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June 14, 2018

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Re: Supplemental comments with respect to Notice 2018-35: Legal arguments in support of applying a cost offset under both section 451(b) and section 451(c)

Dear Sir:

On May 14, 2018, we submitted a comment letter on behalf of our clients in response to the request for comments in Notice 2018-35. That comment letter discussed various issues that arise in applying new sections 451(b) and 451(c) in the Internal Revenue Code. In response to our original comment letter, an issue has been raised regarding the legal support in the statute and the Conference Report for allowing taxpayers that produce goods for customers, and that are subject to either section 451(b) or section 451(c) or both, an offset against gross receipts in applying sections 451(b) and 451(c) for the amount of costs that relate to those gross receipts. The purpose of this supplemental comment letter is to provide a detailed discussion of the arguments in support of a cost offset that are based on the text of the statutory provisions and the Conference Report, as

well as on a comparison of the enacted provisions with the corresponding provisions of the 2014 Camp tax reform proposal. The arguments relating to section 451(b) and section 451(c) are discussed separately in turn below.

I. Arguments in support of allowing a cost offset under section 451(b)

A. The reference in section 451(b) to "any item of gross income" as the amount that is subject to acceleration based on the financial accounting treatment of the item supports allowing a cost offset under section 451(b).

Section 451(b) provides that for a taxpayer using the accrual method of accounting, "the all events test with respect to *any item of gross income* (or portion thereof) shall…be treated as met [no] later than when such item (or portion thereof) is taken into account as revenue" for financial accounting purposes (emphasis added). Thus, section 451(b) is applicable to "any item of gross income (or portion thereof)" that is included in revenue for financial accounting purposes.

In the case of a sale of goods, Treas. Reg. § 1.61-3(a) makes clear that the amount of gross income on the sale is the amount of sales revenue on the sale less the amount of cost of goods sold associated with the sale. Thus, in the case of a sale of goods, when section 451(b) refers to "any item of gross income," it is very clear that the income amount to which section 451(b) refers is the selling price of the goods less the cost of goods sold associated with the sale.

Accordingly, where section 451(b) is determined to be applicable in the case of a sale of goods, the effect on taxable income of the application of section 451(b) should be determined with reference to the amount of sales revenue less the amount of associated cost of goods sold.

B. The cost offset under section 451(b) should include expected future costs.

Moreover, the associated cost amount under section 451(b) should not be limited to costs that have already been incurred at the time section 451(b) affects taxable income, but should also

include all expected future costs, since the true ultimate amount of gross income on the transaction will necessarily reflect all future costs that are properly associated with the relevant amount of sales revenue. Failure to reflect future costs in the cost offset under section 451(b) will not give a correct and accurate amount for the "item of gross income" to which section 451(b) applies.

One potential objection to this conclusion might be that ordinarily, costs are not taken into account for federal income tax purposes until they are considered incurred within the meaning of the all-events test, including the application of the economic performance requirement. However, section 451(b) was clearly intended to override the all-events test with respect to the reporting of an "item of gross income." As a result, the all-events test should be overridden under section 451(b) not only with respect to the reporting of *the sales revenue component* of an "item of gross income" but also with respect to *the cost offset component* of that same "item of gross income." If the IRS and Treasury were to adopt a rule under section 451(b) that resulted in inconsistent treatment of the sales revenue component of an item of gross income and the cost offset component of that same item of gross income, such unjustifiable internal inconsistency would be subject to challenge as being a violation of the arbitrary and capricious standard under the Administrative Procedure Act. *See, e.g., Business Roundtable v. SEC*, 647 F.3d 1144, 1153 (D.C. Cir. 2011).

C. A comparison between section 451(b) and the corresponding provision of the Camp tax reform proposal supports allowing a cost offset under section 451(b).

Some commentators have suggested that sections 451(b) and 451(c) as enacted by the TCJA should be interpreted by reference to the corresponding provisions in the 2014 Camp tax reform proposal from which these provisions were derived. The corresponding provisions in the Camp proposal were included in section 3303 of that proposal. As explained below, the wording

of the Camp proposal was less supportive of the notion of a cost offset than is the language actually used in section 451(b), and the contrast between the wording of the Camp proposal and the text of section 451(b) as enacted by the TCJA provides further support for the conclusion that a cost offset should be allowed under section 451(b).

