(A) *In general.* The portion of the payment allocable to the items of gross income described in paragraph (a)(1)(i)(C) of this section from a contract that includes one or more items of gross income subject to a special method of accounting and one or more items of gross income described in paragraph (a)(1)(i)(C) of this section must be determined based on objective criteria.

(B) *Allocation deemed to be based on objective criteria.* A taxpayer's allocation method is based on objective criteria if an allocation of the payment to each item of gross income is in proportion to the amounts determined in § 1.451–3(d)(5) or as otherwise provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter).

(iv) *Example*—(A) *Facts.* B is a calendar-year accrual method taxpayer with an AFS. In 2020, B enters into a $100x contract to design, build, operate and maintain a toll road and receives an up-front payment of $100x. The contract meets the definition of a long-term contract under § 1.460–1(b)(1). B properly determines that the obligations to design and build the toll road are long-term contract activities under § 1.460–1(d)(1) and accounts for the gross income from these activities under section 460. In addition, B properly determines that the obligations to operate and maintain the toll road are non-long-term contract activities under § 1.460–1(d)(2) and that the gross income attributable to these activities is accounted for under section 451(b). B allocates $60x of the transaction price amount to the long-term contract activities and the remaining $40x to the non-long-term contract activity pursuant to § 1.451–3(d)(5). For AFS purposes, B allocates $55x of the transaction price amount to the performance obligations that are long-term contract activities and $45x to the non-long-term contract activities. B uses the deferral method of accounting.

(B) *Analysis.* For Federal income tax purposes, a method of accounting under section 460 is a special method of accounting under paragraph (c)(8)(iv) of this section. Pursuant to paragraph (c)(8)(iv) of this section, B must allocate the payment among the item(s) of gross income that are subject to section 460 and the item(s) of gross income described in paragraph (a)(1)(i)(C) of this section based on objective criteria. B's allocation is deemed to be based on objective criteria if it allocates the payment in proportion to the amounts determined under § 1.451–3(d)(5). That is, $60x to the items of gross income subject to section 460 and $40x to the items of gross income described in paragraph (a)(1)(i)(C) of this section.

(9) *Special rule relating to eligible gift card sales.* For paragraphs (a)(1)(i)(B) and (c)(1) of this section, if an eligible gift card is redeemable by an entity described in paragraph (a)(10)(ii) of this section whose financial results are not included in the taxpayer's AFS, a payment will be treated as included by the taxpayer in its AFS revenue to the extent the gift card is redeemed by such entity during the taxable year.

(10) *Examples.* The following examples illustrate the rules of paragraph (c) of this section. In each of the following examples, the taxpayer uses an accrual method of accounting for Federal income tax purposes and files its returns on a calendar year basis. In addition, the taxpayer in each example has an AFS and uses the deferral method under paragraph (c) of this section. Further, the taxpayer does not use the advance payment cost offset method in paragraph (e) of this section.

(i) *Example 1: Services.* On November 1, 2021, A, in the business of giving dancing lessons, receives an advance payment of $480 for a 1-year contract commencing on that date and providing for up to 48 individual, 1-hour lessons. A provides eight lessons in 2021 and another 35 lessons in 2022. A takes into account ⅙ ($80) of the payment as AFS revenue for 2021, and ⅚ ($400) of the payment as AFS revenue for 2022. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, A must include ⅙ ($80) of the payment in gross income for 2021, and the remaining ⅚ ($400) of the payment in gross income for 2022.

(ii) *Example 2: Services.* The same facts as in paragraph (c)(10)(i) of this section (*Example 1*) apply. A receives an advance payment of $960 for a 3-year contract under which A provides up to 96 lessons. A provides eight lessons in 2021, 48 lessons in 2022, and 40 lessons in 2023. A takes into account 1/12 ($80) of the payment as AFS revenue for 2021, ½ ($480) of the payment as AFS revenue for 2022, and 5/12 ($400) of the payment as AFS revenue for 2023. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, A must include 1/12 ($80) of the payment in gross income for 2021, and the remaining 11/12 ($880) of the payment in gross income for 2022.

(iii) *Example 3: Services.* On June 1, 2021, B, a landscape architecture firm, receives an advance payment of $100 for landscape services that, under the terms of the agreement, must be provided by December 2022. On December 31, 2021, B estimates that ¾ of the work under the agreement has been completed. B takes into account ¾ ($75) of the payment as AFS revenue for 2021, and ¼ ($25) of the payment as AFS revenue for 2022. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, B must include ¾ ($75) of the payment in gross income for 2021, and the remaining ¼ ($25) of the payment in gross income for 2022, regardless of whether B completes the job in 2022.

(iv) *Example 4: Repair contracts.* On July 1, 2021, C, in the business of selling and repairing television sets, receives an advance payment of $100 for a 2-year contract under which C agrees to repair the customer's television set. C takes into account ¼ ($25) of the payment as AFS revenue for 2021, ½ ($50) of the payment as AFS revenue for 2022, and ¼ ($25) of the payment as AFS revenue for 2023. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, C must include ¼ ($25) of the payment in gross income for 2021 and the remaining ¾ ($75) of the payment in gross income for 2022.

(v) *Example 5: Online website design.* On July 20, 2021, D, a website designer, receives an online payment of $75 to design a website for Customer to be completed on February 1, 2023. D designs and completes Customer's website on February 1, 2023. D takes into account the $75 payment for Customer's website as AFS revenue for 2023. The $75 payment D receives for Customer's website is an advance payment. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, D must include the $75 payment for the website in gross income for 2022.

