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Courier's Desk
Commissioner of Internal Revenue
Internal Revenue Service
Attn: CC:PA:LPD:PR
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: Comments with Respect to Notice 2018-35
Tax Treatment of Advance Payments under New Sections 451(b) and (c)

Dear Sir:

On April 12, 2018, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") issued Notice 2018-35 ("the Notice") to provide interim guidance with respect to the tax treatment of advance payments under newly-enacted sections 451(b) and (c) of the Internal Revenue Code ("Code"). In the Notice, the Treasury and the IRS announced that until further guidance is issued, taxpayers may rely on the provisions in Rev. Proc. 2004-34, 2004-1 C.B. 991, with respect to the tax treatment of advance payments. However, the Treasury and the IRS also requested comments from taxpayers on a number of issues relating to the scope and substance of the rules in Rev. Proc. 2004-34 that may be affected by the provisions in sections 451(b) and (c) of the Code.

We appreciate the opportunity to provide comments on behalf of our clients in response to the Notice. While these comments address certain of the issues on which comments were expressly solicited in the Notice, comments are also provided on a number of subjects not expressly mentioned in the Notice. In addition, we feel strongly that rules that will apply in the case of advance payments under new section 451(c) of the Code are in some respects closely interrelated with the proper interpretation of the provisions in section 451(b). Accordingly, certain of our comments address the interaction between these two new sections of the Code.

Background

Prior to the recent enactment of sections 451(b) and (c) of the Code, the tax law governing the tax treatment of advance payments was divided into two separate items of administrative guidance: (1) Rev. Proc. 2004-34 and (2) Treas. Reg. § 1.451-5. These two separate items of administrative guidance have as their foundation the separate treatment of advance payments for the sale of goods and advance payments for the provision of services, based on the original scope of Rev. Proc. 70-21 and Rev. Proc. 71-21, the predecessors to Rev. Proc. 2004-34, and Treas. Reg. § 1.451-5. The formerly separate treatment of advance payments for goods and advance payments for services was diluted to some extent by the provisions in Rev. Proc. 2004-34, which apply to advance payments for both goods and services, whereas the provisions in Treas. Reg. § 1.451-5 continue to be limited in their application to advance payments for the sale of goods.

Since one of the co-authors of these comments was intimately involved with the Treasury in the original development of the rules governing the tax treatment of advance payments for goods and services back in 1971, we believe it is helpful to a proper understanding of new sections 451(b) and (c) to review the thinking of the Treasury and the IRS at the time the original advance payment rules were initially formulated. In comparing the historical development of these rules with the merging of the rules for goods and services in section 451(c) of the Code, the principal question that arises is why the tax treatments of advance payments for goods and services were originally so different and why the treatment of advance payments for the sale of goods was treated more favorably than the treatment of advance payments for the performance of services.

The answer to this question is both political and substantive. On the political front, a Business Task Force organized by President Nixon issued a report in 1969 recommending that there be greater conformity between the tax and financial reporting rules for various types of transactions. One of the principal types of transactions where greater conformity between the tax and financial treatment was recommended was in the area of the tax treatment of advance payments. This was an area of focus of the Business Task Force because of the considerable amount of litigation that had at that time recently occurred in this area of tax.

In responding to the recommendations of President Nixon's Business Tax Force, the Treasury and the IRS initiated two separate but related projects to address the tax treatment of advance payments – one project for services and a separate project for goods. With respect to the tax treatment of advance payments for services, it was the view of the Treasury and the IRS that their authority to promulgate rules in this area was more limited than in the case of advance payments for goods because the Justice Department had recently successfully litigated three cases in the U.S. Supreme Court (the so-called "Supreme Court trilogy") holding that advance payments received for services to be performed in the future were immediately taxable to the service provider at the time the payments were received.

In contrast, the law with respect to the tax treatment of advance payments for goods to be provided in a future taxable year was more unclear. *Compare Consolidated-Hammer Dry Plate*

& Film Co. v. Commissioner, 317 F.2d 829 (7th Cir. 1963), *with Hagen Advertising Displays, Inc. v. Commissioner*, 407 F.2d 1105 (6th Cir. 1969), which reached opposite conclusions as to whether advance payments for merchandise to be delivered in the future were immediately taxable to the seller at the time the payments were received.

In contrast to the somewhat uncertain tax rules relating to advance payments, generally accepted accounting principles were clearer in their treatment of advance payments. Advance payments for either the sale of goods or for the performance of services were required to be deferred for financial reporting purposes until the time when the goods were delivered or the services were performed. Accordingly, the Business Task Force recommended that the tax treatment of advance payments follow the taxpayer's financial reporting treatment of these payments.

While the Treasury and the IRS were sympathetic to the Business Tax Force's suggestion that the tax treatment of advance payments should more closely follow the financial reporting treatment of such payments, nevertheless, as explained above, it was thought that because of the Supreme Court decisions referred to above, the Treasury had only limited authority to promulgate rules permitting such conforming treatment in the case of services, and this limitation was reflected in the decision to permit the deferral period in the case of advance payments for services to be limited to only one taxable year beyond the end of the year of receipt of the advance payment. That policy was adopted initially in Rev. Proc. 70-21, 1970-2 C.B. 501, and Rev. Proc. 71-21, 1971-2 C.B. 549, and continues in effect more recently in Rev. Proc. 2004-34.

In contrast, it was the Treasury's view that it had greater latitude to permit the deferral of advance payments for the sale of goods and that the deferral period could therefore extend for a longer period of time than one year. This policy was adopted in Treas. Reg. § 1.451-5, which permits advance payments for goods to be deferred until the goods are provided to the customer, regardless of how long a lag there is between the receipt of the advance payment and the time the goods are provided to the customer, provided the advance payments do not exceed the cost of the goods to be sold. In the case of advance payments both for the sale of goods and for the performance of services, the deferral of the advance payments for tax purposes was made contingent on the deferral of such payments in the taxpayer's financial reports.

