

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, Sections 446, 451; 1.446-1, 1.451-1.)

Rev. Proc. 2004-34

SECTION 1. PURPOSE

This revenue procedure allows taxpayers a limited deferral beyond the taxable year of receipt for certain advance payments. Qualifying taxpayers generally may defer to the next succeeding taxable year the inclusion in gross income for federal income tax purposes of advance payments (as defined in section 4 of this revenue procedure) to the extent the advance payments are not recognized in revenues (or, in certain cases, are not earned) in the taxable year of receipt. Except as provided in section 5.02(2) of this revenue procedure for certain short taxable years, this revenue procedure does not permit deferral to a taxable year later than the next succeeding taxable year. This revenue procedure neither restricts a taxpayer's ability to use the methods provided in § 1.451-5 of the Income Tax Regulations regarding advance payments for goods nor limits the period of deferral available under § 1.451-5.

This revenue procedure also provides the exclusive administrative procedures under which a taxpayer within the scope of this revenue procedure may obtain consent to change to a method of accounting provided in section 5 of this revenue procedure.

SECTION 2. BACKGROUND AND CHANGES

.01 In general, § 451 of the Internal Revenue Code provides that the amount of any item of gross income is included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Section 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. All the events that fix the right to receive income generally occur when (1) the payment is earned through performance, (2) payment is due to the taxpayer, or (3) payment is received by the taxpayer, whichever happens earliest. See Rev. Rul. 84-31, 1984-1 C.B. 127.

.02 Section 1.451-5 generally allows accrual method taxpayers to defer the inclusion in gross income for federal income tax purposes of advance payments for

goods until the taxable year in which they are properly accruable under the taxpayer's method of accounting for federal income tax purposes if that method results in the advance payments being included in gross income no later than when the advance payments are recognized in revenues under the taxpayer's method of accounting for financial reporting purposes.

.03 Rev. Proc. 71-21, 1971-2 C.B. 549, was published to implement an administrative decision of the Commissioner in the exercise of his discretion under § 446 to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income for federal income tax purposes of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year. Rev. Proc. 71-21 was designed to reconcile the federal income tax and financial accounting treatment of payments received for services to be performed by the end of the next succeeding taxable year without permitting extended deferral of the inclusion of those payments in gross income for federal income tax purposes.

.04 Considerable controversy exists about the scope of Rev. Proc. 71-21. In particular, advance payments for non-services (and often, for combinations of services and non-services) do not qualify for deferral under Rev. Proc. 71-21, and taxpayers and the Internal Revenue Service frequently disagree about whether advance payments are, in fact, for "services." In addition to the issue of defining "services" for purposes of Rev. Proc. 71-21, questions also arise about whether advance payments received under a series of agreements, or under a renewable agreement, are within the scope of Rev. Proc. 71-21. In the interest of reducing the controversy surrounding these issues, the Service has determined that it is appropriate to expand the scope of Rev. Proc. 71-21 to include advance payments for certain non-services and combinations of services and non-services. Additionally, the Service has determined that it is appropriate to expand the scope of Rev. Proc. 71-21 to include advance payments received in connection with an agreement or series of agreements with a term or terms extending beyond the end of the next succeeding taxable year. The Service has determined, however, that for taxpayers deferring recognition of income under this revenue procedure it is appropriate to retain the limited one-year deferral of Rev. Proc. 71-21 (except as provided in section 5.02(2) of this revenue procedure for certain short taxable years).

SECTION 3. SCOPE

This revenue procedure applies to taxpayers using or changing to an overall accrual method of accounting that receive advance payments as defined in section 4 of this revenue procedure.

SECTION 4. DEFINITIONS

The following definitions apply solely for purposes of this revenue procedure --

.01 *Advance Payment*. Except as provided in section 4.02 of this revenue procedure, a payment received by a taxpayer is an "advance payment" if --

(1) including the payment in gross income for the taxable year of receipt is a permissible method of accounting for federal income tax purposes (without regard to this revenue procedure);

(2) the payment is recognized by the taxpayer (in whole or in part) in revenues in its applicable financial statement (as defined in section 4.06 of this revenue procedure) for a subsequent taxable year (or, for taxpayers without an applicable financial statement as defined in section 4.06 of this revenue procedure, the payment is earned by the taxpayer (in whole or in part) in a subsequent taxable year); and

(3) the payment is for --

(a) services;

(b) the sale of goods (other than for the sale of goods for which the taxpayer uses a method of deferral provided in § 1.451-5(b)(1)(ii));

(c) the use (including by license or lease) of intellectual property as defined in section 4.03 of this revenue procedure;

(d) the occupancy or use of property if the occupancy or use is ancillary to the provision of services (for example, advance payments for the use of rooms or other quarters in a hotel, booth space at a trade show, campsite space at a mobile home park, and recreational or banquet facilities, or other uses of property, so long as the use is ancillary to the provision of services to the property user);

(e) the sale, lease, or license of computer software;

(f) guaranty or warranty contracts ancillary to an item or items described in subparagraph (a), (b), (c), (d), or (e) of this section 4.01(3);

(g) subscriptions (other than subscriptions for which an election under § 455 is in effect), whether or not provided in a tangible or intangible format;

(h) memberships in an organization (other than memberships for which an election under § 456 is in effect); or

(i) any combination of items described in subparagraphs (a) through (h) of this section 4.01(3).