(vi) *Example 6: Online subscriptions.* G is in the business of compiling and providing business information for a particular industry in an online format accessible over the internet. On September 1, 2021, G receives an advance payment from a subscriber for 1 year of access to its online database, beginning on that date. G takes into account ⅓ of the payment as AFS revenue for 2021 and the remaining ⅔ as AFS revenue for 2022. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, G must include ⅓ of the payment in gross income for 2021 and the remaining ⅔ of the payment in gross income for 2022.

(vii) *Example 7: Membership fees.* On December 1, 2021, H, in the business of operating a chain of ''shopping club'' retail stores, receives advance payments for membership fees. The membership fees are not prepaid dues income subject to section 456. Upon payment of the fee, a member is allowed access for a 1-year period to H's stores, which offer discounted merchandise and services. H takes into account 1/12 of the payment as AFS revenue for 2021 and 11/12 of the payment as AFS revenue for 2022. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, H must include 1/12 of the payment in gross income for 2021, and the remaining 11/12 of the payment in gross income for 2022.

(viii) *Example 8: Cruise.* In 2021, I, in the business of operating tours, receives $20x payments from customers for a 10-day cruise that will take place in April 2022. Under the agreement, I charters a cruise ship, hires a crew and a tour guide, and arranges for entertainment and shore trips for the customers. I takes into account the $20x payments as AFS revenue for 2022. For Federal income tax purposes, I must include the $20x payments in gross income for 2022.

(ix) *Example 9: Broadcasting rights*—(A) *Facts.* K, a professional sports franchise, is a member of a sports league that enters into contracts with television networks for the right to broadcast games to be played between teams in the league. The league entered into a 2-year broadcasting contract beginning October 1, 2021. K receives two payments of $100x on October 1 of each contract year, beginning in 2021. K estimates that for each contract year, 25% of the broadcasting rights are transferred by December 31 of the year of payment, and the remaining 75% of the broadcasting rights are transferred in the following year. K takes into account ¼ ($25x) of the first installment payment as AFS revenue for 2021 and ¾ ($75x) as AFS revenue for 2022. K takes into account ¼ ($25x) of the second payment as AFS revenue for 2022 and ¾ ($75x) as AFS revenue for 2023.

(B) *Analysis.* Each installment payment is an advance payment under paragraph (a)(1) of this section because a portion of each payment is included in AFS revenue for a subsequent taxable year and the payment relates to the use of intellectual property. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, K must include ¼ ($25x) of the first $100x installment payment in gross income for 2021 and ¾ ($75x) of the first installment payment in gross income for 2022. In addition, K must include ¼ ($25x) of the second $100x payment in gross income for 2022 and ¾ ($75x) of the second installment payment in gross income for 2023.

(x) *Example 10: Insurance claims administration*—(A) *Facts.* L is in the business of negotiating, placing, and servicing insurance coverage and administering claims for insurance companies. On December 1, 2021, L enters into a contract with an insurance company to provide property and casualty claims administration services for a 4-year period beginning January 1, 2022. Pursuant to the contract, the insurance company makes four equal annual payments to L; each payment relates to a year of service and is made during the month prior to the service year. Since L does not perform any services related to the payment prior to the service year, L does not meet the requirements of § 1.451–1(a) for the payment prior to the service year. For example, L is paid on December 1, 2021, for the service year beginning January 1, 2022. L takes into account the first payment as AFS revenue for 2022; the second payment as AFS revenue for 2023; the third payment as AFS revenue for 2024; and the fourth payment as AFS revenue for 2025.

(B) *Analysis.* Each annual payment is an advance payment under paragraph (a)(1) of this section because each payment is taken into account as AFS revenue for a subsequent taxable year and the payment relates to services. For Federal income tax purposes, under the deferral method in paragraph (c) of this section, L must include: The first payment in gross income for 2022; the second payment in gross income for 2023; the third payment in gross income for 2024; and the fourth payment in gross income for 2025.

(xi) *Example 11: internet services*—(A) *Facts.* M is a cable internet service provider that enters into contracts with subscribers to provide internet services for a monthly fee that is paid prior to the service month. For those subscribers who do not own a compatible modem, M provides a rental cable modem for an additional monthly charge, that is also paid prior to the service month. Pursuant to the contract, M will replace or repair the cable modem if it proves defective during the contract period. In December 2021, M receives $100x payments from subscribers for January 2022 internet service and cable modem use. M takes into account the entire $100x payments as AFS revenue for 2022.

(B) *Analysis.* For Federal income tax purposes, the $100x payments are advance payments. Because M uses the deferral method in paragraph (c) of this section, M must include $100x in gross income for 2022.

(xii) *Example 12: License agreement*—(A) *Facts.* On January 1, 2021, N receives a payment of $250 for entering into a 3-year license agreement for the use of N's trademark throughout the term of the agreement. The $250 payment reflects the first year (2021) license fee of $100 and the third year (2023) license fee of $150. The fee of $125 for the second year is payable on January 1, 2022. N takes into account $100 of the $250 upfront payment as AFS revenue for 2021, $125 as AFS revenue for 2022, and $150 of the $250 payment as AFS revenue for 2023.

(B) *Analysis.* For Federal income tax purposes, N received an advance payment of $150, the 2023 license fee, in 2021. Because N uses the deferral method in paragraph (c) of this section, N must defer the $150 payment and include it in gross income for 2022.