The second consideration that influenced the disparity in treatment between advance payments for services and for goods was more substantive in nature. This consideration relates to the Treasury's preference for a system that matches the revenue from a transaction with the costs incurred in performing the transaction, which is a primary goal of the accrual method of accounting. In the case of advance payments for the performance of services, the matching principle was not as much of a concern as in the case of advance payments for goods, since the expenses of performing services are deductible as the expenses are incurred and as the services are being performed, rather than being deferred until the time when all the required services are completed.

In contrast, in the case of the sale of goods, the cost of the goods is not recognized for tax purposes as cost of goods sold until the goods are completed and shipped to a customer. Thus, if a taxpayer receiving advance payments for the sale of goods were required to include these advance payments in gross income in advance of the completion and shipment of the goods, the result would be that revenue would be recognized without any offset at that time for the cost of goods sold. However, if the inclusion in revenue of advance payments for goods is deferred until the goods are provided to the customer, there will be matching of the revenue from the sale of the goods with the related cost of producing the goods.

For the foregoing reasons, the policy that was adopted in Treas. Reg. § 1.451-5 was to permit deferral of advance payments for the sale of goods until the time when the goods are provided to the customer, provided the advance payments are deferred in the taxpayer's financial reports. The only exception to this unlimited deferral was in Treas. Reg. § 1.451-5(c), in the case of a taxpayer that has received "substantial" advance payments (payments in excess of the cost of the goods) and where the goods are included in the taxpayer's inventory or are readily available to satisfy the customer's needs. Moreover, in the case of the latter exception, while the advance payments must be included in gross income after a two-year deferral period, nevertheless, the taxpayer is entitled to an offset at that time for the actual or estimated cost of goods sold.

The foregoing regime reflects the Treasury's concern that a taxpayer not be required to include advance payments for the sale of goods in gross income without being entitled to an offset against this income inclusion for the cost of the goods to be sold. Thus, the matching of revenue and expenses in the case of the sale of goods was preserved by this regime.

The foregoing history is relevant in analyzing the proper interpretation of new sections 451(b) and (c) and any administrative pronouncements the Treasury and the IRS may issue to implement these new sections of the Code.

Comment Topics

This comment letter will address the following separate topics:

1. What is the proper tax treatment of advance payments received by a taxpayer producing goods for customers in a case where the taxpayer is using the accrual shipments method of accounting for both financial reporting and tax purposes? In addition, how should the cost of goods sold be treated when the advance payments are required to be reported as income for tax purposes prior to the time the goods are shipped to the customer?

2. In certain circumstances described in more detail below, a taxpayer that produces goods for customers and uses the accrual shipments method of accounting for tax purposes is nevertheless required under ASC 606 to use the percentage of completion method of accounting for financial reporting purposes. In each of the following circumstances, the

taxpayer uses the accrual shipments method for tax purposes and the percentage of completion method for financial reporting purposes.

a. If the contract with the customer does not provide for any payments by the customer to the taxpayer prior to the time when the goods are shipped to the customer, is the taxpayer required to report any revenue for tax purposes under section 451(b) of the Code prior to completing production of the goods and shipment of the goods to the customer by reason of using the percentage of completion method for financial accounting purposes?

b. If the contract with the customer provides for an initial payment before any work on the contract begins, is the taxpayer permitted to defer the recognition of income relating to this initial payment under section 451(c) where the taxpayer has not yet reported any revenue for financial reporting purposes under the percentage of completion method, in light of the fact that under the percentage of completion method, payments during the performance of a contract are disregarded in computing the amount of gross income reported each year for financial reporting purposes?

c. If the contract with the customer calls for periodic payments by the customer to the taxpayer as work progresses on the contract, how does advance payment deferral operate in light of the use of the percentage of completion method for financial accounting purposes? Are the costs of performance taken into account in the foregoing determination?

d. For reasons of administrative simplicity, should the IRS consider permitting a taxpayer that is required to use the percentage of completion method for financial reporting purposes to use that same method for tax purposes, even though section 460 is not applicable?

3. Is a closely-held taxpayer that does not issue applicable financial statements permitted to defer the inclusion of advance payments in income for tax purposes, provided those payments are deferred in the taxpayer's non-applicable financial statements issued to creditors and to the owners of the closely-held business?

Detailed Comments

Issue One **Tax treatment of progress payments and related costs in connection with production of goods by a taxpayer using the accrual shipments method for tax and financial reporting purposes.**

Where a taxpayer using the accrual shipments method of accounting for tax and financial reporting purposes receives advance payments with respect to the production of goods for a customer, under section 451(c) the taxpayer is permitted to defer the advance payments for tax purposes for only one taxable year beyond the year of receipt, even though the advance payments might be deferred for a longer period of time for financial reporting purposes as a result of the fact that the goods have not yet been completed and shipped to the customer within the permitted one-year period of tax deferral. In that circumstance, the cost of producing the goods would ordinarily be capitalized and held in inventory for both tax and financial accounting purposes until the production of the goods is complete and the goods have been shipped to the customer.

For example, assume that late in its taxable year, A, a producer of goods, contracts with a customer, B, to produce certain goods for B for $200X. The goods are expected to cost $60X to produce and to take 24 months to produce because of the time required to obtain certain raw materials. Upon signing the contract, A receives an initial payment of $100X, and before the end of that taxable year A incurs production costs of $20X. For financial reporting purposes, the $100X initial payment is deferred, and the $20X of costs are capitalized to inventory.

In the second taxable year, A incurs an additional $20X of costs and adds that amount to the cost of its ending inventory for financial reporting purposes. A continues to defer the $100X initial payment for financial reporting purposes. A completes the production of the goods in year three, incurring additional costs of $20X, and A ships the goods to B in that taxable year. A receives the $100X balance of the sales price in year three. For financial reporting purposes, A reports the entire $200X in revenue, and includes the entire $60X in cost of goods sold, in year three. What is the proper treatment for tax purposes of the initial payment of $100X and the costs incurred each year in this transaction?