.02 Exclusions From Advance Payment. The term “advance payment” does not include --

(1) rent (except for amounts paid with respect to an item or items described in subparagraph (c), (d), or (e) of section 4.01(3));

(2) insurance premiums, to the extent the recognition of those premiums is governed by Subchapter L;

(3) payments with respect to financial instruments (for example, debt instruments, deposits, letters of credit, notional principal contracts, options, forward contracts, futures contracts, foreign currency contracts, credit card agreements, financial derivatives, etc.), including purported prepayments of interest;

(4) payments with respect to service warranty contracts for which the taxpayer uses the accounting method provided in Rev. Proc. 97-38, 1997-2 C.B. 479;

(5) payments with respect to warranty and guaranty contracts under which a third party is the primary obligor;

(6) payments subject to § 871(a), 881, 1441, or 1442; and

(7) payments in property to which § 83 applies.

.03 Intellectual Property. The term “intellectual property” includes copyrights, patents, trademarks, service marks, trade names, and similar intangible property rights (such as franchise rights and arena naming rights).

.04 Received. Income is “received” by the taxpayer if it is actually or constructively received, or if it is due and payable to the taxpayer.

.05 Next Succeeding Taxable Year. The term “next succeeding taxable year” means the taxable year immediately following the taxable year in which the advance payment is received by the taxpayer.

.06 Applicable Financial Statement. The taxpayer's applicable financial statement is the taxpayer's financial statement listed in paragraphs (1) through (3) of this section 4.06 that has the highest priority (including within paragraph (2)). A taxpayer that does not have a financial statement described in paragraphs (1) through

(3) of this section 4.06 does not have an applicable financial statement for purposes of this revenue procedure. The financial statements are, in descending priority --

(1) a financial statement required to be filed with the Securities and Exchange Commission ("SEC") (the 10-K or the Annual Statement to Shareholders);

(2) a certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign corporation, by the report of a similarly qualified independent professional), that is used for --

- (a) credit purposes,
- (b) reporting to shareholders, or
- (c) any other substantial non-tax purpose; or

(3) a financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agencies (other than the SEC or the Internal Revenue Service).

SECTION 5. PERMISSIBLE METHODS OF ACCOUNTING FOR ADVANCE PAYMENTS

.01 Full Inclusion Method. A taxpayer within the scope of this revenue procedure that includes the full amount of advance payments in gross income for federal income tax purposes in the taxable year of receipt is using a proper method of accounting under § 1.451-1, regardless of whether the taxpayer recognizes the full amount of advance payments in revenues for that taxable year for financial reporting purposes and regardless of whether the taxpayer earns the full amount of advance payments in that taxable year.

.02 Deferral Method.

(1) In general.

(a) A taxpayer within the scope of this revenue procedure that chooses to use the Deferral Method described in this section 5.02 is using a proper method of accounting under § 1.451-1. Under the Deferral Method, for federal income tax purposes the taxpayer must --

(i) include the advance payment in gross income for the taxable year of receipt (and, if applicable, in gross income for a short taxable year described in section 5.02(2) of this revenue procedure) to the extent provided in section 5.02(3) of this revenue procedure, and

(ii) except as provided in section 5.02(2) of this revenue procedure, include the remaining amount of the advance payment in gross income for the next succeeding taxable year.

(b) Except as provided in section 5.02(3)(b) of this revenue procedure, a taxpayer using the Deferral Method must be able to determine –

(i) the extent to which advance payments are recognized in revenues in its applicable financial statement (as defined in section 4.06 of this revenue procedure) in the taxable year of receipt (and a short taxable year described in section 5.02(2) of this revenue procedure, if applicable), or

(ii) if the taxpayer does not have an applicable financial statement (as defined in section 4.06 of this revenue procedure), the extent to which advance payments are earned (as described in section 5.02(3)(b) of this revenue procedure), in the taxable year of receipt (and a short taxable year described in section 5.02(2) of this revenue procedure, if applicable).

(2) *Short taxable years.* If the next succeeding taxable year is a 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 the portion of the advance payment not included in the taxable year of receipt in gross income for the short taxable year to the extent provided in section 5.02(3) of this revenue procedure. Any amount of the advance payment not included in the taxable year of receipt and the short taxable year must be reported in gross income for the taxable year immediately following the short taxable year.

(3) *Inclusion of advance payments in gross income.*

(a) Except as provided in paragraph (b) of this section 5.02(3), a taxpayer using the Deferral Method must --

(i) include the advance payment in gross income for the taxable year of receipt (and, if applicable, in gross income for a short taxable year described in section 5.02(2) of this revenue procedure) to the extent recognized in revenues in its applicable financial statement (as defined in section 4.06 of this revenue procedure) for that taxable year, and

(ii) include the remaining amount of the advance payment in gross income in accordance with section 5.02(1)(a)(ii) of this revenue procedure.