(xiii) *Example 13: Computer software subscription with one performance obligation*—(A) *Facts.* On July 1, 2021, O, in the business of licensing off the shelf, fully customized, and semi-customized computer software and providing customer support, receives a payment of $100 for a 2-year ''software subscription contract'' under which O will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. O determines that its obligations under the software subscription contract are one performance obligation for financial accounting purposes, which yields one item of gross income. O takes into account ¼ ($25) of the payment as AFS revenue for 2021, ½ ($50) as AFS revenue for 2022, and the remaining ¼ ($25) as AFS revenue for 2023, regardless of when O provides updates or customer support.

(B) *Analysis.* For Federal income tax purposes, the $100 payment is an advance payment. Because O uses the deferral method in paragraph (c) of this section, O must include ¼ ($25) of the payment in gross income for 2021 and ¾ ($75) in gross income for 2022.

(xiv) *Example 14: Gift cards administered by another*—(A) *General facts.* Q is a corporation that operates department stores and is the common parent of a consolidated group (the Q group). U, V, and W are domestic corporations wholly owned by Q and members of the Q group. X is a foreign corporation wholly owned by Q and not a member of the Q group. U sells Brand A goods, V sells Brand B goods, X sells Brand C goods, and Z is an unrelated entity that sells Brand D goods. W administers a gift card program for the members of the Q group, X, and Z. Pursuant to the underlying agreements, W issues gift cards that are redeemable for goods or services offered by U, V, X, and Z. In addition, U, V, X, and Z sell gift cards to customers on behalf of W and remit amounts received to W. The agreements provide that W is primarily liable to the customer for the value of the gift card until redemption, and U, V, X, and Z are obligated to accept the gift card as payment for goods or services. When a customer purchases goods or services with a gift card at U, V, X, or Z, W reimburses that entity for the sales price of the goods or services purchased with the gift card, up to the total gift card value.

(B) *Facts for taxable year 2021.* In 2021, W sells gift cards with a total value of $900, and, at the end of 2021, the unredeemed balance of the gift cards is $100. In Q group's AFS, the group includes revenue from the sale of a gift card when the gift card is redeemed. Accordingly, of the $900 of gift cards sold in 2021, $800 were redeemed and taken into account as AFS revenue for 2021. W tracks sales and redemptions of gift cards electronically, determines the extent to which advance payments are taken into account as AFS revenue in Q group's AFS for the taxable year of receipt and meets the requirements of paragraph (c)(1) of this section.

(C) *Analysis.* The payments W receives from the sale of gift cards are advance payments because they are payments for eligible gift cards. Under the deferral method, W must include $800 of the payments from gift card sales in gross income in 2021 and the remaining $100 of the payments in gross income in 2022.

(xv) *Example 15: Gift cards of affiliates*—(A) *Facts.* R is a Subchapter S corporation that operates an affiliated restaurant corporation and manages other affiliated restaurants. These other restaurants are owned by other Subchapter S corporations, partnerships, and limited liability companies. R has a partnership interest or an equity interest in some of the restaurants. R administers a gift card program for participating restaurants. Each participating restaurant operates under a different trade name. Under the gift card program, R and each of the participating restaurants sell gift cards, which are issued with R's brand name and are redeemable at all participating restaurants. Participating restaurants sell the gift cards to customers and remit the proceeds to R, R is primarily liable to the customer for the value of the gift card until redemption, and the participating restaurants are obligated under an agreement with R to accept the gift card as payment for food, beverages, taxes, and gratuities. When a customer uses a gift card to make a purchase at a participating restaurant, R is obligated to reimburse that restaurant for the amount of the purchase, up to the total gift card value. In R's AFS, R includes revenue from the sale of a gift card when a gift card is redeemed at a participating restaurant. R tracks sales and redemptions of gift cards electronically, is able to determine the extent to which advance payments are taken into account as AFS revenue for the taxable year of receipt and meet the requirements of paragraph (c)(1) of this section.

(B) *Analysis.* The payments R receives from the sale of gift cards are advance payments because they are payments for eligible gift card sales. For Federal income tax purposes, R is eligible to use the deferral method. Using the deferral method, in the taxable year of receipt, R must include the advance payment in income to the extent taken into account as AFS revenue and must include any remaining amount in income in the taxable year following the taxable year of receipt. Under paragraph (c)(9) of this section, R is treated as taking into account revenue from the sale of a gift card as AFS revenue when a gift card is redeemed at a participating restaurant.

(xvi) *Example 16: Gift cards for domestic and international hotels*—(A) *Facts.* S is a corporation that operates for the benefit of its franchisee members, who own and operate domestic and international individual member hotels. S administers a gift card program for its members by selling gift cards that may be redeemed for hotel rooms and food or beverages provided by any member hotel. The agreements underlying the gift card program provide that S is entitled to the proceeds from the sale of the gift cards, must reimburse the member hotel for the value of a gift card redeemed, and until redemption remains primarily liable to the customer for the value of the card. In S's AFS, S includes payments from the sale of a gift card when the card is redeemed. S tracks sales and redemptions of gift cards electronically, determines the extent to which advance payments are included in AFS revenue for the taxable year of receipt and meets the requirements of paragraph (c)(1) of this section.

(B) *Analysis.* The payments S receives from the sale of gift cards are advance payments because they are payments for eligible gift card sales. Thus, for Federal income tax purposes, S is eligible to use the deferral method. Under the deferral method, in the taxable year of receipt, S must include in income the advance payment to the extent taken into account as AFS revenue and must include any remaining amount in income in the taxable year following the taxable year of receipt.

