(3) Will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Incorporation by reference, Safety.

The Proposed Amendment

Accordingly, under the authority delegated to me by the Administrator, the FAA proposes to amend 14 CFR part 39 as follows:

PART 39—AIRWORTHINESS DIRECTIVES

■ 1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 106(g), 40113, 44701.

§ 39.13 [Amended]

■ 2. The FAA amends § 39.13 by adding the following new airworthiness directive (AD):

328 Support Services GmbH (Type Certificate Previously Held by AvCraft Aerospace GmbH; Fairchild Dornier GmbH; Dornier Luftfahrt GmbH): Docket No. FAA–2019–0674; Product Identifier 2019–NM–079–AD.

(a) Comments Due Date

The FAA must receive comments by October 24, 2019.

(b) Affected ADs

None.

(c) Applicability

This AD applies to 328 Support Services GmbH Model 328–100 airplanes, certificated in any category, serial numbers 3032 through 3063 inclusive.

(d) Subject

Air Transport Association (ATA) of America Code 57, Wings.

(e) Reason

This AD was prompted by a report of missing rivets on landing flap support arm 2. The FAA is issuing this AD to address missing rivets, which could lead to the loss of one of two load paths, reducing the fatigue life of the affected flap arms and leading to fatigue cracking of the support arms of the flaps, which could result in reduced structural integrity of the airplane.

(f) Compliance

Comply with this AD within the compliance times specified, unless already done.

(g) Requirements

Except as specified in paragraph (h) of this AD: Comply with all required actions and compliance times specified in, and in accordance with, European Union Aviation Safety Agency (EASA) AD 2019–0096, dated April 30, 2019 (''EASA AD 2019–0096'').

(h) Exceptions to EASA AD 2019–0096

(1) For purposes of determining compliance with the requirements of this AD: Where EASA AD 2019–0096 refers to its effective date, this AD requires using the effective date of this AD.

(2) The ''Remarks'' section of EASA AD 2019–0096 does not apply to this AD.

(i) Corrective Action for Cracking

If any crack is found during any inspection required by paragraph (2) of EASA AD 2019–0096: Before further flight, repair using a method approved by the Manager, International Section, Transport Standards Branch, FAA; or the EASA; or 328 Support Services GmbH's EASA Design Organization Approval (DOA). If approved by the DOA, the approval must include the DOA-authorized signature.

(j) No Reporting Requirement

Although the service information referenced in EASA AD 2019–0096 specifies to submit certain information to the manufacturer, this AD does not include that requirement.

(k) Other FAA AD Provisions

The following provisions also apply to this AD:

(1) *Alternative Methods of Compliance (AMOCs):* The Manager, International Section, Transport Standards Branch, FAA, has the authority to approve AMOCs for this AD, if requested using the procedures found in 14 CFR 39.19. In accordance with 14 CFR 39.19, send your request to your principal inspector or local Flight Standards District Office, as appropriate. If sending information directly to the International Section, send it to the attention of the person identified in paragraph (l)(2) of this AD. Information may be emailed to: *9-ANM-116-AMOC-REQUESTS@faa.gov*. Before using any approved AMOC, notify your appropriate principal inspector, or lacking a principal inspector, the manager of the local flight standards district office/certificate holding district office.

(2) *Contacting the Manufacturer:* For any requirement in this AD to obtain instructions from a manufacturer, the instructions must be accomplished using a method approved by the Manager, International Section, Transport Standards Branch, FAA; or EASA; or 328 Support Services GmbH's EASA DOA. If approved by the DOA, the approval must include the DOA-authorized signature.

(l) Related Information

(1) For information about EASA AD 2019–0096, contact the EASA, Konrad-Adenauer-Ufer 3, 50668 Cologne, Germany; phone: +49 221 89990 6017; email: *ADs@easa.europa.eu;* Internet: *www.easa.europa.eu*. You may find this EASA AD on the EASA website at *https://ad.easa.europa.eu*. You may view this EASA AD at the FAA, Transport Standards Branch, 2200 South 216th St., Des Moines, WA. For information on the availability of this material at the FAA, call 206–231–3195. EASA AD 2019–0096 may be found in the AD docket on the internet at *http://www.regulations.gov* by searching for and locating Docket No. FAA–2019–0674.

(2) For more information about this AD, contact Todd Thompson, Aerospace Engineer, International Section, Transport Standards Branch, FAA, 2200 South 216th St., Des Moines, WA 98198; phone and fax: 206–231–3228.

Issued in Des Moines, Washington, on August 30, 2019.

Michael Kaszycki,

Acting Director, System Oversight Division, Aircraft Certification Service.

[FR Doc. 2019–19297 Filed 9–6–19; 8:45 am]

BILLING CODE 4910–13–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–104554–18]

RIN 1545–B078

Advance Payments for Goods, Services, and Other Items

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the timing of income inclusion under section 451 of the Internal Revenue Code (Code) of advance payments for goods, services, and certain other items. The proposed regulations reflect changes made by the Tax Cuts and Jobs Act. These proposed regulations affect taxpayers that use an accrual method of accounting and receive advance payments.

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

ADDRESSES: Submit electronic submissions via the Federal eRulemaking Portal at *www.regulations.gov* (indicate IRS and REG–104554–18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment received to its public docket, whether submitted electronically or in hard copy. Send hard copy submissions to Internal Revenue Service, CC:PA:LPD:PR (REG–104554–18), Room 5205, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to Courier's Desk, Internal Revenue Service, CC:PA:LPD:PR (REG–104554–18), 1111 Constitution Avenue NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning this proposed regulation, Peter E. Ford, (202) 317–7003; concerning submission of comments or a request for a public hearing, Regina L. Johnson, (202) 317–6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 451(c). On December 22, 2017, section 451(c) was amended by section 13221 of the Tax Cuts and Jobs Act, Public Law 115–97 (131 Stat. 2054) (the Act), to provide that a taxpayer using an accrual method of accounting (accrual method taxpayer) with an applicable financial statement (AFS) may use the deferral method of accounting provided in section 451(c) for advance payments. These proposed regulations also provide a deferral method of accounting for taxpayers that do not have an AFS. Unless otherwise indicated, all references to section 451(c) in this preamble are to section 451(c), as amended by the Act.

In general, section 451 provides that the amount of any item of gross income is included in gross income for the taxable year in which it is received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Under § 1.451–1, accrual method taxpayers generally include items of income in gross income in the taxable year when all the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy (the all events test). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. See Revenue Ruling 2003–10 (2003–1 CB 288); Revenue Ruling 84–31 (1984–1 CB 127); Revenue Ruling 80–308 (1980–2 CB 162). Section 451(c) requires an accrual method taxpayer who receives an advance payment to include the amount thereof in income in the taxable year of receipt. Section 451(c) also generally codifies the current deferral method of accounting for certain advance payments for goods, services, and other specified items provided by the IRS under Revenue Procedure 2004–34 (2004–22 IRB 991) by allowing accrual method taxpayers to elect to defer the inclusion of income associated with certain advance payments to the taxable year following the taxable year of receipt if such income also is deferred for AFS purposes.

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

Explanation of Provisions

These proposed regulations describe and clarify the statutory requirements of section 451(c) by providing new § 1.451–8.

1. Deferral Methods Under § 1.451–8

A. AFS Deferral Method

Consistent with section 451(c)(1)(A), these proposed regulations provide that an accrual method taxpayer with an AFS includes an advance payment in gross income in the taxable year of receipt unless the taxpayer uses the deferral method in section 451(c)(1)(B) and proposed § 1.451–8(c) (AFS deferral method). A taxpayer using the AFS deferral method must have an AFS, as described in section 451(b)(1)(A)(i) or (ii). These proposed regulations define the term AFS by reference to the definition of that term in proposed § 1.451–3(c)(1) (REG–104870–18). Under the AFS deferral method, a taxpayer with an AFS that receives an advance payment must include: (i) The advance payment in income in the taxable year of receipt, to the extent that it is included in revenue in its AFS, and (ii) the remaining amount of the advance payment in income in the next taxable year. The AFS deferral method provided in these proposed regulations closely follows the deferral method of Revenue Procedure 2004–34, as modified by Revenue Procedure 2011–14 (2011–4 IRB 330), and as modified and clarified by Revenue Procedure 2011–18 (2011–5 IRB 443), and Revenue Procedure 2013–29 (2013–33 IRB 141) (Revenue Procedure deferral method). Because new section 451(c)(1)(B) was intended to generally codify the Revenue Procedure deferral method, the Treasury Department and the IRS believe that rules similar to the Revenue Procedure deferral method are necessary and appropriate for the proper application of section 451(c). *See* H.R. Rep. No. 115–466, at 429 (2017) (Conf. Rep.).

