

Issuance of Advance Payment Revenue Procedure

Announcement 2004-48

PURPOSE

The Internal Revenue Service has issued Rev. Proc. 2004-34, page 991 of this Bulletin, which finalizes, with modifications, the revenue procedure proposed in Notice 2002-79, 2002-2 C.B. 964 (the proposed revenue procedure). The purpose of this announcement is to discuss some of the most significant issues raised in connection with finalizing the revenue procedure.

BACKGROUND

Notice 2002-79 proposed a revenue procedure to modify and supersede Rev. Proc. 71-21, 1971-2 C.B. 549. The proposed revenue procedure provided a limited deferral beyond the taxable year of receipt for certain advance payments for services, certain non-services, and combinations of services and certain non-services. Notice 2002-79 requested comments on the proposed revenue procedure and on the following specific issues:

- whether the proposed revenue procedure should take into account the cost of goods sold in deferring advance payments from the sale of goods;
- whether a taxpayer should be permitted to allocate advance payments between the deferral provisions in § 1.451-5 of the Income Tax Regulations and the proposed revenue procedure;
- whether advance payments should be accelerated as a result of non-taxable transfers, such as transfers under § 351 or § 721 of the Internal Revenue Code, and the treatment of short tax years resulting from § 381(a) transactions; and
- whether the use of statistical methodologies for tracing advance payments should be permitted if the taxpayer is unable to determine the extent to which particular advance payments received

in a given taxable year are actually included in gross receipts for financial reporting purposes in that year.

The Service received comments on these and several other issues. The most significant comments, along with certain other changes to the proposed revenue procedure, are discussed below.

CHANGES TO THE PROPOSED REVENUE PROCEDURE AND OTHER ISSUES

Allocations

Notice 2002-79 requested comments on allocations of advance payments between the Deferral Method in the proposed revenue procedure and § 1.451-5. Commentators suggested various approaches to resolve allocation issues involving § 1.451-5, including providing deferral rules identical to those provided in the regulations (making the regulations redundant), or making the revenue procedure and regulations mutually exclusive. Commentators also suggested that clarifying the types of services that are integral to a sale of goods for which advance payments may be deferred under § 1.451-5 would eliminate confusion about whether an allocation is necessary.

The Service does not believe it is appropriate to conform the deferral provisions of the revenue procedure to the regulations. Instead, the Service continues to believe it is appropriate to retain for purposes of the revenue procedure the one-year limited deferral rather than to use the longer deferral period allowable under the regulations. In addition, the Service does not believe that the revenue procedure and the regulations should be mutually exclusive. One of the purposes of the revenue procedure is to reduce controversy by allowing a taxpayer to use the revenue procedure without requiring the taxpayer to determine whether the payment qualifies for deferral under the regulations.

The Service recognizes that a taxpayer may receive an advance payment that is partially attributable to an item eligible for the Deferral Method under the revenue procedure and partially attributable to another item, such as: (1) an item that is not eligible for the Deferral Method; (2)

an item that is eligible for the Deferral Method, but on a different deferral schedule; or (3) an item that is eligible for deferral under § 1.451-5. In some of these situations, a taxpayer may be able to determine objectively the portion of the advance payment that is eligible for the Deferral Method. In these cases, the Service believes it is appropriate to allow a taxpayer to allocate an advance payment and to apply the Deferral Method to part of the payment and another method of accounting to the rest of the payment. The final revenue procedure, therefore, allows a taxpayer to make allocations if the taxpayer uses objective criteria for the allocation.

A taxpayer that wants to allocate advance payments generally must use the advance consent procedures for a change of accounting method set forth in Rev. Proc. 97-27, 1997-1 C.B. 680, as modified and amplified by Rev. Proc. 2002-19, 2002-1 C.B. 696, as amplified and clarified by Rev. Proc. 2002-54, 2002-2 C.B. 432. However, the final revenue procedure includes a safe harbor allocation for which the taxpayer may use the automatic change of accounting method procedures in Rev. Proc. 2002-9, 2002-1 C.B. 327, as modified and clarified by Announcement 2002-17, 2002-1 C.B. 561, modified and amplified by Rev. Proc. 2002-19, and amplified, clarified, and modified by Rev. Proc. 2002-54. Under the safe harbor, if a taxpayer bases the allocation on payments the taxpayer regularly receives for an item or items it regularly provides separately, the allocation will be deemed to be based on objective criteria.

Treatment Of Short Taxable Years

The proposed revenue procedure retained the requirement under Rev. Proc. 71-21 that advance payments be included in gross income by the end of the “next succeeding taxable year” following the taxable year of receipt. Notice 2002-79 requested comments concerning the application of this rule when the next succeeding taxable year is a short taxable year resulting from a § 381 transaction. Commentators suggested various remedies including disregarding short taxable years or providing a minimum fixed deferral period to approximate the limited

one-year deferral that would be allowed under the revenue procedure.