Section 451(c) of the Code would seem to permit the $100X initial payment in the example to be treated as an advance payment, thereby enabling A to defer the recognition of the $100X of progress payments in revenue for tax purposes until year two. However, the question posed for year two is what role the $20X of costs incurred in year one and the additional $20X of costs incurred in year two play in the calculation of A's gross income for tax purposes in year two.

Rev. Proc. 2004-34 did not provide for any special treatment for the costs of producing goods in respect of which advance payments were received. Accordingly, under Rev. Proc. 2004-34, the $40X of production costs that were incurred in the first two years would be required to be capitalized to inventory until the goods are completed and shipped to the customer, and the full $100X would be included in taxable income in year two.

Treas. Reg. § 1.471-1 provides that goods should remain in a taxpayer's inventory until ownership of the goods passes to the purchaser of such goods. Moreover, section 461(h)(2)(B) provides that in the case of an obligation to provide goods to a third party, economic performance does not occur until the goods are so provided, so that A would not be permitted to take the cost of the goods into account for tax purposes until the goods were completed and shipped to B.

Accordingly, sections 461(h) and 471would prevent A from including the $40X of inventoriable costs in cost of goods sold until the goods are shipped to B in year three. In the past, this situation has not typically posed a problem for taxpayers because if the deferral period for advance payments for the sale of goods lasted for longer than one taxable year beyond the end of the taxable year in which the advance payments were received (or longer than the extended period under the recurring item exception), the taxpayer could elect deferral under Treas. Reg. § 1.451-5 instead of Rev. Proc. 2004-34.

However, under section 451(c), that option will no longer be available. Accordingly, the issue posed under section 451(c) is whether a taxpayer will be permitted any type of cost offset to the inclusion of advance payments in income for tax purposes after the one-year deferral period for the advance payments has expired, where the taxpayer uses the accrual method of accounting for tax and financial reporting purposes. We submit that in contrast to the treatment of advance payments for the future performance of services, a significant mismatching of revenue and expenses will occur if advance payments for the sale of goods are required to be included in income by a taxpayer when the one-year permitted deferral period has expired without any offset for the cost of goods sold related to the advance payment.

As noted above, such a cost offset was permitted under Treas. Reg. § 1.451-5(c) in the limited circumstances where a taxpayer was required to include an advance payment in income prior to the completion of production and shipment of the goods to a customer. That exception remained available despite the subsequent enactment of section 461(h), a result that indicates that the Treasury regarded the treatment under Treas. Reg. § 1.451-5(c) as a permissible exception from the economic performance requirements in section 461(h). Moreover, as discussed previously, the need for a cost offset was uppermost in the Treasury's mind when it created different deferral rules for advance payments for goods and services back in 1970.

In addition, the law relating to the effect of an advance payment inclusion in income on the related cost of goods sold was not fully developed when the Treasury issued Treas. Reg. § 1.451-5(c) was issued. In the leading case in this area, *Hagen Advertising, supra*, the Sixth Circuit rejected the taxpayer's argument for a cost of goods sold offset to the inclusion of advance payments in gross income on the grounds that the taxpayer failed to offer proof of the cost of goods sold that related to the goods in respect of which the advance payments were received.

The court did not suggest that had that proof been offered, the cost of goods sold offset would have been disallowed. The issuance of Treas. Reg. § 1.451-5 and the allowance of a cost of goods sold offset in Treas. Reg. § 1.451-5(c) avoided further litigation on this subject. Accordingly, we submit that the IRS has sufficient authority to address this issue in the context of advance payments for the sale of goods.

We do not believe that the enactment of section 451(c) eliminates the IRS's authority in this area. We submit that in enacting section 451(c), Congress was focused on requiring consistency in the length of deferral periods in the two types of advance payment situations but was not focused on the treatment of costs in the two situations.

Moreover, even if comparability in treatment of costs were also deemed a focus of section 451(c), a strong case could be made that allowing a cost offset for advance payments for the sale of goods results in comparable treatment for goods and services because the costs of performing services are always deductible as the costs are incurred, without regard to the need for being matched with related revenues. Accordingly, permitting a cost of goods sold inclusion for the cost of producing goods as the costs are incurred, to the extent of any advance payments included in gross income, results in the same type of treatment for expenses in the case of advance payments for the sale of goods as is permitted in the case of advance payments for services.

In addition to providing comparability in treatment for advance payments for goods and services, this approach would also be most consistent with the definition of gross income from sales of merchandise, as provided in sections 61(a)(2) and 61(a)(3) and the regulations thereunder. Those provisions define gross income from dealings in property as being limited to the "gain" from the disposition of the property, rather than the entire gross sales price of the property.

Treas. Reg. § 1.61-3(a) provides that "[i]n a manufacturing, merchandising, or mining business, 'gross income' means the total sales, less the cost of goods sold...." Since section 451(c) is drafted in terms of the inclusion of advance payments in gross income, the reference to "gross income" necessarily implies the inclusion of the cost of goods sold associated with the advance payment in the determination of the amount of the gross income inclusion.

Moreover, it is possible that the amount of advance payments received under a particular contract might exceed the total ultimate gross income that would be earned on the contract. Under those circumstances, if no cost of goods sold offset were permitted against the advance payment inclusion, the result would be the recognition of a loss at the time the goods were completed and shipped to the customer, despite the fact that the overall result on the contract was a profit.

In the event the IRS and the Treasury are not willing to accept our suggestion in all cases, we submit that at a minimum the IRS and the Treasury should at least permit a cost of goods sold offset against the inclusion of advance payments in income in a case where the costs incurred during the taxable year in which the advance payments were required to be included in income would satisfy the recurring item exception to the economic performance requirement for that taxable year. Under this approach, a taxpayer would be permitted an offset for its cost of goods sold against the amount of the advance payments in the taxable year in which the advance payments are included in income provided the goods are completed and shipped to the customer within 8½ months after the end of the taxable year in which the advance payments are included in income.