B. Non-AFS Deferral Method

Section 451(c)(4)(A) generally defines an advance payment as any payment the full inclusion of which in gross income of the taxpayer for the year of receipt is a permissible method of accounting, any portion of which is included in revenue by the taxpayer in an AFS, and which is for goods, services, or other items identified by the Secretary. One commenter noted that the financial statement requirement within the definition of an advance payment means that the rule in Revenue Procedure 2004–34 that depended on determining when the advance payment was earned was not within the statutory text of section 451(c). The Treasury Department and the IRS have concluded that section 451(c) does not prohibit a deferral method that is otherwise permissible under Revenue Procedure 2004–34. *See* H.R. Rep. No. 115–466, at 429 (2017) (Conf. Rep.). See also, Joint Committee on Taxation, General Explanation of Public Law 115–97 (JCS–1–18) at 170–171 (Dec. 20, 2018). Revenue Procedure 2004–34 permitted non-AFS taxpayers to use the Revenue Procedure deferral method based on when the income is earned (earned standard). *See* section 5.02(3)(b) of Revenue Procedure 2004–34. The Revenue Procedure deferral method using the earned standard is a permissible method of accounting for non-AFS taxpayers and, therefore, these proposed regulations also provide a similar deferral method for non-AFS taxpayers in proposed § 1.451–8(d) (non-AFS deferral method). Under the non-AFS deferral method, an accrual method taxpayer without an AFS that receives an advance payment must include: (i) The advance payment in income in the taxable year of receipt, to the extent that it is earned, and (ii) the remaining amount of the advance payment in income in the next taxable year.

2. Definition of Advance Payment

A. In General

Section 451(c)(4)(A) generally defines advance payment as any payment (i) the full inclusion of which in gross income of the taxpayer for the taxable year of receipt is a permissible method of accounting, (ii) any portion of which is included in revenue by the taxpayer in an AFS (or such other financial statement as the Secretary may specify) for a subsequent taxable year, and (iii) which is for goods, services, or such other items as may be identified by the Secretary.

Proposed § 1.451–8(b)(1)(i) clarifies that the definition of advance payment under the AFS and non-AFS deferral methods is consistent with the definition of advance payment in Revenue Procedure 2004–34, which section 451(c) was meant to codify. See H.R. Rep. No. 115–466, at 429 (2017) (Conf. Rep.). The Treasury Department and the IRS believe this definition of advance payment: (1) Is consistent with section 451(c), (2) minimizes additional tax compliance burden and cost, (3) provides clarity to taxpayers, and (4) uses rules which are familiar to both taxpayers and the IRS.

Two commenters suggested that airline miles be explicitly included in the list of items for which an advance payment may be received. The commenters suggested that airline miles are a unique type of item, generally redeemed for air travel and non-travel rewards. The Treasury Department and the IRS decline to specifically include airline miles in the definition of advance payment because the use of the deferral method under these proposed regulations, to the extent airline miles are redeemable for goods or services, is already permissible. Therefore, these proposed regulations include examples to illustrate that, to the extent certain reward points are treated as separate performance obligations, they may be eligible for the deferral methods provided under these proposed regulations.

Another commenter suggested that progress payments with respect to the sale of an interest in real property should be included in the definition of an advance payment. Revenue Procedure 2004–34 was intended to provide a simplified and consistent deferral period for the sale of goods, services, and other items. However, the definition of advance payment in Revenue Procedure 2004–34 does not include prepayments for interests in real property. These proposed regulations generally provide the same types of items in the definition of advance payment to those items provided in Revenue Procedure 2004–34. However, the Treasury Department and IRS will consider any comments received in determining whether it is appropriate to include additional types of items in the definition of advance payment.

B. Items Excluded From the Definition of an Advance Payment

Section 451(c)(4)(B) provides that certain items, except as otherwise provided by the Secretary, are to be excluded from the definition of an advance payment. Pursuant to section 451(c)(4)(B), the term advance payment does not 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.

Several commenters requested that certain payments for certain types of goods be excluded from the definition of an advance payment under section 451(c)(4)(B). A commenter requested that certain pre-delivery payments for the sale of high-value customer-configured equipment that will be delivered to customers at reasonably certain times not be included in the definition of advance payment. Another commenter requested that an exclusion be provided for goods for which (i) a taxpayer receives a payment in a taxable year with respect to a contract for the sale of goods not properly includible in such taxpayer's finished goods inventory, and (ii) on the last day of such taxable year 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 during such contract year. This commenter suggested a narrowing of this exclusion could be done according to whether a good is commercially significant or of high-value. A commercially significant good has a useful life equal to or in excess of 10 years and it is developed, marketed, and sold to customers in the aerospace industry. Generally these goods require a significant amount of capital to produce and 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 to the customer and title and risk of loss have transferred to the customer.

Proposed § 1.451–8(b)(1)(ii) provides a list of items excluded from the definition of advance payment that is similar to Revenue Procedure 2004–34. An additional exclusion is provided for 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, as defined in § 1.451–8(b)(9). In response to the comments received, the Treasury Department and IRS have determined that an exclusion is appropriate 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 Treasury Department and the IRS have employed the authority granted to the Secretary in section 451(c)(4)(B)(vii) to exclude certain payments, in a limited manner, that would otherwise constitute advance payments within the meaning of section 451(c)(4)(A), in response to the proposals described in comments already received. In order to fully consider other such potential exclusions, detailed comments that specifically address the following issues are requested:

1. Does the authority granted to the Secretary by section 451(c)(4)(B)(vii) to exclude certain payments from the definition of an advance payment under section 451(c) also permit an exception for those payments from the rules regarding the all events test under section 451(b)?

2. What significance, if any, should the time it takes to manufacture or create an item of property, or such item of property's useful life, be given in determining whether a pre-delivery payment for such item of property should be included in income as an advance payment?

3. Does the authority granted to the Secretary by section 451(c)(4)(B)(vii) authorize rules that change the timing of deductions or provide a safe harbor allowing specified categories of taxpayers to use methods of accounting for recognizing income other than an accrual method under section 451? Is there any particular authority under the Code that would allow changing the timing of deductions in this context under section 451 or another section of Subchapter E?

4. Does the authority granted to the Secretary by section 451(c)(4)(B)(vii) to exclude certain payments from the definition of an advance payment also authorize the imposition of conditions unrelated to an accrual method of accounting with respect to any such exclusions? For example, could the Secretary require that a taxpayer use an alternative method of accounting as a condition for excluding a type of payment from the definition of advance payment?

5. Does the authority granted to the Secretary by section 451(c)(4)(B)(vii) to

exclude certain payments from the definition of advance payment also authorize the imposition of a time limit on such exclusion? For example, could an exclusion under section 451(c)(4)(B)(vii) be limited to a specified number of years after which all remaining amounts would have to be recognized in income? If so, what would be an appropriate time limit?

6. Does the authority granted to the Secretary by section 451(c)(4)(B)(vii) allow deferral of income in an amount equal to the estimated future performance costs while requiring current recognition of estimated profits not in excess of the amounts of advance payments? If so, does the authority granted to the Secretary by section 451(c)(4)(B)(vii) permit rules to account for the time value of money for any variances in estimated costs or profits?

7. Would it be inappropriate to reduce the amount a C corporation would be permitted to defer for a given taxable year under a potential exclusion under section 451(c)(4)(B)(vii) by an amount equal to the excess of (i) distributions the C corporation made to its shareholders with respect to its stock, over (ii) the C corporation's taxable income for that taxable year?.

3. Advance Payment Acceleration Provisions

Section 451(c)(3) provides that the deferral method does not apply to an advance payment received by the taxpayer during a taxable year if such taxpayer ceases to exist during (or with the close of) the taxable year. In contrast, Revenue Procedure 2004–34 provides more detailed acceleration rules.