(b) If the taxpayer does not have an applicable financial statement (as defined in section 4.06 of this revenue procedure), or if the taxpayer is unable to determine, as required by section 5.02(1)(b)(i) of this revenue procedure, the extent to which advance payments are recognized in revenues in its applicable financial statements for the taxable year of receipt (and a short taxable year described in section

5.02(2) of this revenue procedure, if applicable), a taxpayer using the Deferral Method must include the advance payment in gross income for the taxable year of receipt (and, if applicable, in gross income for a short taxable year described in section 5.02(2)) to the extent earned in that taxable year and include the remaining amount of the advance payment in gross income in accordance with section 5.02(1)(a)(ii) of this revenue procedure. The determination of whether an amount is earned in a taxable year must be made without regard to whether the taxpayer may be required to refund the advance payment upon the occurrence of a condition subsequent. If the taxpayer is unable to determine the extent to which a payment (such as a payment for contingent goods or services) is earned in the taxable year of receipt (and, if applicable, in a short taxable year described in section 5.02(2)), the taxpayer may determine that amount --

(i) on a statistical basis if adequate data are available to the taxpayer;

(ii) on a straight line ratable basis over the term of the agreement if the taxpayer receives advance payments under a fixed term agreement and if it is not unreasonable to anticipate at the end of the taxable year of receipt that the advance payment will be earned ratably over the term of the agreement; or

(iii) by the use of any other basis that in the opinion of the Commissioner results in a clear reflection of income.

(4) *Allocable payments.*

(a) *General rule.* A taxpayer that receives a payment that is partially attributable to an item or items described in section 4.01(3) of this revenue procedure may use the Deferral Method for the portion of the payment allocable to such item or items and, with respect to the remaining portion of the payment, may use any proper method of accounting (including the Deferral Method if the remaining portion of the advance payment is for an item or items described in section 4.01(3) of this revenue procedure with a different deferral period (based on the taxpayer's applicable financial statement or the earning of the payment, as applicable)), provided that the taxpayer's method for determining the portion of the payment allocable to such item or items is based on objective criteria.

(b) *Advance payments under section 4.01(3)(i).* An advance payment under section 4.01(3)(i) that is wholly attributable to two or more items described in subparagraphs (a) through (h) of section 4.01(3) of this revenue procedure that have the same deferral period (based on the taxpayer's applicable financial statement or the earning of the payment, as applicable) is not an allocable payment under section 5.02(4)(a) of this revenue procedure.

(c) *Allocation deemed to be based on objective criteria.* A taxpayer's allocation method with respect to an allocable payment described in section 5.02(4)(a) of this revenue procedure will be deemed to be based on objective criteria if

the allocation method is based on payments the taxpayer regularly receives for an item or items it regularly sells or provides separately.

(5) *Acceleration of advance payments.* Notwithstanding section 5.02(1) of this revenue procedure, a taxpayer using the Deferral Method must include in gross income for the taxable year of receipt (or, if applicable, for a short taxable year described in section 5.02(2) of this revenue procedure) all advance payments not previously included in gross income –

(a) if, in that taxable year, the taxpayer either dies or ceases to exist in a transaction other than a transaction to which § 381(a) applies, or

(b) if, and to the extent that, in that taxable year, the taxpayer's obligation with respect to the advance payments is satisfied or otherwise ends other than in --

(i) a transaction to which § 381(a) applies, or

(ii) a § 351(a) transfer in which (a) substantially all assets of the trade or business (including advance payments) are transferred, (b) the transferee adopts or uses the Deferral Method in the year of transfer, and (c) the transferee and the transferor are members of an affiliated group of corporations that file a consolidated return, pursuant to §§ 1504 – 1564.

.03 *Examples.* In each example below, the taxpayer uses an accrual method of accounting for federal income tax purposes and files its returns on a calendar year basis. Except as stated otherwise, the taxpayer in each example has an applicable financial statement as defined in section 4.06 of this revenue procedure.

Example 1. On November 1, 2004, A, in the business of giving dancing lessons, receives an advance payment for a 1-year contract commencing on that date and providing for up to 48 individual, 1-hour lessons. A provides eight lessons in 2004 and another 35 lessons in 2005. In its applicable financial statement, A recognizes 1/6 of the payment in revenues for 2004, and 5/6 of the payment in revenues for 2005. A uses the Deferral Method. For federal income tax purposes, A must include 1/6 of the payment in gross income for 2004, and the remaining 5/6 of the payment in gross income for 2005.

Example 2. Assume the same facts as in *Example 1*, except that the advance payment is received for a 2-year contract under which up to 96 lessons are provided. A provides eight lessons in 2004, 48 lessons in 2005, and 40 lessons in 2006. In its applicable financial statement, A recognizes 1/12 of the payment in revenues for 2004, 6/12 of the payment in revenues for 2005, and 5/12 of the payment in gross revenues for 2006. For federal income tax purposes, A must include 1/12 of

the payment in gross income for 2004, and the remaining 11/12 of the payment in gross income for 2005.

Example 3. On June 1, 2004, *B*, a landscape architecture firm, receives an advance payment for goods and services that, under the terms of the agreement, must be provided by December 2005. On December 31, 2004, *B* estimates that 3/4 of the work under the agreement has been completed. In its applicable financial statement, *B* recognizes 3/4 of the payment in revenues for 2004 and 1/4 of the payment in revenues for 2005. *B* uses the Deferral Method. For federal income tax purposes, *B* must include 3/4 of the payment in gross income for 2004, and the remaining 1/4 of the payment in gross income for 2005, regardless of whether *B* completes the job in 2005.