With respect to the provision in the Camp proposal that corresponded to section 451(b) as enacted by the TCJA, the provision in the Camp proposal stated that for a taxpayer using the accrual method of accounting, "the amount of any portion of any item of income shall be included in gross income not later than the taxable year with respect to which such amount is taken into account in income" for financial accounting purposes. While this provision was unquestionably *similar* to section 451(b) as enacted by the TCJA, nevertheless, there are also notable differences between the two provisions.

The most significant difference between the statutory wording in the two provisions relating to the argument that a cost offset should be allowed under section 451(b) is that while section 451(b) uses the term "item of gross income," in contrast, the corresponding provision in the Camp proposal used the term "item of income." The change from "item of income" to "item of gross income" makes clear that the use of the phrase "item of gross income" in section 451(b) represented a conscious and deliberate decision on the part of the drafters of section 451(b) to measure the effect on taxable income with reference to the definition of gross income in the tax law, since the term "gross income" is not used in financial accounting. As discussed above, in the case of a sale of goods, it is clear that the "item of gross income" is the amount of sales revenue on the sale less the amount of cost of goods sold associated with the sale.

Other differences between section 451(b) as enacted and the corresponding provision of the Camp proposal likewise make clear that section 451(b) as enacted by the TCJA was not simply copied from the Camp proposal. For example, section 451(b) phrases its operative rule in terms of the time when the all events test is satisfied, but the corresponding provision in the Camp proposal made no reference to the all events test.

Section 451(b) states the test based on the financial accounting effect in terms of financial accounting "revenue," which clearly contrasts with the use of the term "item of gross income" to refer to the taxable income. In contrast, the corresponding provision in the Camp proposal stated the test based on the financial accounting effect in terms of financial accounting "income," which was the same term that was used to describe the taxable income effect. Thus, section 451(b) is much more precise in its terminology than the corresponding provision in the Camp proposal, and, once again this precision in the use of terminology in section 451(b) clearly supports the conclusion that the phrase "item of gross income" should be given its precise technical meaning in the tax law, which unquestionably incorporates a cost offset in the case of an "item of gross income" from the sale of goods.

II. Arguments in support of allowing a cost offset under section 451(c)

A. The use of the phrase "item of gross income" in the definition of "receipt" in section 451(c) supports the allowance of a cost offset under section 451(c).

Turning next to the legal issue of whether a cost offset should be permitted for purposes of section 451(c), as noted above with respect to the argument in favor of a cost offset under section 451(b), in the case of a sale of goods a key element in that argument is the fact that section 451(b) refers to "any item of gross income." Like section 451(b), section 451(c) also refers to an "item

of gross income." That reference to an "item of gross income" occurs in the definition of "receipt" in section 451(c)(4)(C): "For purposes of this subsection, *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." (Emphasis added.)

As with the use of the term "item of gross income" in section 451(b), the use of this same term in section 451(c) likewise necessarily carries with it the implication that in the case of a sale of goods, the cost of the goods must be taken into account in determining the amount of the "item of gross income." The term "item of gross income" is much more precise and specific than a mere general reference to "gross income" or "inclusion in gross income."

The use of the term "item of gross income" was clearly not a casual choice of words. "Item of gross income" instead is a very technical and precise phrase that cannot be viewed as having been accidental. Thus, in applying the various rules in section 451(c), the operative amount in all of the rules should be viewed as being "an item of gross income."

B. The allowance of a cost offset in Treas. Reg. § 1.451-5 supports the allowance of a cost offset under section 451(c).

It is also relevant to the allowance of a cost offset under section 451(c) that the provision of the regulations dealing with the deferral of advance payments relating to the sale of goods that was in effect before the enactment of section 451(c), namely, Treas. Reg. § 1.451-5, clearly provided for an offset against an advance payment for the cost of the goods to which the advance payment relates for cases where income recognition relating to the advance payment was required at a time before the time when the goods to which the advance payment related were provided to the customer.