The Treasury Department and the IRS have determined that rules similar to the acceleration rules provided in Revenue Procedure 2004–34 are appropriate for the proper application of the AFS and non-AFS deferral methods. The continued use of the deferral method for an advance payment is not appropriate and should be limited in certain situations, such as when the taxpayer ceases to exist, or when their obligation regarding the advance payment is satisfied or otherwise ends. Accordingly, proposed § 1.451–8(c)(2) and (d)(6) provide rules to ensure the acceleration of an advance payment when a taxpayer either dies or ceases to exist, or when a taxpayer's obligation regarding an advance payment is satisfied or otherwise ends, except in certain circumstances. Consistent with Revenue Procedure 2004–34, the acceleration rules do not apply to a taxpayer that engages in a transaction to which section 381 applies or certain transactions in which section 351 applies in the taxable year in which an advance payment is received.

Section 451(c) does not specifically address whether the deferral method may be used when an amount is earned in the taxable year, but deferred for AFS purposes. The deferral method under section 451(c) is an exception to the requirement to include an amount in income when it is received but is not an exception to the requirement to include an amount in income when it is earned under the all events test. Accordingly, consistent with Revenue Procedure 2004–34, these proposed regulations permit deferral of advance payments received to the extent, in the year of receipt, the amount is not included in revenue in the taxpayer's AFS, and is not otherwise earned in the taxable year of receipt. The amounts not included in gross income in the year of receipt must be included in gross income in the next taxable year.

4. Advance Payments and Financial Statement Adjustments

Section 451(c) does not address the treatment of financial statement adjustments that cause amounts to not be included in income.

Proposed § 1.451–8(c)(3) and (d)(7) provide that a taxpayer that defers inclusion of all or a portion of an advance payment must include the remainder of the advance payment in gross income in the subsequent year, notwithstanding any write-down or adjustment for financial accounting purposes. This provision is consistent with a plain reading of section 451(c)(1)(B) and the rule in proposed § 1.451–3(j), which require that an item of income treated as deferred revenue in a taxpayer's AFS in one year and charged, in whole or part, to a capital account in a subsequent year, is included in revenue in the subsequent year.

A financial accounting adjustment may occur after certain equity acquisitions. For example, after certain equity acquisitions, the acquiring entity may write-down or adjust the target's deferred revenue in the subsequent year under purchase accounting rules. Some taxpayers have asserted that a write-down or adjustment for financial accounting purposes results in a permanent exclusion of income for federal income tax purposes. Proposed § 1.451–8(c)(3) and (d)(7) provide clarification for instances in which a taxpayer defers inclusion of an advance payment and is subsequently acquired in certain equity acquisitions. The Treasury Department and the IRS believe that financial statement write-downs or adjustments to deferred revenue should not be taken into account for federal income tax purposes when determining the proper amount to be included in income under the deferral method. This clarification ensures that a financial statement write-down or adjustment to deferred revenue does not result in a permanent exclusion of income for federal income tax purposes.

5. Short Taxable Years and the 92-Day Rule

Section 451(c) does not provide rules relating to the treatment of short taxable years. Proposed § 1.451–8(c)(4) and (d)(8) use the short taxable year rules of Revenue Procedure 2004–34 for the AFS and non-AFS deferral methods because a rule for short taxable years is necessary to properly implement the deferral method provided in section 451(c)(1)(B).

6. Performance Obligations for AFS and Non-AFS Taxpayers

Sections 451(b) and (c)(4)(D) require that taxpayers with contracts that contain multiple performance obligations must allocate transaction price, and therefore defer (or accelerate) income inclusion, consistent with the transaction price allocation used for AFS purposes. Proposed § 1.451–3(c)(3) (REG–104870–18) defines the term performance obligation to mean a promise in a contract with a customer to transfer to the customer either a good or service (or a bundle of goods or services) that is distinct, or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. Proposed § 1.451–8(b)(4) defines the term performance obligation by cross-reference to proposed § 1.451–3(c)(3) for purposes of the allocation rule provided in section 451(c)(4)(D).

Proposed § 1.451–8(b)(7) defines the term transaction price by cross-reference to proposed § 1.451–3(c)(6). Proposed § 1.451–3(c)(6) defines the term transaction price to mean the gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes in exchange for transferring promised goods, services, or other property, including amounts referred to in proposed § 1.451–3(i). However, the term transaction price does not include certain items, such as amounts collected on behalf of third parties that are not otherwise income to the taxpayer, increases for consideration to which a taxpayer's entitlement is contingent on the occurrence or nonoccurrence of a future event, and reductions for amounts subject to section 461.

Proposed § 1.451–3(c)(6)(ii) presumes that an amount included in the transaction price for AFS purposes is not contingent unless, upon examination of all of the facts and circumstances existing at the end of the taxable year, it can be established to the satisfaction of the Commissioner that the amount is contingent on the occurrence or nonoccurrence of a future event. Proposed § 1.451–3(c)(6)(ii) also provides that certain amounts included in transaction price for AFS purposes, however, will not be treated as contingent on the occurrence or nonoccurrence of a future event.

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

For non-AFS taxpayers, there is a continued need to provide an allocation method consistent with the objective criteria standard in Revenue Procedure 2004–34 because such taxpayers do not have an AFS and cannot use the transaction price allocation used for AFS purposes, as provided in section 451(b)(4). Therefore, proposed § 1.451–8(d)(5) permits a non-AFS taxpayer to allocate the revenue of multiple obligations in a single contract based on how such obligations are separately priced or on any method that may be provided in guidance published in the IRB.

7. Accelerated Cost Offset

Several commenters discussed the need for a regulatory exception to the existing statutory and regulatory timing rules that apply to liabilities (for example, deductions and offsets for rebates, refunds, and cost of goods sold (COGS) prior to when the liability for such items is incurred under section 461) when advance payments are required to be included in income under section 451(c) prior to the completion of the sale of goods or provision of services (accelerated cost offset). The commenters argued that not providing an accelerated cost offset in the regulations would cause a mismatch of income and expenses and result in the taxation of gross receipts.

An allowance to account for future cost of goods sold, for future estimated costs, or other cost offset is inconsistent with sections 461(h) and, 471, 263A, and the accompanying regulations. Moreover, section 13221 does not change the timing rules provided in sections 461, 471, 263A and elsewhere that apply to liabilities. Section 13221 changes the timing of income for advance payments for goods and generally codifies Revenue Procedure 2004–34. *See* H.R. Rep. No. 115–466, at 429 (2017) (Conf. Rep.). Revenue Procedure 2004–34 does not include an accelerated cost offset when amounts are included in income prior to the sale of goods or provision of services.

The Conference Report also indicates that section 13221 of the Act is ''intended to override any deferral method provided by Treasury Regulation § 1.451–5 for advance payments received for goods.'' H.R. Rep. No. 115–466, at 429 n 880 (2017) (Conf. Rep.). Section 1.451–5 includes a deferral method that allows an accelerated cost offset when certain amounts are included in income prior to the sale of goods. *See* § 1.451–5(c). Section 451(c) does not provide a cost offset, and the Conference Report does not provide any indication that Congress intended to preserve the cost offset rules permitted under § 1.451–5. See also, Joint Committee on Taxation, General Explanation of Public Law 115–97 (JCS–1–18) at 156–157 and 164–165 (December 20, 2018). Final regulations were published in the **Federal Register** (84 FR 33691) on July 15, 2019, that withdraw § 1.451–5, consistent with the Act.

The Treasury Department and the IRS believe 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. See H.R. Rep. No. 115–466, at 429 (2017) (Conf. Rep.). Accordingly, the Treasury Department and the IRS decline to provide an accelerated cost offset in these proposed regulations. The Treasury Department and the IRS do not agree with the contention that changes to the timing of income under section 451 without an accelerated cost offset cause a taxation of gross receipts. Section 451(c) and these proposed regulations merely change the timing of income recognition, do not preclude any associated reduction or deduction for properly incurred liabilities, and are consistent with existing statutory and regulatory timing requirements that apply to liabilities.