(xvii) *Example 17: Discount voucher*—(A) *Facts.* On December 10, 2021, T, in the business of selling home appliances, sells a washing machine for $500. As part of the sale, T gives the customer a 40% discount voucher for any future purchases of T's goods up to $100 in the next 60 days. In its AFS, T treats the discount voucher as a separate performance obligation and allocates $30 of the $500 sales price to the discount voucher. T takes into account $12 of the amount allocated to the discount voucher as AFS revenue for 2021 and includes $18 of the discount voucher as AFS revenue for 2022.

(B) *Analysis.* For Federal income tax purposes, the $30 payment allocated to the discount voucher is an advance payment. Using the deferral method, T must include the $12 allocable to the discount voucher in gross income in 2021 and the remaining $18 allocated to the discount voucher in gross income in 2022.

(xviii) *Example 18: Rewards*—(A) *Facts.* On December 31, 2021, U, in the business of selling consumer electronics, sells a new TV for $1,000 and gives the customer 50 reward points. Each reward point is redeemable for a $1 discount on any future purchase of U's products. The reward points are not redeemable for cash and have a 2-year expiration date. U tracks the issue date, redemption date, and expiration date of each customer's reward points. Under the terms of U's reward program, when the customer redeems reward points they are deemed to use the earliest issued points first. In its AFS, U treats the rewards points as a separate performance obligation and allocates $50 of the $1,000 sales price to the rewards points. U is able to determine the extent to which a payment that is allocated to a reward point is taken into account in AFS revenue in the year of receipt. U does not take any of the amount allocated to the reward points into account as AFS revenue for 2021. U takes into account $25 of the reward points as AFS revenue for 2022 and $25 of the reward points as AFS revenue for 2023.

(B) *Analysis.* For Federal income tax purposes, U's treatment of the reward points as a separate performance obligation for AFS purposes yields an item of gross income that must be accounted for separately. The $50 payment allocated to the reward points item is an advance payment as the full inclusion of the payment in gross income in the year of receipt is a permissible method of accounting without regard to this section, a portion of the payment is taken into account as AFS revenue in a subsequent taxable year, and the reward points are redeemable for an item described in paragraph (a)(1)(i)(C) of this section (goods). Because the entire amount of the $50 advance payment is taken into account as AFS revenue in tax years following the year of receipt, U defers the payment and includes the $50 payment in gross income in 2022.

(xix) *Example 19: Credit card rewards*—(A) *Facts.* V issues credit cards and has a loyalty program under which cardholders earn reward points when they use V's credit card to make purchases. Each reward point is redeemable for $1 on any future purchases.

(B) *Analysis.* Payments under credit card agreements, including rewards for credit card purchases, are excluded from the definition of an advance payment under paragraph (a)(1)(ii)(C) of this section. Accordingly, V cannot use the deferral method for these amounts.

(xx) *Example 20: Airline reward miles*—(A) *Facts.* On January 1, 2021, W, a passenger airline company, sells a customer a $700 airline ticket to fly roundtrip in 2021. As part of the purchase, the customer receives 7,000 reward points (air miles) from W to be used for future air travel. The reward points are not redeemable for cash and have a 2-year expiration date. W tracks the issue date, redemption date, and expiration date of each customer's reward points. Under the terms of U's reward program, when the customer redeems reward points they are deemed to use the earliest issued points first. In its AFS, W treats the rewards points as a separate performance obligation and allocates $35 of the $700 ticket price to the reward points. W is able to determine the extent to which a payment that is allocated to a reward point is taken into account in AFS revenue in the year of receipt. W takes into account all $35 as AFS revenue in 2023 when the customer redeems the air miles.

(B) *Analysis.* For Federal income tax purposes, W's treatment of the reward points as a separate performance obligation for AFS purposes yields an item of gross income that must be accounted for separately. The $35 allocated to the reward points item is an advance payment as the full inclusion of the payment in gross income in the taxable year of receipt is a permissible method of accounting without regard to this section, a portion of the payment is taken into account as AFS revenue in a subsequent taxable year, and the reward points are redeemable for an item described in paragraph (a)(1)(i)(C) of this section (services). Because the entire amount of the $35 advance payment is taken into account as AFS revenue in a tax year following the year of receipt, W defers the payment and includes the $35 payment in gross income in 2022.

(xxi) *Example 21: Chargebacks*—(A) *Facts.* In 2021, X, a manufacturer of pharmaceuticals, enters into a contract to sell 1,000 units to W, a wholesaler, for $10 per unit, totaling $10,000 (1,000 × $10 = $10,000). The contract also provides that X will credit W $4 per unit (chargeback) for sales W makes to qualifying customers. X delivers 600 units to W on December 31, 2021, and bills W $6,000 under the contract. X anticipates that all of W's sales will be to qualifying customers and subject to chargeback. For AFS purposes, X adjusts its 2021 AFS revenue of $6,000 by $2,400, the anticipated chargebacks, and reports $3,600 of AFS revenue.

(B) *Analysis.* For Federal income tax purposes, under paragraph (a)(1)(i)(B) of this section, for a payment to qualify as an advance payment, a portion of the payment must be taken into account as AFS revenue for a subsequent taxable year. Under paragraph (a)(1)(i)(B) of this section, the amount of the payment included in AFS revenue for a subsequent taxable year is $0, calculated as the $6,000 payment reduced by $6,000 that is treated as taken into account as AFS revenue for 2021 ($3,600 of AFS revenue for 2021 + $2,400 of anticipated chargebacks (section 461 liabilities) which had reduced AFS revenue for 2021). Because no portion of the $6,000 is taken into account as AFS revenue in a subsequent taxable year (that is, on an AFS after 2021), the $6,000 payment received in 2021 is not an advance payment under paragraph (a)(1)(i) of this section.