Example 4. On July 1, 2004, *C*, in the business of selling and repairing television sets, receives an advance payment for a 2-year contract under which *C* agrees to repair or replace, or authorizes a representative to repair or replace, certain parts in the customer's television set if those parts fail to function properly. In its applicable financial statement, *C* recognizes 1/4 of the payment in revenues for 2004, 1/2 of the payment in revenues for 2005, and 1/4 of the payment in revenues for 2006. *C* uses the Deferral Method. For federal income tax purposes, *C* must include 1/4 of the payment in gross income for 2004 and the remaining 3/4 of the payment in gross income for 2005.

Example 5. On December 2, 2004, *D*, in the business of selling and repairing television sets, sells for \$200 a television set with a 90-day warranty on parts and labor (for which *D*, rather than the manufacturer, is the obligor). *D* regularly sells television sets without the warranty for \$188. In its applicable financial statement, *D* allocates \$188 of the sales price to the television set and \$12 to the 90-day warranty, recognizes 1/3 of the amount allocable to the warranty (\$4) in revenues for 2004, and recognizes the remaining 2/3 of the amount allocable to the warranty (\$8) in revenues for 2005. *D* uses the Deferral Method. For federal income tax purposes, *D* must include the \$4 allocable to the warranty in gross income for 2004 and the remaining \$8 allocable to the warranty in gross income for 2005.

Example 6. *E*, in the business of photographic processing, receives advance payments for mailers and certificates that oblige *E* to process photographic film, prints, or other photographic materials returned in the mailer or with the certificate. *E* tracks each of the mailers and certificates with unique identifying numbers. On July 20, 2004, *E* receives payments for 2 mailers. One of the mailers is submitted and processed on September 1, 2004, and the other is submitted and processed on February 1, 2006. In its applicable financial statement, *E* recognizes the payment for the September 1, 2004, processing in revenues for 2004 and the payment for the February 1, 2006, processing in revenues for 2006. *E* uses the Deferral Method. For federal income tax purposes, *E* must include the payment for the September 1, 2004,

processing in gross income for 2004 and the payment for the February 1, 2006, processing in gross income for 2005.

Example 7. *F*, a hair styling salon, receives advance payments for gift cards that may later be redeemed at the salon for hair styling services or hair care products at the face value of the gift card. The gift cards look like standard credit cards, and each gift card has a magnetic strip that, in connection with *F*'s computer system, identifies the available balance. The gift cards may not be redeemed for cash, and have no expiration date. In its applicable financial statement, *F* recognizes advance payments for gift cards in revenues when redeemed. *F* is not able to determine the extent to which advance payments are recognized in revenues in its applicable financial statement for the taxable year of receipt and therefore does not meet the requirement of section 5.02(1)(b)(i) of this revenue procedure. Further, *F* does not determine under a basis described in section 5.02(3)(b) of this revenue procedure the extent to which payments are earned for the taxable year of receipt. Therefore, *F* may not use the Deferral Method for these advance payments.

Example 8. Assume the same facts as in *Example 7*, except that the gift cards have an expiration date 12 months from the date of sale, *F* does not accept expired gift cards, and *F* recognizes unredeemed gift cards in revenues in its applicable financial statement for the taxable year in which the cards expire. Because *F* tracks the sale date and the expiration date of the gift cards for purposes of its applicable financial statement, *F* is able to determine the extent to which advance payments are recognized in revenues for the taxable year of receipt. Therefore, *F* meets the requirement of section 5.02(1)(b)(i) of this revenue procedure and may use the Deferral Method for these advance payments.

Example 9. *G*, a video arcade operator, receives payments in 2004 for game tokens that are used by customers to play the video games offered by *G*. The tokens cannot be redeemed for cash. The tokens are imprinted with the name of the video arcade, but they are not individually marked for identification. For purposes of its applicable financial statement, *G* completed a study that determined that for payments received for tokens in the current year, *x* percent of tokens are expected to be used in the current year, *y* percent of tokens are expected to be used in the next year, and *z* percent of tokens are expected to never be used. Based on the study, in its applicable financial statement *G* recognizes in revenues for 2004 *x* percent (tokens expected to be used in 2004) and *z* percent (tokens expected never to be used) of the payments received in 2004 for tokens; *G* recognizes in revenues for 2005 the remaining *y* percent of the payments received in 2004 for tokens. *G* uses the Deferral Method. Using the study, *G* determines the extent to which advance payments are recognized in revenues in its applicable financial statement for the taxable year of receipt and therefore meets the requirement of section 5.02(1)(b)(i) of this revenue procedure. Under section 5.02(3)(a) of this revenue procedure, *G* must include advance payments in gross

income in accordance with its applicable financial statement in the taxable year of receipt, provided that any portion of the payment not included in income in the taxable year of receipt is included in gross income for the next succeeding taxable year. Thus, for federal income tax purposes, *G* must include *x* percent and *z* percent of the advance payments in gross income for 2004, and *y* percent of the advance payments in gross income for 2005.

