

## Section 451(b) Overview | The AFS Income Inclusion Rule

As part of the Tax Cuts and Jobs Act, Congress created a new rule for when taxpayers must recognize income. Below are frequently asked questions regarding the rule, including when the rule applies and how it operates.

### Overview

#### What is the AFS Income Inclusion Rule?

The AFS Income Inclusion Rule requires taxpayers to recognize an item of income upon the earlier of when the all-events test (before the legislative change) is met or when the taxpayer includes the item in revenue in its Applicable Financial Statement. I.R.C. § 451(b)(1).

#### Why is there a new rule?

Congress wanted to increase conformity between financial accounting and tax accounting, which it believes will promote simplification and reduce compliance costs. See Senate Budget Explanation of the Bill (2017-11-20) at p. 161.

#### What is the all events test?

The all events test is used to determine when income is recognized for federal tax purposes. Under the all events test, accrual method taxpayers recognize income when in the taxable year in which (1) all events have occurred that fix the right to receive the income and (2) the amount of the income can be determined reasonable accuracy. See I.R.C. § 451(b)(1)(C). The right to income is “fixed” when the required performance takes place, payment is due, or payment is made, whichever happens first. See Rev. Rul. 2003-10, 2003-1 C.B. 288.

#### Does the AFS Income Inclusion Rule replace the all events test?

No, the AFS Income Inclusion Rule simply supplements the all events test. Under the AFS Income Inclusion Rule, the all events test is met no later than when reported in AFS.

### When the rule applies

#### Who has to apply the AFS Income Inclusion Rule?

Taxpayers who use an accrual method of accounting and had an Applicable Financial Statement covering the entire taxable year must follow the rule. I.R.C. § 451(b)(1); Prop. Treas. Reg. 1.1451-3(d).

The rule does not apply to any item of gross income from a mortgage servicing contract (I.R.C. § 451(b)(1)(B)(ii)) or if a taxpayer uses a special method of accounting. I.R.C. § 451(b)(2).

#### What is an Applicable Financial Statement (AFS)?

Generally, an AFS is a financial statement certified as having been prepared under GAAP or IFRS, or a financial statement filed by the taxpayer with a regulatory or government body. I.R.C. § 451(b)(3). All publicly-traded U.S. corporations have an AFS. Many privately held corporations or partnerships will have an AFS for credit or shareholder/partner reporting purposes.

The proposed Treasury regulations provide that a financial statement other than a tax return filed with state government, state agency, or self-regulatory organization qualifies as an AFS. Prop. Treas. Reg. § 1.451-3(c)(1)(iii), 84 Fed. Reg. 47191-01 (Sept. 9, 2019).

#### What if a taxpayer has more than one AFS?

Under the proposed regulations, an AFS istaxpayers must use the financial statements certified under GAAP and filed with the United States Securities Exchange Commission, if there is they have one. Prop. Treas. Reg. § 1.451-3(c)(1). Under the regulations, AFSs are given the

following priority: GAAP Statements, IFRS statements, and then other filed financial statements. Specifically,

- (1) GAAP statements: A financial statement that is certified as being prepared in accordance with GAAP and is:
  - a) a Form 10-K, or annual statement to shareholders, filed with the SEC;
  - b) an audited financial statement of the taxpayer used for credit purposes, reporting to owners (e.g., shareholders, partners), or any other substantial non-tax purpose;
  - c) A financial statement, other than a tax return, filed with the federal government or any federal agency, other than the SEC or the IRS.
- (2) IFRS statements: a financial statement that is certified as being prepared in accordance with IFRS and is:
  - a) filed by the taxpayer with an agency of a foreign government that is equivalent to the SEC and has reporting standards not less stringent than the SEC;
  - b) an audited financial statement of the taxpayer used for credit purposes, reporting to owners (e.g., shareholders, partners), or any other substantial non-tax purpose;
  - c) A financial statement, other than a tax return, filed with the federal government or any federal agency, other than the SEC or the IRS, or a foreign government or agency government, other than a foreign agency equivalent to the SEC or the IRS.
- (3) Other financial statements other than a tax return filed with federal government, federal agency, state government, or state agency, or self-regulatory agency.

#### **What if the taxpayer had an AFS last year, but not this year?**

The rule does not apply to this year. Under IRS proposed regulations, the AFS Income Inclusion Rule applies on a year-by-year basis. Thus, taxpayers must follow the rule for years in for which they have an AFS, but they do not apply it in years in for which they do not have an AFS. Prop. Treas. Reg. § 1.451-3(d).

#### **What if the taxpayer had an AFS part of this year, but not the entire year?**

The rule does not apply this year. Under IRS proposed regulations, the AFS Income Inclusion Rule does not apply unless all of the taxpayer's taxable year is covered by an AFS. Prop. Treas. Reg. § 1.451-3(d).