We submit that this result is justified under the recurring item exception because the allowance of a cost of goods sold offset in the taxable year in which the advance payments are included in income results in a better matching of revenue and expenses pursuant to section 461(h)(3)(A)(iv)(II). Under this approach, we would also recommend including any costs incurred prior to the year in which the advance payments are included in income even though those costs could not satisfy the technical requirements of the recurring item exception for that taxable year.

In making both of the foregoing suggestions, we are mindful of the concern allowing a cost of goods sold offset prior to receipt of the entire sales price in a contract might have the effect of creating an interim loss on the transaction. Accordingly, we would frame any cost offset rule in a way that limits the amount of costs of production that are included in cost of goods sold in connection with advance payments to the amount of any advance payments that have been included in a taxpayer's income.

Issue Two Tax treatment of progress payments and related costs in connection with production of goods by a taxpayer using the accrual shipments method for tax purposes and the percentage of completion method for financial reporting purposes.

As noted above, a number of issues are presented where a taxpayer that produces goods for customers is required to use the percentage of completion method for financial reporting purposes, but uses the accrual shipments method for tax purposes, because the taxpayer is not engaged in the performance of long-term contracts, as that term is defined in section 460(f)(2), and is thus not permitted to use the percentage of completion method for tax purposes. This situation will arise with increasing frequency because of a recent pronouncement by the Financial Accounting Standards Board ("FASB"), ASC Topic 606 ("ASC 606").

ASC 606 deals with the recognition of revenue for financial reporting purposes. ASC 606 went into effect for public companies in 2018 and will go into effect for privately-held companies in 2019. Under ASC 606, a special accounting treatment is prescribed in situations where a company that enters into contracts with customers for the production of goods for the customers satisfies the following two criteria:

1. The goods that are the subject of the contract have no alternative use to the taxpayer if the customer defaults on the contract; and

2. The taxpayer has an enforceable right to payment for the work performed to date, even if the contract is not completed, provided the non-completion does not result from the taxpayer's failure to perform.

ASC 606-10-25-27; ASC 606-10-25-29.

If the foregoing criteria are satisfied, the taxpayer is required to report the revenue and expenses from the contract for financial accounting purposes using the percentage of completion method. In contrast, for tax purposes, a taxpayer is permitted (and required) to use the percentage of completion method only for contracts that meet the definition of a "long-term contract" within the meaning of section 460(f)(2). However, the requirements under section 460(f)(2) do not necessarily conform with those under ASC 606-25-27 and -29. As a result, many types of contracts for the production of goods for customers that come within the requirements of ASC 606-25-27 and -29 will not be permitted to be accounted for using the percentage of completion method for tax purposes.

Thus, in many cases, a taxpayer will be reporting revenue and expenses on contracts with customers using the percentage of completion method for financial reporting purposes but using the accrual shipments method for tax purposes. This disparity between tax and financial reporting methods creates a number of issues with respect to the application of sections 451(b) and (c). These issues are addressed below.

Case A Application of section 451(b) where no progress payments are provided for in the contract with the customer.

The first situation to be addressed involving a taxpayer producing goods for customers that uses the percentage of completion method for financial reporting purposes and the accrual shipments method for tax purposes is a case where the taxpayer's contract with the customer does not provide for any payments by the customer to the taxpayer prior to completion of the contract. In that type of case, the issue is posed as to whether section 451(b) applies based on the recognition of revenue under the percentage of completion method despite the absence of any progress payments in the contract. We submit that it is helpful in considering the application of section 451(c) to situations where progress payments are received in these types of situations for the issue of revenue recognition to be addressed first in a context where there are no progress payments in this type of contract.

This situation is illustrated by the following fact pattern:

> P, a producer of equipment for customers, enters into a contract with a customer, C, to produce for the customer one of its machines for a price of $120X. The expected cost of production of the customized machine is $75X. The contract does not call for any progress payments to be paid by C to P prior to the delivery of the product. During the taxable year in which the contract is entered into, P incurs two thirds of the total expected costs, $50X, to produce the product for C.

This example poses the following three issues:

1. Is P required to report any revenue for tax purposes in the taxable year in which the contract is entered into as a result of the recognition of revenue in that year for financial accounting purposes under the percentage of completion method?

2. If P is required to report some amount of revenue for tax purposes in the taxable year in which the contract is entered into, what is the amount of revenue that is required to be reported for tax purposes?

3. If P is required to report some amount of revenue for tax purposes in the taxable year the contract is entered into, what is the proper treatment of the $50X of costs incurred by P during the taxable year?

A literal reading of the statutory language in section 451(b) might suggest that there is some amount of revenue recognition that is required for tax purposes in the taxable year in which the contract is entered into as a result of the fact that revenue is reported in that taxable year in P's financial statements. However, there has not been any realization event in a tax sense in the taxable year in which the contract is entered into because P has neither completed and shipped the machine to C nor received any progress payments from C with respect to the contract. The normal meaning of realization for tax purposes requires that there must either be a sale or other disposition of property in order for realization to exist, or else the receipt of some consideration with respect to the property.

In the foregoing type of case, we submit that section 451(b) should be interpreted in light of footnote 872 of the Conference Report with respect to TCJA. That footnote provides:

> The provision does not revise the rules associated with when an item is realized for Federal income purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred. For example,....the provision does not require the recognition of gain or loss from securities that are marked to market for financial reporting purposes if the gain or loss from such investments is not realized for Federal income tax purposes until such time that the taxpayer sells or otherwise disposes of the investment.

Conf. Rep. at 275 n. 872.