Example 10. Assume the same facts as in *Example 9*, except that *G* does not have an applicable financial statement (as defined in section 4.06 of this revenue procedure). *G* completed a study on a statistical basis, based on adequate data available to *G*, and concluded that for payments received in the current year, *x* percent of tokens are expected to be used in the current year, *y* percent of tokens are expected to be used in the next year, and the remaining *z* percent of tokens are expected to never be used. Based on the study, *G* treats as earned for 2004 *x* percent (for tokens expected to be used in that year) as well as *z* percent (for tokens that are expected to never be used). *G* uses the Deferral Method. Using the study, *G* determines the extent to which advance payments are earned in the taxable year of receipt and therefore meets the requirement of section 5.02(1)(b)(ii) of this revenue procedure. Because *G* does not have an applicable financial statement, *G* may determine the extent to which a payment is earned in the taxable year of receipt on a statistical basis under section 5.02(3)(b)(i) of this revenue procedure, provided that any portion that is not included in the taxable year of receipt is included in the next succeeding taxable year. Thus, for federal income tax purposes, *G* must include *x* percent and *z* percent of the advance payments in gross income for 2004, and *y* percent of the advance payments in gross income for 2005.

Example 11. *H* is in the business of compiling and providing business information for a particular industry in an online format accessible over the internet. On September 1, 2004, *H* receives an advance payment from a subscriber for 1 year of access to its online database, beginning on that date. In its applicable financial statement, *H* recognizes 1/3 of the payment in revenues for 2004 and the remaining 2/3 in revenues for 2005. *H* uses the Deferral Method. For federal income tax purposes, *H* must include 1/3 of the payment in gross income for 2004 and the remaining 2/3 of the payment in gross income for 2005.

Example 12. On December 1, 2004, *I*, in the business of operating a chain of “shopping club” retail stores, receives advance payments for membership fees. Upon payment of the fee, a member is allowed access for a 1-year period to *I*'s stores, which offer discounted merchandise and services. In its applicable financial statement, *I* recognizes 1/12 of the payment in revenues for 2004 and 11/12 of the payment in revenues for 2005. *I* uses the Deferral Method. For federal income tax purposes, *I* must include 1/12 of the payment in gross income for 2004, and the remaining 11/12 of the payment in gross income for 2005.

Example 13. In 2004, *J*, in the business of operating tours, receives payments from customers for a 10-day cruise that will take place in April 2005. Under the agreement, *J* charters a cruise ship, hires a crew and a tour guide, and arranges for entertainment and shore trips for the customers. In its applicable financial statement, *J* recognizes the payments in revenues for 2005. *J* uses the Deferral Method. For federal income tax purposes, *J* must include the payments in gross income for 2005.

Example 14. On November 1, 2004, *K*, a travel agent, receives payment from a customer for an airline flight that will take place in April 2005. *K* purchases and delivers the airline ticket to the customer on November 14, 2004. *K* retains a portion of the customer's payment (the excess of the customer's payment over the cost of the airline ticket) as its commission. Because *K* is not required to provide any services after the ticket is delivered to the customer, *K* earns its commission when the airline ticket is delivered. The customer may cancel the flight and receive a refund from *K* only to the extent the airline itself provides refunds. *K* does not have an applicable financial statement (as defined in section 4.06 of this revenue procedure), but, in its unaudited financial statements, *K* recognizes its commission in revenues for 2005. The commission is not an advance payment as defined in section 4.01 of this revenue procedure because the payment is not earned by *K*, in whole or in part, in a subsequent taxable year. Thus, *K* may not use the Deferral Method for this payment.

Example 15. *L*, a professional sports franchise, is a member of a sports league that enters into contracts with television networks for the right to broadcast games to be played between teams in the league. The money received by the sports league under the contracts is divided equally among the member teams. The league entered into a 3-year broadcasting contract beginning October 1, 2004. *L* receives three equal installment payments on October 1 of each contract year, beginning in 2004. In its applicable financial statement, *L* recognizes 1/4 of the first installment payment in revenues for 2004 and 3/4 in revenues for 2005; *L* recognizes 1/4 of the second installment in revenues for 2005 and 3/4 in revenues for 2006; *L* recognizes 1/4 of the third installment in revenues for 2006 and 3/4 in revenues for 2007. *L* uses the Deferral Method. Under section 4 of this revenue procedure, each installment payment constitutes an "advance payment." For federal income tax purposes, *L* must include 1/4 of the first installment payment in gross income for 2004 and 3/4 in gross income for 2005; 1/4 of the second installment in gross income for 2005 and 3/4 in gross income for 2006; and 1/4 of the third installment in gross income for 2006 and 3/4 in gross income for 2007.

Example 16. *M* is in the business of negotiating, placing, and servicing insurance coverage and administering claims for insurance companies. On December 1, 2004, *M* enters into a contract with an insurance company to provide property and casualty claims administration services for a 4-year period beginning January 1, 2005.

Pursuant to the contract, the insurance company makes four equal annual payments to *M*; each payment relates to a year of service and is made during the month prior to the service year (for example, *M* is paid on December 1, 2004, for the service year beginning January 1, 2005). In its applicable financial statement, *M* recognizes the first payment in revenues for 2005; the second payment in revenues for 2006; the third payment in revenues for 2007; and the fourth payment in revenues for 2008. *M* uses the Deferral Method. Under section 4 of this revenue procedure, each annual payment constitutes an "advance payment." For federal income tax purposes, *M* must include the first payment in gross income for 2005; the second payment in gross income for 2006; the third payment in gross income for 2007; and the fourth payment in gross income for 2008.