In this regard, Treas. Reg. § 1.451-5(c)(1)(ii) provided that in cases where a taxpayer was required to accelerate the recognition of a "substantial advance payment" relating to the sale of inventoriable goods, the taxpayer was also required to take into account a cost offset against the advance payment at the time the advance payment was recognized for tax purposes:

> [T]he taxpayer must take into account in such taxable year the costs and expenditures included in inventory at the end of such year with respect to such goods (or substantially similar goods) on hand or, if no such goods are on hand by the last day of such…taxable year, the estimated cost of goods necessary to satisfy the agreement.

It is notable that this cost offset under Treas. Reg. § 1.451-5(c)(1)(ii) was not limited to costs that had already been incurred at the time the advance payment was required to be recognized, but also included estimated future costs where the costs related to the advance payment had not yet been incurred. This cost offset provision in Treas. Reg. § 1.451-5(c)(1)(ii) reflected the fact that case law prior to the issuance of the regulations was less clear regarding the treatment of advance payments for the sale of goods than the case law relating to the treatment of advance payments for services, which clearly required that in such cases, the entire amount of the advance payment was required to be included in gross income, with no offset for associated costs in determining the effect of the advance payment on gross income.

Consequently, since it was clear that a cost offset with respect to advance payments relating to the sale of goods was permitted under Treas. Reg. § 1.451-5(c)(1)(ii) prior to the enactment of section 451(c), it is reasonable to conclude that a cost offset was likewise intended under section 451(c) in the case of advance payments relating to the sale of goods.

C. The lack of a cost offset for advance payments for sales of goods in Rev. Proc. 2004-34 does not support denying a cost offset under section 451(c).

In response to the foregoing argument that one reason a cost offset should be permitted under section 451(c) in the case of advance payments relating to the sale of goods is because a cost offset was permitted under Treas. Reg. § 1.451-5(c)(1)(ii), it might be argued that since Rev. Proc. 2004-34 did not provide for any cost offset against advance payments, even in cases where taxpayers used Rev. Proc. 2004-34, rather than Treas. Reg. § 1.451-5, with respect to advance payments relating to the sale of goods, no cost offset was intended in section 451(c). This argument would also rely on the fact that the Conference Report discussion relating to section 451(c) specifically referred to an intention to codify Rev. Proc. 2004-34 in section 451(c).

However, Announcement 2004-48, which was issued at the same time as Rev. Proc. 2004-34 to explain some of the decisions that were reflected in Rev. Proc. 2004-34, included a discussion of the reasons why the decision had been made not to permit a cost offset under Rev. Proc. 2004-34. This discussion included the following:

> The final revenue procedure is designed to simplify the various issues that have arisen under Rev. Proc. 71–21. *After careful consideration, the Service has determined that a special COGS rule is inconsistent with that simplification.* Taxpayers that receive advance payments for goods and qualify to use the deferral method in § 1.451–5 may use that method, including the rule for COGS included in the regulation.

(Emphasis added.)

This passage from Announcement 2004-48 makes clear that the decision not to permit a cost offset under Rev. Proc. 2004-48 in connection with advance payments relating to the sale of goods was based on the rationale that permitting a cost offset in those circumstances would be "inconsistent" with the simplification Rev. Proc. 2004-34 was intended to achieve, and also made

clear that a cost offset remained available under Treas. Reg. § 1.451-5. Thus, the lack of any cost offset provision in Rev. Proc. 2004-34 was based solely on administrative considerations relating to the desire for simplification and therefore should not be viewed as support for denying a cost offset under section 451(c) in the case of advance payments relating to the sale of goods. The reason why the reference to Rev. Proc. 2004-34 in the Conference Report should likewise not be viewed as supporting that position is discussed below.

D. Statements in the Conference Report on section 451(c) do not support denying a cost offset in the case of advance payments relating to the sale of goods.

The section of the Conference Report on the TCJA dealing with section 451(c) includes the following statement regarding the relationship between section 451(c) and Rev. Proc. 2004-34:

> The provision...codifies the current deferral method of accounting for advance payments for goods, services, and other specified items provided by the IRS under Revenue Procedure 2004-34.