In the example, P's situation is directly analogous to the situation described in footnote 872 involving the use of a mark-to-market method of accounting for securities for financial reporting purposes, but where gain or loss on the securities is reported for tax purposes only when the securities are sold (based on the assumption that section 475 is inapplicable). P does not have a realization event solely by performing a portion of the work on the contract, where P has not received any progress payments and the portion of the work that has been performed has not been delivered to the customer. Accordingly, in this situation, because of the lack of a realization event, we submit that P should not report any revenue or expenses in the taxable year in which the contract is entered into.

However, as will be discussed in a later section, in a case where there is not only income recognition for financial accounting purposes under the percentage of completion method but also the receipt of progress payments, we submit that while the receipt of progress payments would represent a realization event for tax purposes, nevertheless, the advance payments should be deferrable under section 451(c) and should not be subject to section 451(b) because it is not the receipt of the progress payments that results in income recognition under the percentage of completion method.

Finally, while we believe we are correct in our conclusion that section 451(b) has no application with respect to the reporting of income for financial accounting purposes under the percentage of completion method, nevertheless, in the event that the IRS and the Treasury do not agree with our conclusion that there has been no realization event in this type of situation, we believe it is useful to proceed to a discussion of the second and third issues identified above.

Since P has incurred two thirds of the total expected costs on the contract in the taxable year the contract is entered into, as a result, under the percentage of completion method that is applicable for financial accounting purposes, P will report two thirds of the total contract price of \$120X in that taxable year, or a portion of the contract price equal to \$80X, with an offset against that \$80X equal to the \$50X of costs P has incurred during that year. We submit that if section 451(b) is applicable in these circumstances, the amount of gross income that should be required to be reported for tax purposes in the taxable year the contract is entered into is \$30X, determined as the portion of the contract price recognized under the percentage of completion method, \$80X, less the \$50X of costs incurred by P in that year.

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.

As discussed in the preceding section of these comments, 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 sales revenue less the 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.

It seems to us that this is the only possible reading of the statutory language of section 451(b) in the context of a sale of goods. Moreover, section 451(b) refers not only to "any item of gross income" but also to "any portion thereof." Under the percentage of completion method, the portion of the total amount of gross income on a particular contract that is recognized during a particular taxable year is the portion of the total contract price that is recognized during that year less the amount of costs that are incurred by the taxpayer during that year in performing the contract. In the example being discussed here, that gross income amount is clearly \$30X for the year the contract is entered into.

In response to this comment, the IRS and the Treasury may contend that under the percentage of completion method, the costs of performance are not treated as cost of goods sold in arriving at gross income under the percentage of completion method as applied for tax purposes. In this regard, we observe that under the original long-term contract regulations that were in effect before the enactment of section 460, the costs of performing long-term contracts were referred to as "deductions" and thus were treated as deductions from gross income.

However, the regulations under section 460 do not follow that approach. Instead, the references to costs as "deductions" under the percentage of completion method (and the completed contract method as well) that existed in the original long-term contract regulations were eliminated in the section 460 regulations. As a result, the references to costs as deductions in these now-withdrawn and obsolete regulations should not carry any current weight in applying section 451(b), and instead the normal meaning of "gross income" in the context of a sale of good as sales revenue less the associated cost of goods sold should clearly prevail.

Case B　　Application of sections 451(b) and (c) where a down payment is made for the production of goods before any production work occurs.

The next case to be addressed involving a taxpayer producing goods for customers that uses the percentage of completion method for financial reporting purposes and the accrual shipments method for tax purposes is a contract where the customer is required to pay a down payment to the taxpayer before the taxpayer performs any production work. This situation is illustrated by the following fact pattern:

> X, a manufacturer, enters into a contract to produce a product for Z for a total price of \$300X. Z is required to pay X a down payment of \$30X at the inception of the contract. However, during the taxable year in which the contract is entered into, X does not begin production of the product and, thus, incurs no production costs. Accordingly, under the percentage of completion method that is used for financial reporting purposes, X reports no revenue or expenses for that taxable year.

This example poses the following two issues:

1. Apart from the possibility of deferral under section 451(c), is X required to report any income for tax purposes in the taxable year in which the contract is entered into as a result of receiving the down payment of \$30X?

2. If X is required to report some amount of income for tax purposes in the taxable year in which the contract is entered into, is X permitted to defer that income for tax purposes pursuant to the provisions in section 451(c)?

This case is different from Case A insofar as no work has been performed on the contract in the taxable year in which the contract was entered into. As a result, X does not recognize any income in that year for financial accounting purposes under the percentage of completion method. In addition, in contrast to Case A, in Case B X has received a $30X down payment in the taxable year the contract is entered into.

Accordingly, it is likely that A would be regarded as having had a realization event in that year with respect to the $30X down payment. No revenue is required to be reported by X for tax purposes under section 451(b) because no revenue is reported in X's financial statements under the percentage of completion method. However, under the claim of right doctrine and prevailing case law, X would be regarded as having $30X of income for tax purposes, without regard to its financial statement treatment of the down payment.

Turning to the second issue, we submit that X should be permitted to defer the $30X down payment for one taxable year under section 451(c). The $30X down payment would be eligible for a one-year deferral under the principles in Rev. Proc. 2004-34, and those principles ought to carry over to section 451(c). While this conclusion might seem self-evident, it should be noted that under the percentage of completion method that is used by X for financial reporting purposes, progress payments are never reported as gross income and have no effect on the application of the percentage of completion method. Instead, a portion of the contract price is recognized as revenue for financial reporting purposes as work progresses and as costs are incurred with respect to the contract.

While this aspect of the percentage of completion method may not affect the conclusion that tax deferral of the $30X down payment is permitted in Case B, we submit that it would be helpful if the administrative guidance issued by the IRS addresses this point. This is particularly true since this issue is highly relevant in considering the next case that is presented below. The subsequent treatment of progress payments that are eligible for deferral under section 451(c) will be discussed under the next case.