Several commenters proposed a cost offset mechanism for manufacturers of certain property and taxpayers with inventoriable goods in order to ensure matching of income and the associated expenses. Commenters made the following suggestions to alleviate the potential mismatch of the acceleration of income recognition with different timing rules for associated costs: (i) Permitting a taxpayer that uses a percentage of completion method for AFS purposes (book PCM), but not subject to section 460, to elect to use their AFS method for tax purposes; (ii) permitting a taxpayer that uses book PCM, but not subject to section 460, to elect to apply section 460 for federal income tax purposes; (iii) expanding the recurring item exception in section 461(h)(3) to permit a taxpayer to offset the portion of the advance payment included in income for the taxable year by the cost of goods sold related to this payment if the goods are completed and shipped to the customer within 8½ months of the end of the taxable year that the advance payment is included in income; or (iv) providing a cost offset for taxpayers that can demonstrate at the time of the purchase agreement that a net operating loss will remain unused for the 5-year period after the taxable year the advance payment is received.

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

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

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

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

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

8. Section 451(c) Is a Method of Accounting

Section 451(c)(2) provides that a taxpayer may elect deferral treatment of an advance payment governed by section 451(c), and such election shall be made at such time and manner and with respect to such categories of advance payments as specified by the Secretary. Section 451(c)(2)(B) provides that the deferral method is treated as a method of accounting and the election is effective for taxable years with respect to which it is first made and for all subsequent taxable years, unless the taxpayer secures the consent of the Secretary to change to a different method of accounting.

The use of the AFS or non-AFS deferral method is the adoption of, or a change in, a method of accounting under section 446. A taxpayer may change its method of accounting to use the deferral methods only with the consent of the Commissioner as required under section 446(e) and the corresponding regulations. The Treasury Department and the IRS intend to issue future guidance that will provide the procedures by which a taxpayer may change its method of accounting to use one of the deferral methods described in these proposed regulations. However, until further guidance for the treatment of advance payments is applicable, a taxpayer may continue to rely on Revenue Procedure 2004–34, as described in Notice 2018–35.

Proposed Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provides that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the **Federal Register**, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the **Federal Register**.

These regulations are proposed to apply to taxable years beginning on or after the date the final regulations are published in the **Federal Register**. Until the date the Treasury decision adopting these regulations as final regulations is published in the **Federal Register**, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2017, provided that the taxpayer: (1) Applies all the applicable rules contained in these proposed regulations, and (2) consistently applies these proposed regulations to all advance payments. See section 7805(b)(7).

Statement of Availability of IRS Documents

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

Special Analysis

I. Regulatory Planning and Review

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

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

1. Background

Under section 451(a) of the Internal Revenue 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 forms 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 when the amount of income can be determined with reasonable accuracy (the ''all events test''). 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 for on the taxpayer's Applicable Financial Statement (AFS). Such payments are referred to as ''advance payments.''

Prior to the December 22, 2017, enactment of, ''An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,'' Public Law 115–97, 131 Stat. 2054 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA), 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. Section 451(c), added by the TCJA, allows accrual-method taxpayers to elect to recognize as income only a portion of such 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.) New section 451(c), the subject of the proposed regulations, deals with issues around how these advance payments are defined and the timing in which they need to be recognized in the business's income tax.

2. Need for the Proposed Regulations

These proposed regulations provide certainty and clarity to taxpayers affected by statutory changes introduced in section 451(c). The Treasury Department and IRS have received questions and comments regarding the meaning of various provisions in section 451(c) and issues not explicitly addressed in the statute. The Treasury Department and the IRS have determined that such comments warrant the issuance of further guidance.

3. Overview of the Proposed Regulations

The proposed regulations provide guidance regarding the new section 451(c). The subsequent economic analysis covers proposed regulations to: (1) Describe and clarify the deferral rules for advance payments for taxpayers without an Applicable Financial Statement (AFS); (2) provide acceleration rules for taxpayers that cease to exist; (3) clarify the treatment of financial statement adjustments for taxpayers that have 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.

4. Economic Analysis

A. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations. The following largely qualitative analysis describes the anticipated economic effects of the proposed regulation relative to this baseline.

B. Summary of Economic Effects

The proposed regulations provide certainty and consistency in the application of section 451(c) by providing definitions and clarifications regarding the statute's terms and rules. An economically efficient tax system generally aims to treat income and expense derived from similar economic decisions consistently across taxpayers and across activities in order to reduce incentives for businesses to make choices based on tax rather than market incentives. In the absence of the guidance provided in these proposed regulations, the chances 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. An economic loss might also arise if all taxpayers have identical interpretations under the baseline of the tax treatment of particular income streams but are more conservative (or less conservative) regarding the interpretation than Congress intended for these income streams. In this case, guidance provides value by bringing economic decisions closer in line with the intents and purposes of the statute.

Because the proposed regulations clarify the tax treatment of certain income streams, there is the possibility that investments or other business decisions may change as a result of these regulations. The Treasury Department and the IRS have not made projections of the change in investment patterns that might arise due to the discretionary aspects of the proposed regulations. The Treasury Department and the IRS have also not made projections of any change in compliance costs arising from the proposed regulations, relative to the baseline. The Treasury Department project that changes in investment patterns and compliance costs relative to the baseline may generally be small because the proposed regulations affect a relatively small number of entities and because they largely mirror the rules of Rev. Proc. 2004–34.

The economic consequences of these proposed regulations depend in part on their interaction with other sections of the Code, including section 460, which governs when costs can be recovered under the percentage of completion method, and section 461(h), which governs when costs incurred by a taxpayer satisfy the all events test, including a requirement for economic performance, and are thereby allowed as deductions for Federal income tax purposes. The economic analysis of the final regulations under section 451(c) may 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 is issued between the proposed and final regulations.

The Treasury Department and the IRS project that approximately 15,000 business entities may be affected by these regulations.

The Treasury Department and the IRS solicit comments on this conclusion and particularly solicit comments that provide data, evidence, or models that would enhance the rigor by which the non-revenue economic effects might be estimated for the final regulations.

C. Economic Analysis of Specific Provisions

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

The Treasury Department and the IRS solicit comments on this decision on the treatment of deferral by non-AFS taxpayers and particularly solicit comments that provide data, other evidence, or models that could enhance the rigor by which the final regulations over non-AFS deferral might be developed.

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 proposed 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 of the remaining amount may never be picked up into income 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 regulations treat the expanded set of accelerated transactions consistently with similar types of transactions based on the timing and structure of the payments involved.

The Treasury Department and the IRS solicit comments on the proposed regulation's treatment of acceleration and particularly solicit comments that provide data, other evidence, or models that would enhance the rigor by which the treatment of acceleration might be developed for the final regulations.

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 is upheld, taxpayers could convert an income ''deferral'' amount into an income ''exemption'' amount. To address this issue and avoid this possibility, the proposed 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.

The Treasury Department and the IRS solicit comments on these proposed regulations and particularly solicits comments that provide data, other evidence, and models that would enhance the rigor by which the final regulations dealing with financial statement adjustments might be developed.

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 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.

The Treasury Department and the IRS solicit comments on these proposed regulations and particularly solicit comments that would provide data, other evidence, and models that would enhance the rigor by the treatment of short taxable years might be developed for the final regulations.

v. Performance Obligations for Non-AFS Taxpayers

A performance obligation is 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. The statute requires that taxpayers with contracts that include multiple performance obligations to allocate the transaction price to each performance obligation in the same manner that revenue is allocated 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 regulations provide allocation rules for non-AFS taxpayers consistent with a similar rule in Revenue Procedure 2004–34. That rule specifies that the transaction price be allocated in a manner that is based on payments the taxpayer regularly receives for an item or items it regularly sells or provides 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. While the allocation rules for AFS taxpayers and non-AFS taxpayers under the proposed regulations do differ, the chosen solution 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.

The Treasury Department and the IRS solicit comments on these proposed regulations and particularly solicit comments that would provide data, other evidence, and models that would enhance the rigor by which final regulations affecting the treatment of performance obligations taxable for non-AFS taxpayers might be developed for the final regulations.

II. Paperwork Reduction Act

These proposed regulations do not impose any additional information collection requirements in the form of reporting, recordkeeping requirements or third-party disclosure requirements related to tax compliance. However, because the deferral methods described in proposed §§ 1.451–8(c) and (d) are methods of accounting, a portion of affected taxpayers would be required to request the consent of the Commissioner for a change in their method of accounting under section 446(e) and the accompanying regulations. The IRS expects that these taxpayers will request this consent by filing Form 3115, *Application for Change in Accounting Method (Parts I, II, IV and Schedule B)*. Filing of Form 3115 and statements attached thereto (for taxpayers who are required to do so or who elect to do so as a result of the proposed regulations) is the sole collection of information requirement imposed by the statute and the proposed regulations. See subsequent paragraphs for a description of taxpayers who would be required to change the method of accounting under the statute and the proposed regulations.