If the foregoing statement were read in isolation, this statement might be viewed as suggesting that section 451(c) was intended to be identical in every aspect of its operation to Rev. Proc. 2004-34, and, under this interpretation, for example, the denial of a cost offset in the case of advance payments for the sale of goods would be carried over from Rev. Proc. 2004-34 to section 451(c). However, the statement in the Conference Report quoted above is followed immediately by an additional statement that makes clear that the first statement was not intended to imply the wholesale importation of the rules in Rev. Proc. 2004-34:

> That is, the provision allows accrual method taxpayers to elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes.

The foregoing statement makes clear that it was only limited aspects of the rules in Rev. Proc. 2004-34 that were codified in section 451(c), namely, the one-year deferral period provided in Rev. Proc. 2004-34, and the requirement that amounts must be deferred for financial reporting purposes in order to be eligible for deferral for tax purposes under section 451(c). Moreover, it seems reasonably clear that other aspects of Rev. Proc. 2004-34 were not intended to be carried over into section 451(c), such as the rule in Rev. Proc. 2004-34 that taxpayers with financial statements other than applicable financial statement would report a deferred advance payment as it was earned. There is nothing in section 451(c) that suggests this aspect of Rev. Proc. 2004-34 would carry over to section 451(c).

An additional extremely important aspect of the second statement relating to section 451(c) quoted above from the Conference Report is the way this statement describes the amounts that are eligible for deferral under section 451(c): "defer the inclusion of *income associated* with certain advance payments." (Emphasis added.) It is extremely significant that this statement does not refer to deferring the inclusion of the *total amount* of advance payments, but instead refers to deferring the inclusion of "*income associated* with certain advance payments." (Emphasis added.)

Thus, the amount that is deferred under section 451(c) is not *the total amount* of the advance payment but rather *the amount of income associated* with the advance payment. This aspect of this statement is consistent with the fact, noted earlier, that the definition of "receipt" in section 451(c) refers to the time when *an item of gross income* is received, not the time when *an advance payment* is received.

Finally, a footnote to the second statement in the Conference Report quoted above reads as follows: "Thus, the provision is intended to override any deferral method provided by Treasury Regulation section 1.451-5 for advance payments received for goods." This footnote is entirely consistent with the conclusion that the intended codification of Rev. Proc. 2004-34 was limited to the one-year deferral period and the financial conformity requirement in Rev. Proc. 2004-34, since Treas. Reg. § 1.451-5 provided a much more generous deferral period than Rev. Proc. 2004-34. Moreover, as will be discussed below, there was a similar but not identical footnote in the Joint Committee explanation of the provision in the 2014 Camp tax reform proposal that corresponded to section 451(c), but the differences between the two footnotes provide support for the conclusion that the intended codification of Rev. Proc. 2004-34 in section 451(c) did not encompass the denial of a cost offset.

E. The contrast between the definition of "receipt" in section 451(c) and the definition of "received" in Rev. Proc. 2004-34 provides further support for the conclusion that section 451(c) was not intended to codify every aspect of Rev. Proc. 2004-34.

In further support of the conclusion that section 451(c) was not intended to codify all aspects of Rev. Proc. 2004-34, it is notable that the definition of "receipt" in section 451(c) differs in one significant respect from the definition of "received" in Rev. Proc. 2004-34. As noted earlier, section 451(c)(4)(C) defines "receipt" as follows: "For purposes of this subsection, *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." (Emphasis added.)

As noted earlier, it is significant that this definition of "receipt" defines receipt in terms of the time when "*an item of gross income* is received by the taxpayer." (Emphasis added.) In

contrast, section 4.04 of Rev. Proc. 2004-34 defined "received" as follows: "*Income* is 'received' by the taxpayer if it is actually or constructively received, or if it is due and payable to the taxpayer." (Emphasis added.)

Thus, the definition of "received" in Rev. Proc. 2004-34 used the very general term "income" to refer to the amount that was received, whereas the definition of "receipt" in section 451(c) uses the much more precise and specific term "an item of gross income" to refer to the amount that is received. This contrast between the definition of "receipt" in section 451(c) and the definition of "received" in Rev. Proc. 2004-34 makes clear that it was a very conscious and deliberate choice to use the precise and technical phrase "an item of gross income" in the definition of "receipt" in section 451(c), rather than the much more general term "income" that had been used in the definition of "received" in Rev. Proc. 2004-34. Thus, the use of the phrase "an item of gross income" in the definition of "receipt" in section 451(c) should be given effect, and giving effect to the use of this term requires allowing a cost offset in determining the amount of gross income that is deferred under section 451(c).