Case C Application of sections 451(b) and (c) as progress payments for the production of goods are received and as production work occurs.

Building on the conclusions from the preceding cases, the next case to be considered involving a taxpayer producing goods for customers that uses the percentage of completion method for financial reporting purposes and the accrual shipments method for tax purposes is a contract where the customer is required to make periodic progress payments to the taxpayer as the taxpayer performs production work. This situations is illustrated by the following fact pattern:

E, a producer of machines, enters into a contract to produce a machine for F for a price of $1,000X. The machine is expected to cost $600X to produce. Assume that during the initial taxable year of the contract, F makes progress payments to E of $600X. During that same taxable year, E incurs $300X of costs while working on the production of the machine. In those circumstances, E reports $500X of revenue and $300X of expenses in its financial statements pursuant to the percentage of completion method.

This example poses the following issues:

1. How does section 451(b) apply in determining the amount of revenue that E must report for tax purposes in the initial taxable year of the contract? How does E's treatment of the costs incurred in that taxable year for financial reporting purposes affect the determination under section 451(b)?

2. Is E permitted to defer for tax purposes any portion or all of the progress payment that it received in the initial taxable year pursuant to the provisions in section 451(c)?

Turning first to the issues under section 451(b), as noted above, during the taxable year in which the contract is entered into, E reports $500X of revenue and $300X of costs for financial reporting purposes under the percentage of completion method. Under the percentage of completion method, those amounts are not affected by the amount of progress payments E receives.

Assuming the IRS accepts our suggestion in Case A that no revenue is recognized for tax purposes for purposes of section 451(b) based on the reporting of revenue for financial accounting purposes under the percentage of completion method, then the $500X of revenue that is reported for financial reporting purposes would not be required to be reported for tax purposes pursuant to section 451(b). Moreover, as previously discussed, since the reporting of revenue under the percentage of completion method is not affected by the receipt of progress payments, as a result, the progress payments received should be eligible for deferral under section 451(c), with the only issue being the amount that is eligible for deferral, an issue that is discussed below.

Turning to the tax treatment of the progress payments, and the application of sections 451(b) and (c), in the initial taxable year, E reports for financial reporting purposes an amount of revenue of $500X in comparison to the receipt of a progress payment in the amount of $600X. In addition, E reports the $300X of costs incurred as an offset to the $500X portion of the contract price under the percentage of completion method for financial accounting purposes and thus reports $200X of gross income for financial accounting purposes. This gives rise to the question of whether under sections 451(b) and (c), E would be permitted to defer for tax purposes $600X, $100X, or $400X.

The argument for tax deferral of the entire $600X of progress payments would be based on the fact that, as discussed earlier, under the percentage of completion method that is used for financial reporting purposes, the progress payments received are never themselves reported as revenue and have no effect on the operation of the percentage of completion method. Accordingly, the progress payments of $600X are not subject to section 451(b), and thus the entire amount is eligible for deferral under section 451(c).

If the IRS is unwilling to adopt the interpretation in the preceding paragraph, the issue is posed as to what amount of the progress payments less than $600X is eligible for deferral under section 451(c). One possibility would be to conclude that the amount eligible for deferral is the excess of the $600X total progress payment received over the $500X that is reported as revenue under the percentage of completion method, $100X. The rationale for this approach is that the $500X represents the amount of revenue that has been reported for financial accounting purposes so that only $100X of the $600X total progress payment has not yet been reported for financial accounting purposes.

Another possibility is that the $300X of costs incurred during the year are taken into account in determining the portion of the advance payment that is considered to have been recognized for financial reporting purposes. If this interpretation is adopted, then $200X ($500X minus $300X) of the $600X of progress payments would be deemed to have been recognized for financial reporting purposes, and the remaining $400X of the progress payments would therefore be eligible for tax deferral under section 451(c).

The argument in support of the latter interpretation is that since the operation of the percentage of completion method is not affected by the receipt of progress payments, as a result, only the amount of profit reported under the contract should be viewed as representing the portion of the progress payments that is being reported as revenue for financial reporting purposes, and the balance of the progress payments is viewed as being deferred.

This approach would be consistent with the way income is measured for purposes of new section 451(b), since, as discussed earlier, section 451(b) is based on the amount of gross income that is reported for financial accounting purposes, and $200X is the amount of gross income reported under the percentage of completion method for this year. We acknowledge that prior to the enactment of section 451(c), Treas. Reg. § 1.451-5 determined whether a taxpayer was deferring an advance payment for financial reporting purposes based on whether the advance payment was treated as part of a taxpayer's current gross receipts in the taxpayer's financial statements. The fact a taxpayer had incurred inventoriable costs of performance played no role in the determination of whether advance payments were deferred in the taxpayer's financial statements.

However, in light of the simultaneous enactment of section 451(b) and section 451(c), sections 451(b) and (c) should be interpreted in a consistent manner. As discussed earlier, the fact that section 451(b) refers to the taxpayer's treatment in the taxpayer's financial statements of an item of "gross income," not an item of "gross receipts," makes clear that for purposes of applying section 451(b) the relevant income amount must be determined by taking into account an offset against the amount of gross receipts reported for the associated costs.

Now that the deferral of advance payments has been codified in section 451(c), a strong argument can be made that for purposes of interpreting the financial conformity requirement in section 451(c), the amount of an advance payment that is considered deferred in a taxpayer's financial statements should likewise take into account the costs of performance that are included in the determination of the taxpayer's gross income. This follows from the fact that section 451(c)(1)(B)(ii) provides that a taxpayer that properly defers the inclusion in income of a portion of an advance payment from the taxable year in which the advance payment is received is required to "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." (Emphasis added.)