For purposes of the Paperwork Reduction Act, the reporting burden associated with the collection of information with respect to section 451(c) will be reflected in the Paperwork Reduction Act submissions for IRS Form 3115 (OMB control numbers 1545–0074 for individual filers, 1545–0123 for business filers, and 1545–2070 for all other types of filers). The IRS may provide streamlined method change procedures which could permit the filing of a statement in lieu of filing a Form 3115, or, in certain cases, no notification (see, for example, the revenue procedure accompanying these proposed regulations).

The Treasury Department and the IRS anticipate that these proposed regulations would require an accrual method taxpayer that receives an advance payment and chooses to make an election to use the deferral method described in proposed § 1.451–8(c) or (d) to file a Form 3115 to change the method of accounting to comply with these proposed regulations. See proposed § 1.451–8(e). The Treasury Department and IRS estimate that 20,000–40,000 taxpayers will be required to file a Form 3115 in order to change to the deferral method described in proposed § 1.451–8(c).[a] The Treasury Department and the IRS anticipate a certain number of accrual method taxpayers without an AFS that receive advance payments may choose to use the non-AFS deferral method described in proposed § 1.451–8(d). The Treasury Department and IRS plan to provide streamlined procedures for taxpayers to change to the methods of accounting described in proposed § 1.451–8(c) and (d). See the revenue procedure accompanying these proposed regulations.

For a taxpayer with an AFS that uses the deferral method in proposed § 1.451–8(c), a change in the taxpayer's revenue recognition policies for financial accounting purposes requires the taxpayer to seek the consent of the Commissioner under section 446(e) to use the method for federal income tax purposes. See proposed § 1.451–8(e). It is anticipated that the reporting burden associated with the collection of information for a statement in lieu of the Form 3115 would be reflected in the Paperwork Reduction Act Submission associated with Revenue Procedure 2018–31, 2018–22 IRB 637 (or successor) (OMB control number 1545–1551). See the revenue procedure accompanying these proposed regulations.

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

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

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

[a] This estimate is based on data from the Compliance Data Warehouse of accrual-method taxpayers (includes C corporations, S corporations, partnerships, and sole proprietorships) with an AFS that E-filed schedule M–3 during 2012–2016. Schedule M–3 is used to report a net income (loss) reconciliation but not all taxpayers who should file an M–3 do so. The rules for filing the M–3 differ based on taxpayer status. For example, for C corporations, in general only those with assets of $10 million or more file an M–3 schedule with their Form 1120.

Form	Type of Filer	OMB Number(s)	Status
Form 3115	All other Filers (mainly trusts and estates) (Legacy system)	1545-2070	Published in the Federal Register on 2/15/17 by IRS. 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 3-2019. 60-Day Federal Register notice not published yet for full collection.
	Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031		
Revenue Procedure 2018-31	IRS Research estimates	1545-1551	Published in the Federal Register on 8-31-16. Public Comment period closed on 9/30/16.
	Link: https://www.federalregister.gov/documents/2016/08/31/2016-20993/submission-for-omb-review-comment-request		

III. Regulatory Flexibility Act

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

The Treasury Department and the IRS have estimated the number of business entities that may be affected by the statute and these proposed regulations. The statute and proposed regulations affect only those business entities that use an accrual method of accounting.

Regarding the accrual method of accounting, the Treasury Department and the IRS estimate that approximately 9 percent of business entities with gross receipts of $25 million or less used an accrual method of accounting in taxable year 2016. Furthermore, section 13102 of TCJA modified section 448 to expand the number of taxpayers eligible to use the cash method. In general, C corporations and partnerships with a C corporation partner are now permitted to use the cash receipts and disbursements method of accounting if average annual gross receipts are $25 million or less (up from $5 million or less in 2016). The Treasury Department and the IRS project that in future years, the number of entities with gross receipts not greater than $25 million that will be using the accrual method will be less than 9 percent of all entities with gross receipts not greater than $25 million.

Entity	Number of returns (taxable year 2016) (thousands)		
	All returns	Method of accounting	
		Accrual	Cash
C Corporations:			
Gross Receipts >$25 mil	30	28	2
Gross Receipts ≦$25 mil	1,567	700	867
Total	1,597	728	869
S Corporations:			
Gross Receipts >$25 mil	41	34	7
Gross Receipts ≦$25 mil	4,551	1,140	3,411
Total	4,592	1,174	3,418
Partnerships:			
Gross Receipts >$25 mil	20	17	3
Gross Receipts ≦$25 mil	3,743	860	2,883
Total	3,763	877	2,886
Sole Proprietors and LLCs:			
Gross Receipts >$25 mil	1	1	0
Gross Receipts ≦$25 mil	25,524	358	25,166
Total	25,525	359	25,166
All Entities:			
Gross Receipts >$25 mil	92	80	12
Gross Receipts ≦$25 mil	35,385	3,058	32,327
Total	35,477	3,138	32,339

Source: Statistics of Income data. Cash accounting includes cash, other, and unknown.

Regarding the applicable financial statement, the Treasury Department and the IRS estimate that 235,000–250,000 entities with gross receipts of $25 million or less had an audited income statement in taxable year 2016. This is an upper bound estimate of entities that may be affected by these proposed regulations because small entities are less likely to have a financial statement that falls within the definition of AFS in proposed § 1.451–3(c)(1) (which generally refers to certified audited financial statements in accordance with GAAP or IFRS). An AFS is generally a financial statement that is certified as being prepared in accordance with GAAP or IFRS that is issued for credit purposes, reporting to shareholders, or other non-tax purpose. The smaller the entity, the less likely that it will engage a CPA firm to audit their financial statements. An AFS does not include financial statements that have only been compiled or reviewed by a CPA firm, which are more affordable for small entities, as these types of statements are not certified as prepared in accordance with GAAP or IFRS.

Affected taxpayers would be required to file Form 3115. As an indicator of whether a taxpayer is likely to have to file a Form 3115, the Treasury Department and the IRS estimated the number of businesses that used the accrual method of accounting, had a financial statement, and indicated they had unearned or deferred income. Approximately 15,000 businesses with gross receipts of $25 million or less fit this category. This is an upper bound estimate of the number of taxpayers relying of Revenue Procedure 2004–34 that will need to file a Form 3115 since some reporting of unearned or deferred income may just have deferral for financial reporting and not tax reporting reasons.

These proposed rules will not have a significant economic impact on small entities affected because the costs to comply with these proposed regulations are not significant. An entity is required to file a Form 3115 (Parts I, II, IV and Schedule B) to change its method of accounting in order to use the deferral method described in proposed § 1.451–8(c) or (d). The Treasury Department and IRS plan to provide streamlined procedures for taxpayers to change to the methods of accounting described in proposed § 1.451–8(c)1 and (d). See the revenue procedure accompanying these proposed regulations. As noted in this revenue procedure, the estimated cumulative annual reporting and/or recordkeeping burden for the statutory method changes described under OMB control number 1545–1551, before publication of the revenue procedure, is 27,336 respondents, and a total annual reporting and/or recordkeeping burden of 30,580 hours. The estimated annual burden per respondent/recordkeeper under OMB control number 1545–1551 before publication of this revenue procedure varies from 1⁄6 hour to 8½ hours, depending on individual circumstances, with an estimated average of 1¼ hours. The estimated cumulative annual reporting and/or recordkeeping burden for the method changes described under OMB control number 1545–1551 after that revenue procedure is accounted for is 27,346 respondents, and a total annual reporting and/or recordkeeping burden is 31,479 hours, leaving the average reporting and recordkeeping burden essentially unchanged. These burdens are essentially unaffected by these proposed regulations.

Notwithstanding this certification that the proposed rule would not have a significant economic impact on a substantial number of small entities, the Treasury Department and the IRS invite comments from the public about the impact of this proposed rule on small entities.

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

IV. Unfunded Mandates Reform Act

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

V. Executive Order 13132: Federalism

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

Comments and Requests for a Public Hearing

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

Effect on Other Documents

When finalized, these proposed regulations will obsolete Revenue Procedure 2004–34, Revenue Procedure 2011–18, Revenue Procedure 2013–29 and Notice 2018–35.