(d) *Deferral method for taxpayers without an AFS (non-AFS deferral method)*—(1) *In general.* Only a taxpayer described in paragraph (d)(2) of this section may elect to use the non-AFS deferral method of accounting described in paragraph (d)(4) of this section.

(2) *Taxpayers eligible to use the non-AFS deferral method.* A taxpayer is eligible to use the non-AFS deferral method if the taxpayer does not have an applicable financial statement and can determine the extent to which advance payments are earned in the taxable year of receipt and, if applicable, a short taxable year described in paragraph (d)(6) of this section. The determination whether the advance payment is earned in the taxable year of receipt, or a short taxable year described in paragraph (d)(6) of this section, if applicable, is determined on an item by item basis.

(3) *Deferral of advance payments based on when payment is earned*—(i) *In general.* Except as otherwise provided in this section, a taxpayer that uses the non-AFS deferral method of accounting includes the advance payment in gross income for the taxable year of receipt to the extent that it is earned in that taxable year and includes the remaining portion of the advance payment in gross income in the next succeeding taxable year.

(ii) *When payment is earned.* Under the non-AFS deferral method, a payment is earned when the all events test described in § 1.451–1(a) is met, without regard to when the amount is received, as defined under paragraph (a)(14) of this section, by the taxpayer. If a taxpayer is unable to determine the extent to which a payment is earned in the taxable year of receipt, or a short taxable year described in paragraph (d)(6) of this section, if applicable, the taxpayer may calculate the amount:

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

(B) On a straight-line basis over the term of the agreement if the taxpayer receives the advance payment under a fixed term agreement and if it is reasonable to anticipate at the end of the taxable year of receipt that the advance payment will be earned ratably over the term of the agreement; or

(C) Using any other method that may be provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter).

(4) *Contracts with multiple items of gross income*—(i) *In general.* If a taxpayer receives a payment that is attributable to one or more items described in paragraph (a)(1)(i)(C) of this section, the taxpayer must determine the portion of the payment that is allocable to such item(s) by using an allocation method that is based on objective criteria.

(ii) *Objective criteria.* A taxpayer's allocation method for a payment described in paragraph (d)(4)(i) of this section is deemed to be based on objective criteria if the allocation method is based on payments the taxpayer receives for an item or items it regularly sells or provides separately or any method that may be provided in guidance published in the Internal Revenue Bulletin (see § 601.601(d) of this chapter).

(5) *Acceleration of advance payments.* The acceleration rules in paragraph (c)(4) of this section also apply to a taxpayer that uses the non-AFS deferral method under paragraph (d) of this section.

(6) *Short taxable year rule.* If the taxpayer's next succeeding taxable year is a short taxable year, other than a taxable year in which the taxpayer dies or ceases to exist in a transaction other than a transaction to which section 381(a) applies, and the short taxable year consists of 92 days or less, a taxpayer using the non-AFS deferral method must include the portion of the advance payment not included in the taxable year of receipt in gross income for the short taxable year to the extent earned in such taxable year. Any amount of the advance payment not included in gross income in the taxable year of receipt, or the short taxable year, must be included in gross income for the taxable year immediately following the short taxable year.

(7) *Eligible gift card sale.* For paragraphs (a)(1)(i)(B) and (d)(3) of this section, if an eligible gift card is redeemable by an entity described in paragraph (a)(10)(ii) of this section, including an entity whose financial results are not included in the taxpayer's financial statement, a payment will be treated as earned by the taxpayer to the extent the gift card is redeemed by such entity during the taxable year.

(8) *Examples.* The following examples illustrate the rules of paragraph (d) of this section. In the examples in this paragaph (d)(8), the taxpayer is a calendar year taxpayer that uses the non-AFS deferral method described in paragraph (d) of this section. None of the taxable years are short taxable years.

(i) *Example 1*—(A) *Facts.* A, a video arcade operator, receives payments in 2021 for tokens that customers use to play A's arcade games. The tokens cannot be redeemed for cash, are imprinted with the name of the arcade, but are not individually marked for identification. A completed a study on a statistical basis, based on adequate data available to A, and concluded that for payments received in 2021, 70% of tokens are expected to be used in 2021, 20% of tokens are expected to be used in 2022, and 10% of tokens are expected to never be used. Based on the study, under paragraph (d)(3)(ii)(A) of this section, A determines that 80% of the advance payments are earned for 2021 (70% for tokens expected to be used in 2021 plus 10% for tokens that are expected to never be used).

(B) *Analysis.* For Federal income tax purposes, A must include 80% of the advance payments in gross income for 2021 and 20% of the advance payments in gross income for 2022.

(ii) *Example 2*—(A) *Facts.* B is in the business of providing internet services. On September 1, 2021, B receives an advance payment from a customer for a 2-year term for access to its internet services, beginning on that date. B does not have an AFS. B is unable to determine the extent to which the payment is earned in the taxable year of receipt. However, at the close of the 2021 taxable year, it is reasonable for B to anticipate that the advance payment will be earned ratably over the term of the agreement.

(B) *Analysis.* For Federal income tax purposes, pursuant to paragraph (d)(3)(ii)(B) of this section, B determines the extent to which the payment is earned in tax year 2021 on a straight-line basis over the term of the agreement and takes that amount into income in 2021. The remaining amount of the advance payment is taken into gross income in the 2022 taxable year.