While inventoriable costs incurred by a taxpayer using the accrual method of accounting for financial reporting purposes are normally deferred until the product is completed and shipped to the customer, in contrast, under the percentage of completion method, the costs of performance are offset against the portion of the contract price reported under the percentage of completion method each year as the costs are incurred. Accordingly, when the percentage of completion method is used for financial reporting purposes, the amount of gross income that is reported by the taxpayer is the amount of revenues recognized based on the percentage of the work that is completed less the amount of costs incurred in performing that work.

Thus, when a taxpayer uses the percentage of completion method for financial reporting purposes, we submit that for purposes of section 451(c) the taxpayer should be deemed as having deferred for financial reporting purposes the portion of any advance payment that is received based on the amount of gross income that is reported by the taxpayer in its financial statements, namely, the portion of the contract price reported as revenue for the year less the amount of costs incurred during the year, rather than by the treatment of the fraction of the gross contract price that is includible in net income for financial reporting purposes.

Case D **Permit elective use of the percentage of completion method for tax purposes where that method is used for financial accounting purposes in the interests of administrative simplicity.**

In lieu of all the complexity involved in resolving the issues in the foregoing situations, we request that the IRS consider permitting a taxpayer that is required to use the percentage of completion method for financial reporting purposes to also use the percentage of completion method for tax purposes, regardless of whether section 460 is applicable.

Taxpayers that are subject to the new requirement in ASC 606 that they account for certain of their contracts on the percentage of completion method for financial reporting purposes will frequently have numerous individual contracts that are subject to that requirement. For those contracts, if a taxpayer is required to use an accrual shipments method for tax purposes, a Schedule M adjustment is likely to be required to be made for every single one of those contracts.

Such a situation could easily arise because the criteria for defining a long-term contract in section 460(f)(2) of the Code do not conform with the requirements in ASC 606. Section 460(f)(2) provides that in the case of a manufacturing contract, a long-term contract is a contract that either involves the production of unique items not normally included in finished goods inventory or involves subject matter that requires more than 12 calendar months to produce. As discussed above, the requirements in ASC 606 do not contain either of those criteria that are included in section 460(f)(2).

Thus, a taxpayer that is required to use the percentage of completion method for financial reporting purposes, but that is not permitted to use that method for tax purposes, will for tax purposes need to be able to keep track of its inventoriable costs on a contract, even though for financial reporting purposes the taxpayer has treated the costs of performance as an offset to recognition of portions of the contract price as the costs have been incurred. This will be a time-consuming and an administratively burdensome task.

In lieu of requiring that type of burdensome task, it would be much easier if such taxpayers were permitted to elect to report the income and expenses of such contracts on the percentage of completion method for tax purposes, basically following the financial accounting approach. For many of such taxpayers, reporting on a percentage of completion method, rather than an accrual shipments method, would result in some acceleration of income, rather than a net deferral of income, in comparison with their prior tax treatment. However, if a taxpayer is willing to accept that additional tax burden in exchange for less administrative burden, the IRS should consider allowing such an approach.

The IRS's legal justification for this approach could be based on the interpretation of the term "unique" in section 460(f)(2)(A). Heretofore, the IRS has interpreted the term "unique" to mean "one of a kind." As a result, when a taxpayer enters into a contract to produce a new type of product for the first time, the IRS has taken the position that the product is unique and has required the taxpayer in that circumstance to use the percentage of completion method to account for the income and costs of that initial contract. However, if the taxpayer enters into follow-on contracts for the same type of goods, the IRS has generally treated the follow-on contracts as not being subject to section 460.

Since the foregoing positions are administrative in nature and are not based either on specific language in section 460 itself or on particular court decisions, we submit that the IRS has the authority to administer the advance payment rules in a way that permits a taxpayer that is using the percentage of completion method for a particular contract for financial accounting purposes pursuant to the requirements of ASC 606 to treat the work product under that contract as unique for tax purposes and, therefore, to use the percentage of completion method for tax purposes, even if the contract would not otherwise have qualified as a long-term contract for tax purposes under the IRS's existing interpretation of section 460(f)(2). This approach would confer on taxpayers the option to use the percentage of completion method for tax purposes if they are required to use that method for financial reporting purposes.

Issue Four Inclusion of non-applicable financial statements in the financial conformity eligibility test in section 451(c)

Section 451(c)(4)(A)(ii) provides that an advance payment that is eligible for deferral for tax purposes is any payment any portion of which is included in revenue by the taxpayer in a taxable year subsequent to the taxable year in which the payment was received in any financial statement issued by a taxpayer that is described in clause (i) or (ii) of subsection 451(b)(1)(A). Subsection 451(b)(1)(A) provides that the types of financial statement that are covered by these provisions are either an "applicable" financial statement or any other financial statement that the Treasury may specify.

An "applicable" financial statement is defined in section 451(b)(3) as being any of the following categories of financial statements:

1. A financial statement that is certified as being prepared in accordance with generally accepted accounting principles ("GAAP") and that is any of the following:

   a. a Form 10K required to be filed with the SEC;

   b. an audited financial statement used for reporting to shareholders, partners, or other proprietors, or for credit purposes, or any other substantial nontax purposes; or

   c. a financial statement that is filed with any other federal agency for purposes other than tax purposes.

2. A financial statement that is prepared based on international financial reporting standards ("IFRS") and that is filed with an agency of a foreign government under certain prescribed standards.

3. A financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Treasury.

Based on the foregoing categories of eligibility, a non-audited financial statement issued by a privately-held taxpayer would not ordinarily be considered an applicable financial statement for purposes of triggering the gross income recognition rule in section 451(b) or enabling the taxpayer to elect the deferral method of accounting for advance payments under section 451(c). However, the statute also authorizes the Treasury to specify other types of financial statements for purposes of both triggering the gross income recognition rule in section 451(b) as well as conferring eligibility to use the deferral method of accounting for advance payments under section 451(c). For the reasons discussed below, we submit that a taxpayer issuing only non-audited financial statements should nevertheless be entitled to elect the deferral method of accounting for tax purposes for qualifying advance payments under section 451(c) with the consequence, as discussed below, that these financial statements would also be subject to the gross income triggering rule in section 451(b).