#### **What if the taxpayer's financial results are reported on an AFS for a group of entities?**

If the taxpayer's financial results are reported on an AFS for a group of entities, the statement is treated as the taxpayer's AFS. Prop. Treas. Reg. § 1.451-3(h)(1)(i).

If a consolidated or combined AFS lists items separately for each member, the taxpayer determines the amount of revenue attributed to it based on the separately stated items. If the amounts for all members are aggregated, the taxpayer must use the source documents used to create the group's AFS to determine its percentage of each aggregated item on the consolidated or combined AFS. Prop. Treas. Reg. § 1.451-3(h)(2) and (3).

#### **What if the taxpayer's financial reporting period is different than the taxpayer's taxable year?**

If a taxpayer's financial reporting period is different than its tax reporting period, the proposed regulations provide three options for taxpayers to use when determining whether an item of income has been included in revenue on an AFS:

- (1) The taxpayer uses the accounting principles used to create its AFS to determine the items of income to be reported in revenue as if its financial reporting period coincided with its taxable year.
- (2) A taxpayer includes a pro rata portion of the revenue for each financial accounting year that includes any part of the taxpayer's taxable year using estimates if necessary.
- (3) If a taxpayer's financial accounting year ends five or more months after the end of its taxable year, the taxpayer computes revenue based on the revenue reported on the AFS for the financial accounting year ending within the taxable year.

See Prop. Treas. Reg. § 1.451-3(h)(4)(ii).

Once the taxpayer adopts one of these three methods, that is the taxpayer's method of accounting and the taxpayer cannot change the method without consent of the Commissioner. See Prop. Treas. Reg. § 1.451-3(h)(4)(iii).

## What if a taxpayer restates its AFS?

If a taxpayer restates revenue on an AFS and it changes the timing of when an item of income is taken into account as revenue on the AFS, the change constitutes a change in method of accounting, which requires the consent of the Commissioner. See Prop. Treas. Reg. § 1.451-3(h)(5).

## How the rule works

### Does this affect when income is realized?

The AFS Income Inclusion Rule was not intended to change when an item of income is realized. However, the proposed regulations provide that the AFS Income Inclusion Rule applies to unbilled receivables included in revenue for AFS purposes related to both services and goods. 84 Fed. Reg. at 47193. Consequently, in some situations the AFS Income Inclusion Rule may require a taxpayer to include an amount in gross income when the taxpayer has not had a realization event for tax purposes.

### Does the AFS Income Inclusion Rule change the treatment of a transaction?

No, the AFS Income Inclusion Rule does not change treatment of a transaction for federal income tax purposes. There can still be different treatment of a transaction or event for tax and financial accounting purposes (e.g., an agreement may be treated as a lease for tax purposes and as a sale for financial purposes). Prop. Treas. Reg. § 1.451-3(e).

### What about the Internal Revenue Code's exclusion provisions and non-recognition transactions?

Proposed Treasury regulations provide that the AFS Income Inclusion Rule does not change the applicability of any exclusion provision or the treatment of non-recognition transactions. Prop. Treas. Reg. § 1.451-3(f).

### Can taxpayers accelerate the recognition of the expenses associated with the revenue that is being recognized?

No. In the preamble to the proposed regulations, Treasury said the regulations did not include a cost offset provision because of the potential distortions of income and Congress did not indicate it intended for there to be a cost offset. 84 Fed. Reg. at 47195-96.

### What if the taxpayer is using a special method of accounting?

The AFS Income Inclusion Rule does not apply to any item of income when the timing of income inclusion is determined under a required or permitted special method of accounting used for federal income tax purposes. Prop. Treas. Reg. § 1.451-3(b). These methods include the crop method of accounting, the long-term contracting method of accounting, and the installment method of accounting. Prop. Treas. Reg. § 1.451-3(c)(5).

### What about taxpayers with multiple year contracts?

Taxpayers with multiple year contracts must apply the all events test by applying a cumulative approach. That is, taxpayers are required to take into account the cumulative amounts previously included in prior taxable years in determining a given contract year's income inclusions. Prop. Treas. Reg. § 1.451-3(k).

### Many of these answers cite the proposed regulations. Can taxpayers rely on proposed regulations?

Yes, a taxpayer may rely on these proposed regulations for taxable years beginning after December 31, 2017, if the taxpayer (1) applies all the applicable rules in the proposed regulations (other than those applicable to specified fees) and (2) consistently applies the proposed regulations to all items of income during the taxable year (other than specified fees). For certain credit card fees, taxpayers cannot rely on the proposed regulations until taxable years beginning after December 31, 2018. Prop. Treas. Reg. § 1.451-3(n)(3).

## Contacts



**Dwight Mersereau**

Partner

Washington, D.C.

+1.202.624.2856

dmersereau@crowell.com



**Teresa Abney**

Counsel

Washington, D.C.

+1.202.624.2667

tabney@crowell.com

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