Drafting Information

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

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

■ Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Sections 26 U.S.C. 451(c)(2)(A), (3), (4)(A)(iii), (4)(B)(vii);

■ Par. 2. Section 1.451–8 is added to read as follows:

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

(a) *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 as provided under § 1.451–1(a).

(b) *Definitions.* Except as otherwise provided in this section, the following definitions apply for purposes of 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 included in revenue by the taxpayer in an applicable financial statement for a subsequent taxable year;

(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 (b)(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 (b)(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 (b)(1)(i)(C)(*8*);

(*9*) An eligible gift card sale;

(*10*) Any other payment specified by the Secretary in other guidance published in the Internal Revenue Bulletin (*see* § 601.601(d)(2)); or

(*11*) Any combination of items described in paragraphs (b)(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 with respect to an item or items described in paragraph (b)(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;

(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 CB 479);

(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; and

(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.

(2) *Applicable financial statement.* Applicable financial statement has the same meaning as provided in proposed § 1.451–3(c)(1).

(3) *Eligible gift card sale.* 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 (b)(1)(i)(C)(*1*) through (*11*) of this section.

(4) *Performance obligation.* Performance obligation has the same meaning as provided in proposed § 1.451–3(c)(3).

(5) *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.

(6) *Revenue.* Revenue has the same meaning as provided in proposed § 1.451–3(c)(4) and is determined under the rules provided in proposed § 1.451–3.

(7) *Transaction price.* Transaction price has the same meaning as provided in proposed § 1.451–3(c)(6).

(8) *Contractual delivery date.* Contractual delivery date means the month and year of delivery listed in the written contract to the transaction.

(9) *Specified good.* A 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.

(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 is able to determine the extent to which advance payments are included in revenue in its AFS in the taxable year received, including a short taxable year (if applicable). A taxpayer that uses the deferral method must:

(i) Include the advance payment, or any portion thereof, in gross income in the taxable year of receipt to the extent included in revenue in its AFS; 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.

(2) *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 of receipt or, if applicable, for a short taxable year described in paragraph (c)(4) of this section, 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 with respect to 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) *Example. Ceasing to exist.* A is a calendar year taxpayer and is in the business of selling and licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support. On July 1, 2018, 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, 2018, in a transaction that does not involve a section 351(a) transfer described in paragraph (c)(2)(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 2018 taxable year.

(3) *Financial statement adjustments*—(i) *In general.* Notwithstanding section 451(c)(4)(A)(ii), 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 (for example, retained earnings) or otherwise writes-down or adjusts that item of deferred revenue in a subsequent taxable year, revenue for that subsequent taxable year includes that item, or portion thereof, that is written down or adjusted.

(ii) *Examples*—(A) *Example 1.* On May 1, 2018, A, a corporation that files its federal income tax return on a calendar year basis, 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 of the advance payment in revenue in its AFS for 2018, ½ for 2019, and ¼ for 2020. On August 31, 2018, C, an unrelated corporation that files its federal income tax return on a calendar year basis, acquired all of the stock of A, and A joined C's consolidated group. A's short taxable year ended on August 31, 2018, and, as of that date, A had included only ¼ ($25) of the advance payment in revenue in its AFS. On September 1, 2018, 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 will be included in revenue on A's AFS in accordance with the method of accounting A uses for financial accounting purposes. For federal income tax purposes, A uses the deferral method. For federal income tax purposes, A must take ¼ ($25) of the advance payment into income for its short taxable year ending August 31, 2018, and the remainder of the advance payment ($75) ($65 write down + $10 future financial statement revenue) must be included in income for A's next succeeding taxable year.

(B) *Example 2.* On May 1, 2018, B, a corporation that files its federal income tax return on a calendar year basis, received $100 advance payment for a contract to be performed in 2018, 2019, and 2020. On August 31, 2018, D, a corporation that is not consolidated for federal income tax purposes, acquired all of the stock of B. Before the stock acquisition, on its AFS for 2018, B included $40 of the advance payment in revenue, and $60 as a deferred revenue liability. On September 1, 2018, after the stock acquisition and in accordance with purchase accounting rules, D 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 include in revenue any of the $10 deferred revenue liability in its 2018 AFS. B does include $5 in revenue in 2019, and $5 in revenue in 2020. For federal income tax purposes, B uses the deferral method. For federal income tax purposes, B must take $40 of the advance payment into income in 2018, and the remainder of the advance payment ($60) ($50 write down + $10 future financial statement revenue) must be included in income for B's next succeeding taxable year, 2019.

(4) *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 included in revenue in an AFS. Any amount of the advance payment not included in the taxable year of receipt and the short taxable year must be included in gross income for the taxable year immediately following the short taxable year.

(ii) *Example.* A is a calendar year taxpayer and is in the business of selling and licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support. On July 1, 2018, A receives an advance payment for a 2-year software maintenance contract. 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 changes its taxable period to a fiscal year ending March 31 so that A has a short taxable year beginning January 1, 2019, and ending March 31, 2019. In its AFS, A includes ¼ of the payment in revenue for the taxable year ending December 31, 2018; ⅙ in revenue for the short taxable year ending March 31, 2019; ¼ in revenue for the taxable year ending March 31, 2020; and ¼ in revenue for the taxable year ending March 31, 2021. Because the taxable year ending March 31, 2019, is 92 days or less, A must include ¼ of the payment in gross income for the taxable year ending December 31, 2018, ⅙ in gross income for the short taxable year ending March 31, 2019, and the remaining amount in gross income for the taxable year ending March 31, 2020.

(5) *Financial statement conformity requirement.* A taxpayer that uses the deferral method under this paragraph (c) must use the same financial statement that is used to apply the rules in section 451(b) and the accompanying regulations when applying the deferral method provided in section 451(c) and these regulations.

(6) *Allocation of transaction price.* A taxpayer using the deferral method under this paragraph (c) must use the allocation rules provided in proposed § 1.451–3(g).

(7) *Rules relating to eligible gift card sales.* For purposes of paragraphs (b)(1)(i)(B) and (c)(1) of this section, if an eligible gift card is redeemable by an entity described in paragraph (b)(3)(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 revenue in its AFS to the extent the gift card is redeemed by the entity during the taxable year.

(8) *Examples.* The following examples illustrate the rules of this paragraph (c). In each example in paragraphs (c)(8)(i) through (xxv) of this section, the taxpayer uses an accrual method of accounting for federal income tax purposes and files its returns on a calendar year basis. Except as stated otherwise, the taxpayer in each example has an AFS.

(i) *Example 1. Services.* On November 1, 2018, A, in the business of giving dancing lessons, receives an advance payment for a 1-year contract commencing on that date and providing for up to 48 individual, 1-hour lessons. A provides eight lessons in 2018 and another 35 lessons in 2019. In its AFS, A includes ⅙ of the payment in revenue for 2018, and ⅚ of the payment in revenue for 2019. A uses the deferral method. For federal income tax purposes, A must include ⅙ of the payment in gross income for 2018, and the remaining ⅚ of the payment in gross income for 2019.

(ii) *Example 2. Services.* Assume the same facts as in Example 1 in paragraph (c)(8)(i) of this section, except that the advance payment is received for a 3-year contract under which up to 96 lessons are provided. A provides eight lessons in 2018, 48 lessons in 2019, and 40 lessons in 2020. In its AFS, A includes 1⁄12 of the payment in revenue for 2018, ½ of the payment in revenue for 2019, and 5⁄12 of the payment in gross revenue for 2020. For federal income tax purposes, A must include 1⁄12 of the payment in gross income for 2018, and the remaining 11⁄12 of the payment in gross income for 2019.

(iii) *Example 3. Goods and Services.* On June 1, 2018, B, a landscape architecture firm, receives an advance payment for goods and services that, under the terms of the agreement, must be provided by December 2019. On December 31, 2018, B estimates that ¾ of the work under the agreement has been completed. In its AFS, B includes ¾ of the payment in revenue for 2018 and ¼ of the payment in revenue for 2019. B uses the deferral method. For federal income tax purposes, B must include ¾ of the payment in gross income for 2018, and the remaining ¼ of the payment in gross income for 2019, regardless of whether B completes the job in 2019.