(e) *Advance payment cost offset method*—(1) *In general.* This paragraph (e) provides an optional method of accounting for advance payments from the sale of inventory (advance payment cost offset method). A taxpayer that chooses to use the advance payment cost offset method for a trade or business must use the method of accounting for all advance payments received by that trade or business that meet the criteria in this paragraph (e). Additionally, a taxpayer that chooses to use this method for a trade or business and that has an AFS must also use the AFS cost offset method described in § 1.451–3(c). A taxpayer that uses the AFS cost offset method and the advance payment cost offset method to account for gross income, including advance payments, from the sale of an item of inventory, determines the corresponding AFS income inclusion amount, as defined in § 1.451–3(a)(1), and the advance payment income inclusion amount for a taxable year by following the rules in § 1.451–3(c)(2) rather than the rules under this paragraph (e). However, if all payments received for the sale of item of inventory meet the definition of an advance payment under paragraph (a)(1) of this section, a taxpayer that uses the advance payment cost offset method determines the corresponding advance payment income inclusion amount for a taxable year by:

(i) Following the rules in paragraph (e)(2) of this section, subject to the additional rules and limitations in paragraphs (e)(5) through (8) of this section, if the taxable year is a taxable year prior to the taxable year in which ownership of the item of inventory is transferred to the customer; and

(ii) Following the rules in paragraph (e)(3) of this section, subject to the additional rules and limitations in paragraphs (e)(5) through (8) of this section, if the taxable year is the taxable year in which ownership of the item of inventory is transferred to the customer.

(2) *Determining the advance payment income inclusion amount in a year prior to the year of sale.* To determine the advance payment income inclusion amount for a taxable year prior to the year in which ownership of the item of inventory is transferred to the customer, the taxpayer must first determine the advance payment inventory inclusion amount for such item for such year. This advance payment inventory inclusion amount is then reduced by the cost of goods in progress offset for the taxable year, as determined under paragraphs (e)(4), (5), and (8) of this section. This net amount is the advance payment income inclusion amount for the taxable year.

(3) *Determining the advance payment income inclusion amount in the year of sale.* The advance payment income inclusion amount for the taxable year in which ownership of the item of inventory is transferred to the customer is equal to the portion of any advance payment for such item that was not required to be included in gross income in a prior taxable year. This amount is not reduced by a cost of goods in progress offset under paragraph (e)(4) of this section. However, the taxpayer is entitled to recover the costs capitalized to the item of inventory as cost of goods sold in accordance with sections 471 and 263A or any other applicable provision of the Internal Revenue Code. See § 1.61–3.

(4) *Cost of goods in progress offset.* The cost of goods in progress offset for the taxable year is calculated as:

(i) The cost of goods allocable to the item of inventory through the last day of the taxable year; reduced by

(ii) The cumulative cost of goods in progress offset attributable to the item of inventory, if any.

(5) *Limitations to the cost of goods in progress offset.* The cost of goods in progress offset is determined separately for each item of inventory. The cost of goods in progress offset attributable to one item of inventory cannot reduce the advance payment inventory inclusion amount attributable to a different item of inventory. Further, the cost of goods in progress offset cannot reduce the advance payment inventory inclusion amount for the taxable year below zero.

(6) *Exception for gift cards.* The cost of goods in progress offset in this paragraph (e) does not apply to eligible gift card sales or payments received for customer reward points.

(7) *Acceleration of advance payments.* The acceleration rules in paragraph (c)(4) of this section also apply to a taxpayer that uses the advance payment cost offset method under this paragraph (e), regardless of whether the taxpayer uses such method in connection with the full inclusion method under paragraph (b) of this section, or the deferral method under paragraph (c) or (d) of this section. If an advance payment is subject to the acceleration rules, paragraph (e)(2) of this section does not apply to determine the advance payment income inclusion amount for the taxable year described in paragraph (c)(4) of this section. Further, a taxpayer that uses the advance payment cost offset method under this paragraph (e) applies paragraph (c)(4)(i)(B)(*2*)(*ii*) of this section by substituting ''same advance payment method as the transferor'' for ''deferral method.''

(8) *Inventory costs for the advance payment cost offset method*—(i) *Inventory costs not affected by cost of goods in progress offset.* The cost of goods comprising the cost of goods in progress offset does not reduce the costs that are capitalized to the items of inventory produced or items of inventory acquired for resale by the taxpayer. While the cost of goods in progress offset reduces the amount of the advance payment inventory inclusion amount, the cost of goods in progress offset does not affect how and when costs are capitalized to inventory under sections 471 and 263A or any other applicable provision of the Internal Revenue Code or when those capitalized costs will be recovered.

(ii) *Consistency between inventory methods and advance payment cost offset method.* The costs of goods comprising the cost of goods in progress offset must be determined by applying the taxpayer's methods of accounting for inventory for Federal income tax purposes. A taxpayer using the advance payment cost offset method must calculate its cost of goods in progress offset by reference to all costs that the taxpayer has permissibly capitalized and allocated to items of inventory under its methods of accounting for inventory for Federal income tax purposes, but including no more costs than what the taxpayer has permissibly capitalized and allocated to items of inventory.