Example 17. *N* is a cable internet service provider that enters into contracts with subscribers to provide internet services for a monthly fee (paid prior to the service month). For those subscribers who do not own a compatible modem, *N* provides a rental cable modem for an additional monthly charge (also paid prior to the service month). Pursuant to the contract, *N* will replace or repair the cable modem if it proves defective during the contract period. In December 2004, *N* receives payments from subscribers for January 2005 internet service and cable modem use. In its applicable financial statement, *N* recognizes the entire amount of these payments in revenues for 2005. *N* uses the Deferral Method. Because a subscriber's use of a cable modem is ancillary to the provision of internet services by *N*, and because the cable modem warranty is ancillary to the use of the cable modem, the payments are advance payments within the meaning of section 4.01(3)(i) of this revenue procedure. Further, because the deferral period for each item is the same in *N*'s applicable financial statement, *N* is not required to allocate the advance payments (see section 5.02(4)(b) of this revenue procedure). For federal income tax purposes, *N* must include the advance payments in gross income for 2005.

Example 18. On January 1, 2005, *O* enters into, and receives advance payments pursuant to, a 5-year license agreement for its computer software. Under the contract, the licensee pays *O* both the first-year (2005) license fee and the fifth-year (2009) license fee upon commencement of the agreement. The fees for the second, third, and fourth years are payable on January 1 of each license year. In its applicable financial statement, *O* recognizes the fees in revenues for the respective license year. *O* uses the Deferral Method. For federal income tax purposes, *O* must include the first-year license fee in gross income for 2005, the second-year and the fifth-year license fee in gross income for 2006, the third-year license fee in gross income for 2007, and the fourth-year license fee in gross income for 2008.

Example 19. On July 1, 2004, *P*, in the business of selling and licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support, receives an advance payment for a 2-year "software maintenance

contract” under which *P* will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. In its applicable financial statement, *P* recognizes 1/4 of the payment in revenues for 2004, 1/2 in revenues for 2005, and the remaining 1/4 in revenues for 2006, regardless of when *P* provides updates or customer support. *P* uses the Deferral Method. For federal income tax purposes, *P* must include 1/4 of the payment in gross income for 2004 and 3/4 in gross income for 2005.

Example 20. Assume the same facts as in *Example 19*, except that *P* changes its taxable period to a fiscal year ending March 31 so that *P* has a short taxable year beginning January 1, 2005, and ending March 31, 2005. In its applicable financial statement, *P* recognizes 1/4 of the payment in revenues for the taxable year ending December 31, 2004; 1/8 in revenues for the short taxable year ending March 31, 2005; 1/2 in revenues for the taxable year ending March 31, 2006; and 1/8 in revenues for the taxable year ending March 31, 2007. Because the taxable year ending March 31, 2005, is 92 days or less, section 5.02(2) of this revenue procedure applies. For federal income tax purposes, *P* must include 1/4 of the payment in gross income for the taxable year ending December 31, 2004, 1/8 in gross income for the short taxable year ending March 31, 2005, and the remaining 5/8 in gross income for the taxable year ending March 31, 2006.

Example 21. Assume the same facts as in *Example 19*, except that *P* ceases to exist on December 1, 2004, in a transaction other than a transaction to which § 381(a) applies. For federal income tax purposes, *P* must include the entire advance payment in gross income for 2004.

Example 22. On July 1, 2004, *Q*, in the business of selling and licensing computer software (off the shelf, fully customized, and semi-customized) and providing customer support, receives an advance payment of \$100 for a 2-year software license agreement that includes a 1-year “software maintenance contract” under which *Q* will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. In its applicable financial statement, *Q* allocates \$20 of the payment to the maintenance contract and \$80 to the license agreement, based on objective criteria. With respect to the \$20 allocable to the maintenance contract, *Q* recognizes 1/2 (\$10) in revenues for 2004 and the remaining 1/2 (\$10) in revenues for 2005 regardless of when *Q* provides updates or customer support. With respect to the \$80 allocable to the license agreement, *Q* recognizes 1/4 (\$20) in revenues for 2004, 1/2 (\$40) in revenues for 2005, and the remaining 1/4 (\$20) in revenues for 2006. *Q* uses the Deferral Method. For federal income tax purposes, *Q* must include \$30 in gross income for 2004 (\$10 allocable to the maintenance contract and \$20 allocable to the license agreement) and the remaining \$70 in gross income for 2005.

SECTION 6. EFFECTIVE DATE

.01 *In General.* Except as provided in section 6.02 of this revenue procedure, this revenue procedure is effective for taxable years ending on or after May 6, 2004.

.02 *Automatic Change for 2003.* For a change in accounting method under section 8.02 or 8.04(1) of this revenue procedure, this revenue procedure is effective for taxable years ending on or after December 31, 2003. See section 8.06 of this revenue procedure for applicable transition rules.