Finally, if it is concluded that a cost offset is appropriate under section 451(b), then, since section 451(b) and section 451(c) were enacted together, the two provisions should be interpreted consistently with one another, and, since both provisions use the term "item of gross income," a cost offset should be allowed for purposes of section 451(c) as well as for purposes of section 451(b).

F. A comparison between section 451(c) and the corresponding provision of the Camp tax reform proposal supports the allowance of a cost offset under section 451(c).

As is the case with respect to section 451(b) and the corresponding provision in the Camp proposal, while section 451(c) as enacted by the TCJA is unquestionably very similar to the corresponding provision in the Camp proposal, nevertheless, the two provisions are not identical. By far the most significant difference between the two provisions is the fact that the provision in the Camp proposal that corresponded to section 451(c) did not include any provision corresponding to the definition of "receipt" in section 451(c).

As discussed above, it is the use of the phrase "item of gross income" in the definition of "receipt" in section 451(c) that provides the clearest evidence that section 451(c) was intended to incorporate a cost offset concept. The fact that the inclusion of this definition of "receipt" in section 451(c) represented an entirely new addition that was not present in the corresponding provision of the Camp proposal provides very strong evidence that the addition of this definition with its use of the term "item of gross income" represented a very conscious and deliberate choice on the part of the drafters of section 451(c), and this conscious and deliberate choice should be given full effect by giving effect to the cost offset concept that is clearly incorporated in the use of the phrase "item of gross income."

Finally, even though the provision in the Camp proposal that corresponded to section 451(c) did not include any provision corresponding to the definition of "receipt" in section 451(c), nevertheless, the Joint Committee explanation of this provision in the Camp proposal included two sentences that were identical to the two sentences in the Conference Report relating to section 451(c) that have been discussed above. As discussed above, these two sentences make clear not

only that the "codification" of Rev. Proc. 2004-34 was limited to the one-year deferral period and the financial conformity requirement, but also that the amount that is subject to elective deferral is not the full amount of the advance payment but rather the "income associated" with the advance payment. Thus, as discussed above with respect to the two sentences in the Conference Report, the corresponding two sentences in the Joint Committee explanation of the Camp proposal provide strong support for the inclusion of a cost offset concept in the advance payment provision.

Finally, as noted above, there was a footnote to the second sentence in the Joint Committee explanation that was similar, but not identical, to the footnote in the Conference Report on the TCJA that was discussed above. The footnote in the Joint Committee explanation read as follows: "Thus, the proposal is intended to override the exception in Treasury Regulation section 1.451-1(c) for inventoriable goods." As discussed above, the corresponding footnote in the Conference Report on the TCJA reads as follows: "Thus, the provision is intended to override any deferral method provided by Treasury Regulation section 1.451-5 for advance payments received for goods."

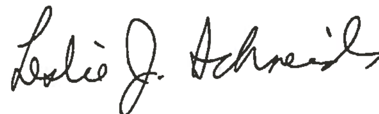
The fact that the footnote in the Joint Committee explanation referred to Treas. Reg. § 1.451-1(c) and the "exception...for inventoriable goods" in that subsection could be viewed as indicating an intention in the Camp proposal to override the cost offset provision that was included in that subsection of the regulation. However, the fact that the corresponding footnote in the TCJA Conference Report was modified in comparison to the footnote in the Joint Committee explanation to refer instead to the entirety of Treas. Reg. § 1.451-5, rather than to the subsection of that regulation dealing with the special rule for inventoriable goods, as the Joint Committee explanation did, provides strong evidence that there was a conscious decision on the part of the drafters of

section 451(c) to eliminate the implication that the cost offset provision in the regulation was being overridden in section 451(c).

III. Conclusion

For the reasons discussed above, a cost offset should be allowed under both section 451(b) and section 451(c). If you would like to discuss any of these comments in more detail, please feel free to contact the undersigned at (202) 393-7600.

Sincerely yours,



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