(iii) *Allocation of ''additional section 263A costs'' for taxpayers using simplified methods.* If a taxpayer uses the simplified production method as defined under § 1.263A–2(b), the modified simplified production method as defined under § 1.263A–2(c), or the simplified resale method as defined under § 1.263A–3(d) to determine the amount of its ''additional section 263A costs,'' as defined under § 1.263A–1(d)(3), to be included in ending inventory, then solely for computing the cost of goods in progress offset, the taxpayer must determine the portion of additional section 263A costs allocable to an item of inventory by multiplying its total additional section 263A costs accounted for under the simplified method for all items of inventory subject to the simplified method by the following ratio:

$$\frac{\text{Section 471 costs allocable to the specific item of inventory}}{\text{Total section 471 costs for all items of inventory subject to the simplified method}}$$

(9) *Additional procedural guidance.* The IRS may publish procedural guidance in the Internal Revenue Bulletin (see § 601.601(d) of this chapter) that provides alternative procedures for complying with the rules under this paragraph (e), including alternative methods of accounting for cost offsets.

(10) *Examples.* The following examples illustrate the rules of paragraph (e) of this section. In each of the following examples, the taxpayer is a C corporation, has an AFS, uses an accrual method of accounting for Federal income tax purposes, and uses a calendar year for Federal income tax purposes and AFS purposes. In addition, in each example, the taxpayer uses the deferral method and the advance payment cost offset method under paragraph (e) of this section. Lastly, the taxpayer does not produce unique items, as described in § 1.460–2(a)(1) and (b), or any item that normally requires more than 12 calendar months to complete, as determined under § 1.460–2(a)(2) and (c). Any production period that exceeds 12 calendar months is due to unforeseen production delays.

(i) *Example 1*—(A) *Facts.* In December 2021, A enters into a contract with Customer to manufacture and deliver a good in 2024, with a total contract price of $100x. The costs to produce the good are required to be capitalized under sections 471 and 263A as the good is inventory in the hands of A. On the same day, A receives a payment of $40x from the customer. For its AFS, A reports all of the revenue from the sale of the good as AFS revenue in the year of delivery, which is also the year in which ownership of the good transfers from A to Customer. As of December 31, 2021, A has not incurred any cost to manufacture the good. The payment of $40x does not satisfy the specified good exception in paragraph (a)(1)(ii)(H) of this section, and thus qualifies as an advance payment. During 2022, A does not receive any additional payments on the contract and incurs $10x of costs to manufacture the good. A properly capitalizes and allocates such costs to the manufactured good under sections 471 and 263A.

(B) *Analysis.* Because no portion of the $40x advance payment is taken into account as AFS revenue as of the end of 2021, A is not required to include any portion of the advance payment in gross income for 2021. For 2022, A's advance payment inventory inclusion amount is $40x, which is the amount of the advance payment that, but for the cost of goods in progress offset, would be includable in gross income in 2022 under the deferral method. Pursuant to paragraph (e)(2) of this section, A reduces such amount by the $10x cost of goods in progress offset, determined as the costs of goods through the end of 2022 ($0 costs incurred in 2021 plus 10x of costs incurred in 2022 = $10x). A is required to include this net amount of $30x in gross income in 2022. The remaining portion of the payment ($10x) is deferred and included in gross income in 2024, the taxable year in which ownership of the good is transferred to Customer.

(ii) *Example 2*—(A) *Facts.* The same facts as in paragraph (e)(10)(i) of this section (*Example 1*) apply. In addition, in 2023, A incurs costs of $20x to manufacture the good but does not receive any additional payments from Customer.

(B) *Analysis.* A includes $0 in gross income in 2023. A's cost of goods in progress offset for 2023 is $20x under paragraph (e)(4) of this section ($30x costs of goods through the last day of 2023 ($10x for 2022 plus $20x for 2023 = $30x) less $10x cumulative cost of goods in progress offset amounts taken in prior taxable years). However, because A's advance payment inventory inclusion amount for 2023 is $0, which is the amount of the advance payment that, but for the cost of goods in progress offset, would be includable in gross income in 2023 under the deferral method, paragraph (e)(5) of this section limits the cost offset to $0.

(iii) *Example 3*—(A) *Facts.* The same facts as in paragraph (e)(10)(i) of this section (*Example 1*) apply, except that in taxable year 2022, A incurs additional costs of $25x to manufacture the good, resulting in total costs of $35x to manufacture the good in taxable year 2022.

(B) *Analysis.* For 2022, A's advance payment inventory inclusion amount is $40x, which is the amount of the advance payment that, but for the cost of goods in progress offset, would be includable in gross income in 2022 under the deferral method. Pursuant to paragraph (e)(2) of this section A reduces such amount by the $35x cost of goods in progress offset, determined as the costs of goods through the end of 2022 ($0 costs incurred in 2021 plus $35x costs incurred in 2022 = $35x). A is required to include this net amount of $5x in gross income in 2022. The remaining portion of the payment ($35x) is deferred and included in gross income in 2024, the taxable year in which ownership of the good is transferred to the customer.

(iv) *Example 4*—(A) *Facts.* The same facts as in paragraph (e)(10)(iii) of this section (*Example 3*) apply, except that for tax year 2023, A receives an additional advance payment of $60x, and does not incur any costs to manufacture the good in 2023. In 2024, A incurs the remaining $10x to manufacture the good, and delivers the good to Customer.

(B) *Analysis for 2023.* Because no portion of the $60x advance payment is taken into account as AFS revenue as of the end of 2023, A is not required to include any portion of the $60x advance payment in gross income for 2023.