The Service agrees that an additional taxable year of deferral should be permitted in the case of certain short taxable years. Therefore, the final revenue procedure provides that, when the next succeeding taxable year is a short taxable year (other than a taxable year in which the taxpayer dies or ceases to exist in a transaction other than a transaction to which § 381(a) applies) of 92 days or less, a taxpayer using the deferral method must include in gross income for the short taxable year the portion of the advance payment recognized for financial reporting purposes (or earned, if applicable) in the short taxable year. Any remaining amount must be included in gross income for the taxable year immediately following the short taxable year.

Acceleration Of Income

The proposed revenue procedure retained the requirement in Rev. Proc. 71-21 regarding the acceleration of inclusion in gross income if the taxpayer dies or ceases to exist (other than in a transaction to which § 381(a) applies) or if the taxpayer's obligation related to the advance payment otherwise ends. The notice requested comments on whether acceleration should be required with respect to certain non-taxable transfers. Several commentators suggested a "step-into-the-shoes" treatment for the transferee, which the Service believes would create significant complexity. Another commentator suggested an exception similar to the exception provided in the method change procedures for § 481(a) adjustments for transfers under § 351 within a consolidated group.

The final revenue procedure incorporates a limited exception for § 351 transfers. A taxpayer will not be required to include the advance payment in gross income if, in a § 351 transaction, (1) substantially all assets of the trade or business (including advance payments) are transferred, (2) the transferee adopts or uses the Deferral Method in the procedure in the year of transfer, and (3) the transferee and the transferor are members of an affiliated group of corporations that file a consolidated return pursuant to §§ 1504 - 1564.

Definition Of "Applicable Financial Statement"

The deferral permitted under the proposed revenue procedure was based on the amount deferred under the taxpayer's method of financial reporting. Commentators expressed concern that, without specific guidelines, taxpayers would adopt financial reporting methods that would maximize deferrals but that might not accurately reflect the true nature of the taxpayer's financial condition. Some commentators recommended adopting a standard based on generally accepted accounting principles (GAAP), and other commentators expressed concern that taxpayers without financial reports would be excluded from using the Deferral Method.

The final revenue procedure adopts an "applicable financial statement" standard similar to that set forth in § 1.56-1(c) regarding the types, and priority, of financial statements. Under the revenue procedure, a taxpayer's applicable financial statement is the first listed of the following:

- Financial statement required to be filed with Securities and Exchange Commission ("SEC") (the 10-K or the Annual Statement to Shareholders);
- Certified audited financial statement used for (in this priority) credit purposes, reporting to shareholders, or other substantial non-tax purposes; and
- Financial statement provided to a government regulator other than the SEC or the Internal Revenue Service.

Thus, for example, a taxpayer that both files a 10-K with the SEC and provides financial statements to a government regulator would be required to use the 10-K as the applicable financial statement under the revenue procedure. For those taxpayers that do not have an applicable financial statement described above, the final revenue procedure provides deferral methodologies based on when the advance payments is earned through performance.

Statistical Sampling

Because the deferral method in the proposed revenue procedure was based exclusively on the taxpayer's financial reporting method, the proposed revenue procedure

did not provide an independent method for using a statistical or other basis for determining when an advance payment is earned through performance. Section 3.06 of Rev. Proc. 71-21 provided a rule for using a statistical basis, if adequate data are available to the taxpayer, for determining when services are performed with respect to contingent service agreements. Some commentators were concerned that a similar provision was not included in the proposed revenue procedure.

Because some taxpayers do not have an applicable financial statement as previously described, and because some taxpayers are unable to trace the recognition of individual advance payments in their applicable financial statements, section 5.02(3)(b) of the final revenue procedure was added to allow these taxpayers to use certain other methods, including a statistical basis (if adequate data are available to the taxpayer), to include advance payments in gross income. If a taxpayer seeks to use a statistical basis or other methodology (other than a straight line ratable basis) to determine the amount deferred, the taxpayer must use the advance consent procedures for a change of accounting method set forth in Rev. Proc. 97-27.

Items Not Eligible For Deferral As Advance Payments

Credit Card Fees

The proposed revenue procedure excluded credit card fees from the definition of advance payments. Several commentators requested that credit card fees (including annual fees) be included within the document's scope. The final revenue procedure continues to exclude payments with respect to credit card agreements because the Service has addressed credit card fees in separate guidance. See Rev. Rul. 2004-52, page 973 of this Bulletin, Rev. Proc. 2004-32, page 988 of this Bulletin, and Rev. Proc. 2004-33, page 989 of this Bulletin.

