

CLIENT ALERT

Possible Controversy Ahead on the AFS Income Inclusion Rule

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The AFS Income Inclusion Rule requires accrual method taxpayers to recognize an item of income upon the earlier of when the all-events test is met (before the legislative change) or when the taxpayer includes the item in revenue in its “Applicable Financial Statement.” Generally, an Applicable Financial Statement is a financial statement certified as having been prepared under GAAP or IFRS, or a financial statement other than a tax return filed by the taxpayer with a regulatory or government body. Any taxpayer who uses an accrual method of accounting and had an Applicable Financial Statement covering the entire taxable year must follow the AFS Income Inclusion Rule.

For an overview of when the AFS Income Inclusion Rule applies and how it works, please see our [Section 451\(b\) Quick Reference Guide](#).

Controversy Ahead?

Although published proposed Treasury regulations resolved some prior issues, they raised some new issues. The proposed regulations are, in some respects, contrary to long recognized tax principles. That is, they arguably ignore the basic tax principle that taxpayers do not pay tax on income until it is realized. Under the proposed regulations, some taxpayers must recognize income even though there has not been a realization event (the “unbilled receivables” issue). Specifically, the proposed regulations will tax any unbilled receivables for partially performed services to the extent those amounts are recognized for financial statement purposes. In addition, the proposed regulations arguably impose a tax on gross receipts by denying taxpayers the ability to offset gross receipts with the associated costs of goods sold.

These issues were brought to the attention of the Treasury and the IRS, but it is unclear whether they intend to revise the regulations to resolve these issues. Unless they do so, taxpayers might have to challenge the validity of the regulations.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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