SECTION 7. AUDIT PROTECTION

If a taxpayer uses the Deferral Method described in section 5.02 of this revenue procedure for advance payments (as defined in section 4 of this revenue procedure), the taxpayer's use of the Deferral Method will not be raised as an issue by the Service in a taxable year that ends before May 6, 2004. *But* see sections 9 and 10 of 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, 2002-1 C.B. 696, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-2 C.B. 432); section 11 of Rev. Proc. 97-27, 1997-1 C.B. 680 (as modified and amplified by Rev. Proc. 2002-19, as amplified and clarified by Rev. Proc. 2002-54). If the taxpayer uses the Deferral Method described in section 5.02 of this revenue procedure, and the treatment of advance payments (as defined in section 4 of this revenue procedure) under the Deferral Method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9) in examination, in appeals, or before the U.S. Tax Court in a taxable year that ends before May 6, 2004, that issue will not be further pursued by the Service.

SECTION 8. CHANGE IN METHOD OF ACCOUNTING

.01 *In General.* A change in a taxpayer's treatment of advance payments to either of the methods described in section 5 of this revenue procedure is a change in method of accounting to which the provisions of §§ 446 and 481, and the regulations thereunder, apply. A taxpayer may adopt any permissible method of accounting for advance payments for the first taxable year in which the taxpayer receives advance payments. A taxpayer that seeks to change its method of accounting for advance payments must use Form 3115, Application for Change in Accounting Method, and complete all applicable parts thereof. See § 1.446-1(e).

.02 *Automatic Change.* Except with respect to a change in method to which section 8.03 or 8.04(2) of this revenue procedure applies, a taxpayer within the scope of this revenue procedure that wants to change to one of the methods of accounting

provided in section 5 of this revenue procedure must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9 (or its successor) with the following modifications –

(1) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply to a taxpayer that wants to change its method for its first or second taxable year ending on or after December 31, 2003, provided the taxpayer's method of accounting for advance payments is not an issue under consideration for taxable years under examination, within the meaning of section 3.09 of Rev. Proc. 2002-9, at the time the copy of the Form 3115 is filed with the national office;

(2) For purposes of Line 1a of Form 3115, the designated automatic accounting method change number for the changes in accounting method provided in section 5A of the Appendix of Rev. Proc. 2002-9, as added by this revenue procedure, are 83 for changes to the Full Inclusion Method and 84 for changes to the Deferral Method; and

(3) In lieu of providing the information and documentation required by line 1 of Schedule B to Form 3115, a taxpayer changing to the Deferral Method under this section must –

(a) state whether the taxpayer uses an applicable financial statement (as defined in section 4.06 of this revenue procedure) and, if so, identify the type;

(b) describe the basis used for deferral (*i.e.*, the method the taxpayer uses in its applicable financial statement or how the taxpayer determines amounts earned, as applicable); and

(c) if the taxpayer makes an allocation to which section 5.02(4)(c) of this revenue procedure applies, include a statement that the allocation method is based on payments the taxpayer regularly receives for an item or items it regularly provides separately.

.03 Advance Consent Change.

(1) A taxpayer within the scope of this revenue procedure that wants to use the Deferral Method for allocable payments described in section 5.02(4)(a) of this revenue procedure (other than allocable payments described in section 5.02(4)(c) of this revenue procedure) or for payments for which a method under section 5.02(3)(b)(i) or (iii) of this revenue procedure applies must follow the change in method of accounting provisions in Rev. Proc. 97-27.

(2) In lieu of providing the information and documentation required by line 1 of Schedule B to Form 3115, a taxpayer changing to the Deferral Method under this section 8.03 must --

(a) state whether the taxpayer uses an applicable financial statement (as defined in section 4.06 of this revenue procedure) and, if so, identify the type;

(b) describe the basis used for deferral (*i.e.*, the method the taxpayer uses in its applicable financial statement or how the taxpayer determines amounts earned, as applicable);

(c) provide a redacted copy of representative actual contracts or representative sample contracts relating to the advance payments and indicate the particular parts of the contract(s) that are relevant to the requested change;

(d) if the taxpayer makes an allocation to which section 5.02(4)(a) of this revenue procedure applies, include a representation that the claimed allocation is based on objective criteria and a description of the criteria used for the allocation;

(e) if the taxpayer has advance payments to which the method under section 5.02(3)(b)(i) applies, describe the statistical basis used to determine when the advance payments are earned and describe the data and methodology used to develop the statistical basis; and

(f) if the taxpayer has advance payments to which the method under section 5.02(3)(b)(iii) applies, provide an explanation of how the basis used for deferral results in a clear reflection of income.

.04 Changes to an Overall Accrual Method and the Deferral Method.

(1) Automatic change.

(a) *In general.* This section 8.04(1) applies to a taxpayer that qualifies under section 8.02 of this revenue procedure to change automatically to the Deferral Method and that either --

(i) qualifies under Rev. Proc. 2002-9 to change automatically to an overall accrual method or to an overall accrual method in conjunction with the recurring item exception of § 461(h)(3) (see section 5.01(1)(a)(i) or (ii) of the Appendix of Rev. Proc. 2002-9), or

(ii) is required to change to an overall accrual method under § 448 for the first taxable year it is subject to § 448 ("first § 448 year") and otherwise would be required to make the change under the provisions of § 1.448-1(h)(3).