Insurance Premiums

The proposed revenue procedure excluded "insurance premiums" from the definition of "advance payments" to avoid conflicts with accounting rules applicable to insurance companies. After further consideration, the Service determined that

a more focused definition would be appropriate. Therefore, the final revenue procedure excludes “insurance premiums, to the extent the recognition of those premiums is governed by Subchapter L.” This language is intended to exclude insurance companies as well as other entities that recognize income from insurance activities under the subchapter L accounting regime, but not taxpayers that are ineligible for the subchapter L regime (for example, taxpayers that issue insurance contracts but are not insurance companies within the meaning of § 816(a) or § 1.801-3(a)).

Advance Rentals

In conjunction with the final revenue procedure, the Service and Treasury are amending the regulations at § 1.61-8(b) to allow the Service to provide for the deferral of advance rentals. These amendments will be effective retroactively to the date the regulations were proposed in the Federal Register (December 18, 2002). The final revenue procedure applies to advance payments for the use of computer software and intellectual property, which may otherwise be considered advance rentals. Some commentators requested that the revenue procedure be expanded to include advance rentals for tangible property. The Service has not adopted this suggestion. The Service continues to believe that advance rentals for tangible property should be included in gross income when received unless § 467 requires otherwise.

Other Excluded Items

The proposed revenue procedure included payments for warranties in the list of items that may be eligible to be deferred as advance payments. Commentators stated that there could be confusion whether a warranty would be excluded as insurance. In addition to the clarifications made with respect to insurance as discussed above, the Service determined that it was appropriate to exclude warranties and guaranty contracts under which a third party is the primary obligor.

The proposed revenue procedure did not exclude payments in property to which § 83 applies or payments subject to the withholding rules in § 871, 881, 1441, or 1442. Upon further consideration, the Service has determined that because of the

specific statutory and regulatory income treatment for transactions under § 83, it is appropriate to exclude payments in property to which § 83 applies from the deferral provisions of the revenue procedure. Additionally, the final revenue procedure excludes payments subject to the specific withholding rules in § 871, 881, 1441, or 1442 from the deferral provisions.

Method Change Issues

The proposed revenue procedure provided that taxpayers would use the automatic change in accounting method procedures in Rev. Proc. 2002-9 to change to either the Deferral Method or the Full Inclusion Method. The Service believes that certain changes permitted under the final revenue procedure raise issues that warrant closer scrutiny by the Service. Therefore, the Service has determined that a taxpayer that wants to change to an accounting method that involves allocations of payments between the Deferral Method in the revenue procedure and some other method generally must follow the advance consent procedures in Rev. Proc. 97-27, rather than the automatic method change procedures. Similarly, a taxpayer that wants to use the Deferral Method, but either does not have an applicable financial statement or does not trace individual advance payments for purposes of its applicable financial statements, must follow the advance consent procedures of Rev. Proc. 97-27 if it wants to defer advance payments on a basis other a straight line ratable basis. The final revenue procedure also provides automatic method change procedures for certain changes to an overall accrual method of accounting combined with a change to the Deferral Method.

Record Keeping

Section 8 of the proposed revenue procedure set forth record keeping rules for taxpayers using an accounting method provided by the revenue procedure. However, because that section did not add to the general record keeping rules applicable to all taxpayers, it was determined that the provision is unnecessary. Thus, although the final revenue procedure does not include this provision, the record keeping rules in § 6001 and the regulations thereunder continue to apply to taxpayers that use

a method of accounting provided by the final revenue procedure.

COGS

The proposed revenue procedure did not provide a special rule for cost of goods sold (COGS), but requested comments on whether the revenue procedure should take into account COGS in deferring advance payments from the sale of goods.

Some commentators suggested that the Service does not have the authority to treat advance payments for the sale of goods as income when received, on the theory that the Code and regulations do not allow a tax on gross receipts, and that the Service should *require* taxpayers to defer advance payments for the sale of inventoriable goods.

The revenue procedure does not adopt this recommendation. The long-standing position of the Service has been that advance payments are income when received, unless the taxpayer *elects* to defer under an exception to that general rule. 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. Taxpayers that use the deferral method provided in the final revenue procedure must use the general rules under § 461 and the regulations thereunder for determining when a liability (including COGS) is incurred.

Effective Date

The revenue procedure is effective for taxable years ending on or after May 6, 2004. However, a transition rule allows taxpayers who are eligible to use the automatic change provisions to adopt or change to a method provided in the revenue procedure for taxable years ending on or after December 31, 2003.

DRAFTING INFORMATION

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