

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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to: Robert E. Cudlip  
Attorney  
CC:LM:CTM:SD

from: John P. Moriarty  
Chief, Branch 1  
(Income Tax and Accounting)

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subject: Inclusion in gross income for federal tax purposes of advance payments.

This Chief Counsel Advice responds to your request for assistance dated June 15, 2009, in which you ask whether Taxpayer may use the deferral method of Rev. Proc. 2004-34, 2004-1 C.B. 991, for advance payments received in Year 2 pursuant to a settlement agreement entered into in Year 1. For the reasons described below, we conclude that Taxpayer may use the deferral method of Rev. Proc. 2004-34 for advance payments received in Year 2 pursuant to the settlement agreement entered into in Year 1, provided the Taxpayer's method of allocating the payment satisfies the requirements of section 5.02(4) of Rev. Proc. 2004-34. If you have any questions regarding this memorandum or our conclusion, please contact Innessa Glazman at 202-622-5020.

This advice may not be used or cited as precedent.

LEGEND

Taxpayer =  
Year 1 =  
Year 2 =  
Year 3 =  
Year 4 =  
Date 1 =  
Date 2 =

Date 3 =  
Date 4 =  
Date 5 =  
\$A =  
\$B =  
\$C =  
\$D =  
\$E =  
\$F =

### ISSUE

May Taxpayer use the deferral method of Rev. Proc. 2004-34, 2004-1 C.B. 991, for advance payments received in Year 2 pursuant to a settlement agreement entered into in Year 1?

### CONCLUSION

Taxpayer may use the deferral method of Rev. Proc. 2004-34, supra, for advance payments received in Year 2 pursuant to the settlement agreement entered into in Year 1, provided the Taxpayer's method of allocating the payment satisfies the requirements of section 5.02(4) of Rev. Proc. 2004-34.

### FACTS

Taxpayer uses an accrual method of accounting and defers advance payments as described in Rev. Proc. 2004-34, supra.<sup>1</sup> Taxpayer prevailed in patent infringement litigation prior to the years at issue. As a result of a settlement in Year 1, taxpayer received advance payments for services and licensing fees. Taxpayer intends to defer the inclusion of the advance payments in its gross income to the next succeeding taxable year under the provisions of Rev. Proc. 2004-34. Taxpayer is participating in Compliance Assurance Program with respect to Year 2.

Taxpayer settled the patent infringement litigation and entered into a settlement agreement on Date 1 in Year 1. The settlement agreement, accompanied by a term sheet, provided that the parties would dismiss certain litigation with prejudice and would enter into a license agreement upon terms set forth in the term sheet. The settlement agreement stated that the parties' counsel would promptly prepare definitive

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<sup>1</sup> We understand that the Director is not, at this time, challenging whether Taxpayer properly elected to defer income under Rev. Proc. 2004-34. You have not asked for assistance on that issue and we express no opinion on it.

agreements to give effect to the terms of the settlement. On Date 2 in Year 1, the parties executed a license agreement, effective Date 1, which superseded the term sheet but not the settlement agreement. Under the settlement, taxpayer was to receive total consideration of \$A, consisting of cash in the amount of \$B and patents valued in the amount of \$C.

Taxpayer's Year 1 ended on Date 3. Subsequently, pursuant to the terms of the license agreement, Taxpayer received a lump sum cash payment from the other party on Date 4 in Year 2 in the amount of \$B. This payment was partial consideration for (i) royalties for licensed products sold by the other party during and prior to Year 1, (ii) pre-paid royalties for sales of covered products during the term of the license agreement, and (iii) a fully paid-up license for licensed products. On Date 5 in Year 2, taxpayer received the patents. The license agreement expires in Year 4.

In its applicable financial statement for Year 1, Taxpayer recognized \$D as payment for royalties payable for licensed products sold by the other party during and prior to Year 1. The remaining portion of the cash payment of \$B and the value of the patents, \$C, were booked as deferred revenue for financial accounting purposes. Taxpayer will recognize this remainder as deferred revenue in its applicable financial statement in the amount of \$E for Year 2 and the amount of \$F for Year 3.

## LAW AND ANALYSIS

Section 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) of the Income Tax Regulations 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 required performance occurs; (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.

Rev. Proc. 2004-34, supra, generally permits a taxpayer to defer the inclusion in gross income of advance payments to the next succeeding taxable year. A payment is an advance payment within the meaning of Rev. Proc. 2004-34 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; (2) the payment is recognized by the taxpayer (in whole or in part) in revenues in its applicable financial statement for a subsequent taxable year; and (3) the payment is for certain specified activities including the performance of services or the use of intellectual property. See section 4.01 of Rev. Proc. 2004-34.

Further, a taxpayer that receives a payment that is partially attributable to payments for services or the use of intellectual property, may use the deferral method for the portion of the payment allocable to such items, provided that the taxpayer's method for determining the portion of the payment allocable to such items is based on objective criteria. See sections 4.01(3) and 5.02(4)(a) of Rev. Proc. 2004-34.

In the present case, Taxpayer received consideration of \$A in Year 2 pursuant to the agreement settling the patent infringement litigation. A portion of this amount, \$D, was for licensed products sold by the other party during and prior to Year 1.<sup>2</sup> As a result of the patent infringement settlement agreement, Taxpayer had a fixed right in Year 1 to receive the portion of the settlement payment attributable to licensed products sold during and prior to Year 1, and the amount could be determined with reasonable accuracy. See Rev. Rul. 84-31, supra. Taxpayer recognized this amount, \$D, in revenues in Year 1 on its applicable financial statement. Accordingly, this amount is not an advance payment as defined in section 4.01 of Rev. Proc. 2004-34.

The remaining portion of the \$A consideration was received in Year 2 and its inclusion in gross income in Year 2 would be a permissible method of accounting for federal income tax purposes under Rev. Proc. 84-31, supra. Of this amount, \$F will be recognized by Taxpayer in its applicable financial statement for Year 3. Accordingly, \$F is an advance payment within the meaning of section 4.01 of Rev. Proc. 2004-34. This payment may be deferred under the provisions of Rev. Proc. 2004-34, provided the Taxpayer's method of allocating the consideration between Year 2 and Year 3 satisfies the requirements of section 5.02(4) of Rev. Proc. 2004-34.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

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<sup>2</sup>For purposes of this memorandum we assume that this portion can be determined using objective criteria in accordance with section 5.02(4) of Rev. Proc. 2004-34. This should be verified by the Director.