(iv) *Example 4. Repair Contracts.* On July 1, 2018, C, in the business of selling and repairing television sets, receives an advance payment for a 2-year contract under which C agrees to repair or replace, or authorizes a representative to repair or replace, certain parts in the customer's television set if those parts fail to function properly. In its AFS, C includes ¼ of the payment in revenue for 2018, ½ of the payment in revenue for 2019, and ¼ of the payment in revenue for 2020. C uses the deferral method. For federal income tax purposes, C must include ¼ of the payment in gross income for 2018 and the remaining ¾ of the payment in gross income for 2019.

(v) *Example 5. Online website Design.* D, in the business of building and designing websites, receives advance payments that oblige D to build and design various websites. D tracks each request for a website with unique identifying numbers. On July 20, 2018, D receives online payments for 2 websites. One of the website requests is submitted and processed on September 1, 2018, and the other is submitted and processed on February 1, 2020. In its AFS, D includes the payment for the September 1, 2018, website in revenue for 2018 and the payment for the February 1, 2020, website in revenue for 2020. D uses the deferral method. For federal income tax purposes, D must include the payment for the September 1, 2018, website in gross income for 2018 and the payment for the February 1, 2020, website in gross income for 2019.

(vi) *Example 6. Gift Cards.* 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 look like standard credit cards, and each gift card has a magnetic strip that, in connection with E's computer system, identifies the available balance. The gift cards may not be redeemed for cash and have no expiration date. In its AFS, E includes advance payments for gift cards in revenue when redeemed. E is not able to determine the extent to which advance payments are included in revenue in its AFS for the taxable year of receipt and therefore does not meet this requirement of paragraph (c)(1) of this section. Therefore, E may not use the deferral method for these advance payments.

(vii) *Example 7. Gift Cards.* Assume the same facts as in Example 6 in paragraph (c)(8)(vi) of this section, 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 revenue in its AFS for the taxable year in which the cards expire. Because E tracks the sale date and the expiration date of the gift cards for purposes of its AFS, E is able to determine the extent to which advance payments are included in revenue for the taxable year of receipt. Therefore, E meets this requirement of paragraph (c)(1) of this section and may use the deferral method for these advance payments.

(viii) *Example 8. 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, 2018, G receives an advance payment from a subscriber for 1 year of access to its online database, beginning on that date. In its AFS, G includes ⅓ of the payment in revenue for 2018 and the remaining ⅔ in revenue for 2019. G uses the deferral method. For federal income tax purposes, G must include ⅓ of the payment in gross income for 2018 and the remaining ⅔ of the payment in gross income for 2019.

(ix) *Example 9. Membership Fees.* On December 1, 2018, H, in the business of operating a chain of ''shopping club'' retail stores, receives advance payments for membership fees. 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. In its AFS, H includes 1⁄12 of the payment in revenue for 2018 and 11⁄12 of the payment in revenue for 2019. H uses the deferral method. For federal income tax purposes, H must include 1⁄12 of the payment in gross income for 2018, and the remaining 11⁄12 of the payment in gross income for 2019.

(x) *Example 10. Cruise.* In 2018, I, in the business of operating tours, receives payments from customers for a 10-day cruise that will take place in April 2019. 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. In its AFS, I includes the payments in revenue for 2019. I uses the deferral method. For federal income tax purposes, I must include the payments in gross income for 2019.

(xi) *Example 11. Travel agent services.* On November 1, 2018, J, a travel agent, receives payment from a customer for an airline flight that will take place in April 2019. J purchases and delivers the airline ticket to the customer on November 14, 2018. J retains a portion of the customer's payment (the excess of the customer's payment over the cost of the airline ticket) as its commission. Because J is not required to provide any services after the ticket is delivered to the customer, J earns its commission when the airline ticket is delivered. 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 2019. The commission is not an advance payment because the payment is not earned by J, in whole or in part, in a subsequent taxable year. Thus, J may not use the deferral method for this payment.

(xii) *Example 12. Broadcasting Rights.* 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 money received by the sports league under the contracts is divided equally among the member teams. The league entered into a 3-year broadcasting contract beginning October 1, 2018. K receives three equal installment payments on October 1 of each contract year, beginning in 2018. In its AFS, K includes ¼ of the first installment payment in revenue for 2018 and ¾ in revenue for 2019; K includes ¼ of the second installment in revenue for 2019 and ¾ in revenue for 2020; K includes ¼ of the third installment in revenue for 2020 and ¾ in revenue for 2021. K uses the deferral method. Each installment payment constitutes an advance payment under paragraph (b)(1) of this section. For federal income tax purposes, K must include ¼ of the first installment payment in gross income for 2018 and ¾ in gross income for 2019; ¼ of the second installment in gross income for 2019 and ¾ in gross income for 2020; and ¼ of the third installment in gross income for 2020 and ¾ in gross income for 2021.

(xiii) *Example 13. Insurance Claims Administration.* L is in the business of negotiating, placing, and servicing insurance coverage and administering claims for insurance companies. On December 1, 2018, 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, 2019. 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 (for example, L is paid on December 1, 2018, for the service year beginning January 1, 2019). In its AFS, L includes the first payment in revenue for 2019; the second payment in revenue for 2020; the third payment in revenue for 2021; and the fourth payment in revenue for 2022. L uses the deferral method. Each annual payment constitutes an advance payment under paragraph (b)(1) of this section. For federal income tax purposes, L must include the first payment in gross income for 2019; the second payment in gross income for 2020; the third payment in gross income for 2021; and the fourth payment in gross income for 2022.

(xiv) *Example 14. Internet Services.* M is a cable internet service provider that enters into contracts with subscribers to provide internet services for a monthly fee (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 (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 2018, M receives payments from subscribers for January 2019 internet service and cable modem use. In its AFS, M includes the entire amount of these payments in revenue for 2019. M uses the deferral method. Because a subscriber's use of a cable modem is ancillary to the provision of internet services by M, and because the cable modem warranty is ancillary to the use of the cable modem, the payments are advance payments. For federal income tax purposes, M must include the advance payments in gross income for 2019.

(xv) *Example 15. License Agreement.* On January 1, 2019, N enters into, and receives advance payments pursuant to, a 5-year license agreement for the use of N's trademark. Under the contract, the licensee pays N both the first-year (2019) license fee and the fifth-year (2023) license fee upon commencement of the agreement. The fees for the second, third, and fourth years are payable on January 1 of each license year. The contract provides the customer with access to N's trademark throughout the term of the agreement. In its AFS, N includes the fees in revenue for the respective license year. N uses the deferral method. For federal income tax purposes, N must include the first-year license fee in gross income for 2019, the second-year and the fifth-year license fee in gross income for 2020, the third-year license fee in gross income for 2021, and the fourth-year license fee in gross income for 2022.

(xvi) *Example 16. Computer Software Subscription.* On July 1, 2018, O, in the business of licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support, receives an advance payment 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. In its AFS, O includes ¼ of the payment in revenue for 2018, ½ in revenue for 2019, and the remaining ¼ in revenue for 2020, regardless of when O provides updates or customer support. O uses the deferral method. For federal income tax purposes, O must include ¼ of the payment in gross income for 2018 and ¾ in gross income for 2019.

(xvii) *Example 17. Performance Obligation.* P is in the business of licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support. On July 1, 2018, P receives an advance payment of $100 for a 2-year software subscription that includes a 1-year ''software maintenance contract'' under which P will provide integral software updates within the contract period, as well as a ''customer support agreement'' for online and telephone customer support. In its AFS, P allocates $80 of the payment to the subscription agreement and $20 to the customer support agreement. With respect to the $80 allocable to the subscription agreement, P includes ¼ ($20) in revenue for 2018, ½ ($40) in revenue for 2019, and the remaining ¼ ($20) in revenue for 2020. With respect to the $20 allocable to the customer support agreement, P includes ½ ($10) in revenue for 2018, and the remaining ½ ($10) in revenue for 2019 regardless of when P provides the customer support. For federal income tax purposes, P must include $30 in gross income for 2018 ($20 allocable to the subscription agreement and $10 allocable to the customer support agreement) and the remaining $70 in gross income for 2019.