(b) *Application.* A taxpayer described in section 8.04(1)(a) of this revenue procedure must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9 (or its successor) (including all the requirements of section 5.01 of the Appendix of Rev. Proc. 2002-9), with the following modifications --

(i) The taxpayer must file a single Form 3115 for both changes;

(ii) The taxpayer must include both change number 30 and change number 84 on Line 1a of Form 3115;

(iii) The taxpayer must complete all parts of Form 3115 that are applicable to both the change to an overall accrual method and the change to the Deferral Method (see section 8.02(3) of this revenue procedure);

(iv) For changes under section 8.04(1)(a)(i) of this revenue procedure, the taxpayer must complete Schedule A (computation of the § 481(a) adjustment) of Form 3115, including line 1b (income received or reported before it was earned), and must take the net § 481(a) adjustment into account as provided in section 5.04 of Rev. Proc. 2002-9 or section 2.02 of Rev. Proc. 2002-19, as applicable; and

(v) For changes under section 8.04(1)(a)(ii) of this revenue procedure, the taxpayer must complete Schedule A (computation of the § 481(a) adjustment) of Form 3115, including line 1b (income received or reported before it was earned), and must take the net § 481(a) adjustment into account as provided in § 1.448-1(g)(2)(i), (g)(2)(ii), or (g)(3), as applicable.

(2) *Advance consent change.*

(a) *In general.* A taxpayer within the scope of this revenue procedure that wants to change to the Deferral Method under section 8.03 of this revenue procedure, and also wants to change to an overall accrual method or to an overall accrual method in conjunction with the recurring item exception, must request to make both changes by filing one Form 3115, and the taxpayer must follow the change in method of accounting provisions in Rev. Proc. 97-27. Only one user fee is required for these changes. See section 5.01(3) of the Appendix of Rev. Proc. 2002-9. The taxpayer must complete all parts of Form 3115 that are applicable to both the change to an overall accrual method and the change to the Deferral Method (see section 8.03(2) of this revenue procedure).

(b) *First § 448 year and Deferral Method change.* A taxpayer within the scope of this revenue procedure that wants to change to the Deferral Method under section 8.03 of this revenue procedure and is required to change to an overall accrual

method under § 448 for its first § 448 year must make the change under the provisions of § 1.448-1(h)(3). Only one user fee is required for these changes and the taxpayer must complete all parts of Form 3115 that are applicable to both the change to an overall accrual method and the change to the Deferral Method (see section 8.03(2) of this revenue procedure).

.05 Previously Filed Forms 3115. If a taxpayer within the scope of this revenue procedure that qualifies to change its method automatically under section 8.02 or 8.04(1) of this revenue procedure filed a Form 3115 with the national office for a taxable year ending on or after December 31, 2003, and the Form 3115 is pending with the national office on May 6, 2004, the taxpayer must notify the national office in writing prior to July 6, 2004, if the taxpayer wants to withdraw its Form 3115 to make the change under section 8.02 or 8.04(1) of this revenue procedure. If the taxpayer notifies the national office within the time provided in this section 8.05, the taxpayer's Form 3115, and any user fee that was submitted with the Form 3115, will be returned to the taxpayer. A taxpayer whose Form 3115 is returned under this section 8.05 may file a new Form 3115 under the provisions prescribed in section 8.02 or 8.04(1) of this revenue procedure. If the taxpayer does not notify the national office within the time provided in this section 8.05, the national office will continue to process the taxpayer's Form 3115 in accordance with the administrative procedures under which it was originally filed, using existing authority (such as Rev. Proc. 71-21 or § 1.451-5, as applicable). With regard to changes under section 8.04(1) of this revenue procedure, this section 8.05 does not waive the generally applicable scope provisions and other requirements in section 5.01 of the Appendix of Rev. Proc. 2002-9.

.06 Automatic Change Transition Rule. A taxpayer within the scope of this revenue procedure that qualifies to change its method automatically under section 8.02 or 8.04(1) of this revenue procedure may change to the Full Inclusion Method, the Deferral Method, or an overall accrual method and the Deferral Method, as applicable, for taxable years ending on or after December 31, 2003. If a taxpayer has timely filed its federal income tax return for its first taxable year ending on or after December 31, 2003, and has not attached a Form 3115 to change its method of accounting for that taxable year to a method provided in this revenue procedure, the taxpayer, as provided in section 6.02(3)(b)(i) of Rev. Proc. 2002-9, is granted an automatic extension of 6 months from the due date of its federal income tax return for the year of change (excluding extensions) to obtain the automatic consent provided by this revenue procedure, provided the taxpayer attaches Form 3115 to an amended return for the year of change and otherwise complies with section 6.02(3)(b)(i) of Rev. Proc. 2002-9.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 71-21 is modified and superseded. Rev. Proc. 2002-9 is modified and amplified to include in section 5 of the Appendix the automatic change provided in section 8.04(1) of this revenue procedure, and to include in section 5A of the Appendix

the automatic change provided in section 8.02 of this revenue procedure. The Deferral Method provided in this revenue procedure is available to qualifying taxpayers notwithstanding revenue rulings, revenue procedures, notices, or announcements published by the Service that may provide different rules for when advance payments must be included in gross income. See, e.g., Rev. Rul. 70-445, 1970-2 C.B. 101; Rev. Rul. 68-44, 1968-1 C.B. 191; Rev. Rul. 65-141, 1965-1 C.B. 210; and Rev. Rul. 60-85, 1960-1 C.B. 181.

SECTION 10. DRAFTING INFORMATION

The principal author of this revenue procedure is Edwin B. Cleverdon of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Cleverdon at (202) 622-7900 (not a toll-free call).