(C) *Analysis for 2024.* In 2024, the ownership of the good is transferred to Customer. Accordingly, pursuant to paragraph (e)(3) of this section, A is required to include $95x, the remaining portion of all advance payments that were not required to be included in gross income in a prior taxable year ($100x of total advance payments received less $5x that was required to be included in gross income in 2022). Although A does not reduce such amount by a cost offset, it reduces gross income in 2024 by recovering the $45x of costs capitalized to inventory as cost of goods sold ($35x costs incurred in 2022 plus $10x costs incurred in 2024) in accordance with sections 471 and 263A. Accordingly, A's gross income for 2024 is $50x.

(f) *Method treating payments qualifying for the specified goods exception as advance payments*—(1) *In general.* A taxpayer may choose to use the *specified good section 451(c)* *method* to treat all payments that qualify for the specified goods exception in paragraph (a)(1)(ii)(H) of this section as advance payments that are eligible to be accounted for under this section. Under the specified good section 451(c) method, an advance payment is a payment received by the taxpayer in a taxable year earlier than the taxable year immediately preceding the taxable year of the contractual delivery date for a specified good. A taxpayer that chooses to use the specified good section 451(c) method for a trade or business must apply this method of accounting for all advance payments that meet the criteria described in paragraph (a)(1)(ii)(H) of this section.

(2) *Example: Method for the specified goods exception to not apply.* On May 1, 2021, A, a corporation that files its Federal income tax return on the calendar year basis, receives a prepayment for $100x, for a contract to manufacture and deliver a good in September of 2023. All of the revenue from the sale of the good is recognized in A's AFS in the year of delivery. During 2021, A does not have on hand, or available to it in such year through its normal source of supply, goods of a substantially similar kind and in a sufficient quantity to satisfy the contract to transfer the good to the customer. The payment of $100x satisfies the specified good exception. A uses the method under paragraph (f) of this section to treat all payments that otherwise satisfy the specified good exception as advance payments under this section. For Federal income tax purposes, A must treat the payment of $100x as an advance payment and account for such payment under the full inclusion method in paragraph (b) of this section, or the deferral method in paragraph (c) of this section, as applicable. Additionally, the taxpayer may choose to apply the advance payment cost offset method in paragraph (e) of this section.

(g) *Election and methods of accounting*—(1) *Procedures for making election under section 451(c)(1)(B).* An election to apply the deferral method under section 451(c)(1)(B) is made by the taxpayer filing a Federal income tax return reflecting the deferral method in computing its taxable income. If the application of the deferral method under section 451(c)(1)(B) results in the taxpayer changing its method of accounting, the election may only be made by the taxpayer complying with the method change procedures under this paragraph (g).

(2) *Methods of accounting.* A change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations in this part under sections 446 and 481 of the Code apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with § 1.446–1(e) and follow the administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method. For example, use of the full inclusion method under paragraph (b) of this section, the AFS deferral method under paragraph (c) of this section, the non-AFS deferral method under paragraph (d) of this section, the advance payment cost offset method under paragraph (e) of this section, and the specified good section 451(c) method under paragraph (f) of this section are adoptions of, or changes in, a method of accounting under section 446 of the Internal Revenue Code or the regulations in this part under section 446 of the Code. In addition, a change in the manner of recognizing advance payments in revenue in an AFS that changes or could change the timing of the inclusion of income for Federal income tax purposes is a change in method of accounting under section 446 and the regulations in this part under section 446 of the Code.

(h) *Applicability date*—(1) *In general.* The rules of this section apply to taxable years beginning on or after January 1, 2021.

(2) *Early application.* Taxpayers and their related parties, within the meaning of sections 267(b) and 707(b), may apply both the rules in this section and, to the extent relevant, the rules in § 1.451–3, in their entirety and in a consistent manner, to a taxable year beginning after December 31, 2017, and before January 1, 2021, provided that, once applied to a taxable year, the rules in this section and, to the extent relevant, the rules in § 1.451–3, are applied in their entirety and in a consistent manner to all subsequent taxable years. See section 7805(b)(7) and § 1.451–3(m).

■ **Par. 7.** Section 1.1271–0 is amended by adding entries for § 1.1275–2(l) and (l)(1) and (2) to read as follows:

§ 1.1271–0 Original issue discount; effective date; table of contents.

* * * * *

§ 1.1275–2 Special rules relating to debt instruments.

* * * * *

(l) *OID rule for income item subject to section 451(b).*

(1) In general.

(2) Applicability dates.

* * * * *

■ **Par. 8.** 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 because the item of income is a specified fee described in § 1.451–3(j) (such as 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 paragraph (l)(2)(ii) and (iii) of this section, for a specified credit card fee as defined in § 1.451–3(j)(2), paragraph (l)(1) of this section applies for taxable years beginning on or after January 1, 2021, and, for a specified fee that is not a specified credit card fee, paragraph (l)(1) of this section applies for taxable years beginning on or after January 6, 2022.

(ii) *Early application.* For a taxable year beginning after December 31, 2018, and before January 1, 2021, a taxpayer and its related parties, within the meaning of sections 267(b) and 707(b), may choose to apply both paragraph (l)(1) of this section and the rules in § 1.451–3, in their entirety and in a consistent manner, to all specified credit card fees subject to § 1.451–3, provided that once applied to a taxable year the rules in paragraph (l)(1) of this section and the rules in § 1.451–3 that apply to specified credit card fees, are applied in their entirety and in a consistent manner for all subsequent taxable years. See section 7508(b)(7).

(iii) *Applicability date for accounting method changes.* Paragraph (l)(1) of this section will not apply in applying section 13221(e) of Public Law 115–97, 131 Stat. 2054 (2017), 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 for a specified credit card fee.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

Approved: December 14, 2020.

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).

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