Under Rev. Proc. 2004-34, a taxpayer that did not issue applicable financial statements was nevertheless eligible to defer advance payments for tax purposes under specified circumstances. In that situation, rather than rely on a financial conformity test to determine the taxpayer's eligibility to defer advance payment for tax purposes, Rev. Proc. 2004-34 instead relied on whether any portion of the advance payment was earned in a later taxable year than the taxable year in which the payment was received and permitted such a taxpayer to defer to the following year any portion of the advance payment that was not earned in the year in which it was received.

While sections 451(b) and 451(c) clearly give the Treasury the authority to extend the treatment provided by these sections for applicable financial statements to other categories of financial statements, nothing in the relevant statutory text would provide support for carrying over the rule in Rev. Proc. 2004-34 that depended on determining when the advance payment was earned in the case of financial statements other than applicable financial statements. Nevertheless, the fact that the Treasury was authorized to treat financial statements other than applicable financial statements in the same way as applicable financial statements for purposes of applying sections 451(b) and 451(c) strongly suggests that Congress anticipated that the Treasury would exercise that authority.

We believe that in deciding whether to exercise that authority, Treasury should be guided by the fact that the relevant provisions in sections 451(b) and 451(c) clearly require parallel treatment under sections 451(b) and 451(c) for financial statements other than applicable financial statements. Thus, to the extent that the Treasury makes the decision to exercise its authority in this regard with respect to either the gross income triggering rule in section 451(b) or the advance payment deferral rule in section 451(c), the same treatment must also apply with respect to the other subsection.

In light of this fact, to the extent the Treasury exercises its authority under sections 451(b) and 451(c) to extend the treatment given by those provisions to applicable financial statements to other categories of financial statements, taxpayers that issue only financial statements other than applicable financial statements will not only receive the benefit of advance payment deferral under section 451(c) but also will suffer the detriment of gross income triggering under section 451(b). We believe the existence of these dual and opposite effects should weigh in favor of the Treasury deciding to exercise its authority in this area. In addition, in light of these dual effects, we believe the Treasury should make the application of these two rules to financial statements other than applicable financial statements elective rather than mandatory for taxpayers.

With respect to the conclusion that consistency is required in the treatment of financial statements other than applicable financial statements under sections 451(b) and 451(c), it is noteworthy that section 451(b)(1)(A) provides that in the case of an accrual-method taxpayer, "the all events test with respect to any item of gross income (or portion thereof)" must be treated as being satisfied no "later than when such item (or portion thereof) is taken into account as revenue in" either "an applicable financial statement of the taxpayer" (section 451(b)(1)(A)(i)) or "such other financial statement as the Secretary may specify for purposes of this subsection" (section 451(b)(1)(A)(ii)). As discussed above, the foregoing provision in section 451(b) clearly gives the Treasury the authority to specify through regulations categories of financial statements other than "applicable" financial statements that will trigger the gross income inclusion rule in section 451(b)(1)(A).

Notice 2018-35 fails to acknowledge that the reference to "such other financial statement as the Secretary may specify" in the definition of advance payments in section 451(c) operates entirely by reference to the provision in section 451(b) authorizing the Treasury to specify financial statements other than applicable financial statements that will trigger the gross income inclusion rule in section 451(b). The portion of the definition of advance payment discussed above that actually appears in section 451(c)(4)(A)(ii) is as follows: "any portion of which is included in a financial statement described in clause (i) or (ii) of subsection (b)(1)(A) for a subsequent taxable year." Clause (i) of subsection (b)(1)(A) refers to applicable financial statements, and clause (ii) of subsection (b)(1)(A) refers to "such other financial statement as the Secretary may specify for purposes of this subsection."

The reason it is important that this aspect of the definition of advance payment in section 451(c) operates entirely by cross-reference to the reference to "such other financial statement as the Secretary may specify for purposes of this subsection" in section 451(b)(1)(A)(ii) is that the Treasury is clearly not given the authority to prescribe inconsistent categories of financial statement other than applicable financial statements for purposes of section 451(b) and section 451(c).

Thus, if the Treasury makes the decision that it would be appropriate to specify certain categories of financial statements other than applicable financial statements for purposes of permitting the deferral of advance payments for tax purposes under section 451(c), it would also be necessary for the Treasury to extend parallel treatment for those same categories of financial statements for purposes of triggering the gross income inclusion rule in section 451(b). The Treasury is clearly not given the authority to include categories of financial statements other than applicable financial statements for purposes of the definition of advance payments in section 451(c), but exclude those categories of financial statements other than applicable financial statements from the gross income inclusion rule of section 451(b).

Likewise, the Treasury would not have the authority to include certain categories of financial statements other than applicable financial statements for purposes of the gross income inclusion rule in section 451(b) but exclude those same categories of financial statements for purposes of the advance payments deferral rule in section 451(c). Accordingly, a privately-held taxpayer that does not have audited financial statements may obtain the benefits of the deferral of advance payments in section 451(c) only if the taxpayer also accepts the detriment of being subject to the acceleration of income rule in section 451(b). This insures that a privately-held taxpayer will not take lightly its reporting obligations under section 451(c).

In conclusion, we submit that the IRS should continue to follow the expansive eligibility rules for the deferral of advance payments in Rev. Proc. 2004-34 when adapting those rules to section 451(c) and section 451(b).

Thank you again for providing taxpayers with this opportunity to comment on the rules for deferral of advance payments in section 451(c), as well as the close relationship of these rules to the income recognition rules in section 451(b). If you would like to discuss any of these comments in more detail, please feel free to contact the undersigned at (202) 39307600.

Sincerely yours,

Leslie J. Schneider

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Pat S

Patrick J. Smith