(xviii) *Example 18. Gift Cards Administered by Another.* Q corporation operates department stores. U corporation, V corporation, and W corporation are wholly owned domestic subsidiaries of Q that file a consolidated federal income tax return with Q. X corporation is a controlled foreign subsidiary of Q that is prohibited from filing a consolidated return with Q. 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 Q consolidated 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. In 2018, W sells gift cards with a total value of $900,000, and, at the end of 2018, the unredeemed balance of the gift cards is $100,000. In the consolidated group's AFS, the group includes revenue from the sale of a gift card when the gift card is redeemed. W tracks sales and redemptions of gift cards electronically, is able to determine the extent to which advance payments are included in revenue in its consolidated AFS for the taxable year of receipt, and meets the requirements of paragraph (c)(1) of this section. The payments W receives from the sale of gift cards are advance payments because they are payments for eligible gift cards. Thus, W is eligible to use the deferral method. At the end of 2018, W includes $800,000 in income in its consolidated AFS. Under the deferral method, W must include $800,000 of the payments from gift card sales in gross income in 2018 and the remaining $100,000 of the payments in gross income in 2019.

(xix) *Example 19. Gift Cards of Affiliates.* 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 included in revenue in its AFS for the taxable year of receipt, and meets the requirements of paragraph (c)(1) of this section. The payments R 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, R is eligible to use the deferral method. In the taxable year of receipt, R must include the advance payment in income to the extent included in its AFS, and must include any remaining amount in income in the taxable year following the taxable year of receipt.

(xx) *Example 20. Gift Cards for Domestic and International Hotels.* S is a corporation that operates for the benefit of its franchisee members, who own and operate domestic and international individual member hotels. S collects membership fees from the member hotels in exchange for providing a wide variety of management support services, which include making reservations for customers at the various member hotels. S also 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, is able to determine the extent to which advance payments are included in revenue in its AFS for the taxable year of receipt, and meets the requirements of paragraph (c)(1) of this section. 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. In the taxable year of receipt, S must include in income the advance payment to the extent included in its AFS, and must include any remaining amount in income in the taxable year following the taxable year of receipt.

(xxi) *Example 21. Discount Voucher.* On December 10, 2018, 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 percent 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 includes $12 of the amount allocated to the discount voucher in revenue for 2018 and includes $18 of the discount voucher in revenue for 2019. T uses the deferral method. For federal income tax purposes, T must include the $12 allocable to the discount voucher in gross income in 2018 and the remaining $18 allocated to the discount voucher in gross income in 2019.

(xxii) *Example 22. Rewards.* On December 31, 2018, 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 each customer's reward points and does not sell reward points separately. In its AFS, U treats the rewards points as a separate performance obligation and allocates $45 of the $1,000 sales price to the rewards points. U does not include any of the amount allocated to the reward points in revenue for 2018. U includes $25 of the reward points in revenue for 2019 and $20 of the reward points in revenue for 2020. U uses the deferral method. For federal income tax purposes, U does not include any amount of the reward points in gross income in 2018, and includes the entire $45 allocated to the reward points in gross income in 2019.

(xxiii) *Example 23. Credit Card Rewards.* V, a wholly owned credit card company, issues credit cards. V also has a loyalty program in which cardholders earn reward points for the use of its credit card to make purchases. Each reward point is redeemable for a $1 on any future purchases. V may not use the deferral method because payments under credit card agreements including rewards for credit card purchases are excluded from the definition of an advance payment under paragraph (b)(1)(ii)(C) of this section.

(xxiv) *Example 24. Airline Reward Miles.* On January 1, 2018, W, in the business of transporting passengers on airplanes, sells a customer a $700 airline ticket to fly roundtrip in 2018. As part of the purchase, the customer also receives 7,000 points (air miles) from W to be used for future air travel. In its AFS, W allocates $665 to the roundtrip airfare and $35 to the air miles. In its AFS, the $665 allocated to the airfare is included in Year 1 when the customer takes the roundtrip flight. The $35 allocated to the air miles is deferred and included in Year 3 when the customer redeems the air miles. W uses the deferral method described in paragraph (c) of this section. For federal income tax purposes, the $665 is included in gross income in Year 1 and the $35 allocated to the air miles is included in gross income in Year 2.

(xxv) *Example 25. Chargebacks.* Taxpayer X, a manufacturer of pharmaceuticals, is a calendar-year accrual method taxpayer with an AFS. In addition to billing the wholesaler for the sale of the pharmaceuticals at the wholesale acquisition cost under the contract, X generally credits or pays wholesalers a chargeback of 40% of the wholesale acquisition cost for sales made by those wholesalers to qualifying customers. In 2018, X enters into a contract to sell 1,000 units to W, a wholesaler, for $10 per unit, totaling $10,000 ($1,000 \times \$10 = \$10,000$). The contract also provides that X will issue a 40% chargeback for sales by W to certain qualifying customers. X delivers 600 units to W on December 31, 2018, and bills W $6,000 under the contract. For AFS purposes, X adjusts its revenue by 40% for all sales to W for anticipated chargebacks. As such, in its 2018 AFS, X reports $3,600 ($\$6,000 - \$2,400 = \$3,600$) of revenue from the contract with W, decreasing revenue by $2,400 ($40\% \times \$6,000 = \$2,400$) for anticipated chargeback claims. For federal income tax purposes, under proposed § 1.451–3(c)(4), X's 2018 revenue is $6,000 because revenue is not reduced for anticipated chargebacks. Because no portion of the $6,000 is included in revenue on an AFS in a subsequent taxable year (that is, on an AFS after 2018), none of the $6,000 is an advance payment under paragraph (b)(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 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 as defined in proposed § 1.451–3(c)(1) and is able to determine the extent to which advance payments are earned in the taxable year of receipt, or a short taxable year, if applicable.

(3) *Advance payment.* For purposes of the non-AFS deferral method, in applying paragraph (b)(1)(i)(B) of this section, an advance payment is any portion of the payment received that is earned by the taxpayer, in whole or in part, in a subsequent taxable year.

(4) *Deferral of advance payments based on when payment is earned*—(i) *In general.* The non-AFS deferral method described in this paragraph (d) is a permissible method of accounting that may be used only by a taxpayer described in paragraph (d)(2) of this section. Under the non-AFS deferral method of accounting, a taxpayer includes the advance payment in gross income for the taxable year of receipt, including, if applicable, a short taxable year described in paragraph (d)(8) of this section, 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.* A payment is earned when the all events test described in § 1.451–1(a) is met, without regard to when the amount is received, as defined under paragraph (b)(5) of this section, by the taxpayer. If a taxpayer is unable to determine the extent to which a payment is earned in the taxable year of receipt, the taxpayer may determine that amount:

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

(B) On a straight line ratable basis over the term of the agreement if the taxpayer receives advance payments under a fixed term agreement and if it is not unreasonable to anticipate at the end of the taxable year of receipt that the advance payment will be earned ratably over the term of the agreement; or

(C) By the use of any other basis that in the opinion of the Commissioner results in a clear reflection of income.

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

(ii) *Objective criteria.* A taxpayer's allocation method with respect to a payment described in paragraph (d)(5)(i) of this section is based on objective criteria if the allocation method is based on payments the taxpayer regularly receives for an item or items it regularly sells or provides separately or any method that may be provided in guidance published in the Internal Revenue Bulletin (*see* § 601.601(d) of this chapter).

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

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

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

(9) *Eligible gift card sale.* For purposes of paragraphs (b)(1)(i)(B) and (d)(4) of this section, if an eligible gift card is redeemable by an entity described in paragraph (b)(3)(ii), including an entity whose financial results are not included in the taxpayer's financial statement, a payment will be treated as earned by the taxpayer to the extent the gift card is redeemed by the entity during the taxable year.

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

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

(ii) *Example 2.* B is in the business of providing internet services. On September 1, 2018, B receives an advance payment from a customer for a 2-year term for access to its internet services, beginning on that date. B does not have an AFS. B is unable to determine the extent to which the payment is earned in the taxable year of receipt. For federal income tax purposes, B may determine the extent to which the payment is earned in the year of receipt on a straight line ratable basis over the term of the agreement if it is not unreasonable to anticipate at the end of the taxable year of receipt that the advance payment will be earned ratably over the term of the agreement.

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

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

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–104870–18]

RIN 1545–BO68

Taxable Year of Income Inclusion Under an Accrual Method of Accounting

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

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