

Advance Payments

Notice 2002-79

This notice provides a proposed revenue procedure that, if finalized, will modify and supersede Rev. Proc. 71-21, 1971-2 C.B. 549. Pursuant to the discretion granted the Commissioner of Internal Revenue under § 446 of the Internal Revenue Code, Rev. Proc. 71-21 allows, and this proposed revenue procedure (if finalized) will allow, taxpayers using an accrual method of accounting to defer the inclusion in gross income for federal income tax purposes of advance payments in certain limited situations. This proposed revenue procedure is intended to reduce the administrative and tax compliance burdens on taxpayers and to minimize disputes between the Internal Revenue Service and taxpayers regarding advance payments.

In conjunction with this proposed revenue procedure, the Treasury Department and the Service plan to propose regulations that will modify § 1.61-8(b) of the Income Tax Regulations to conform with the proposed revenue procedure. The current regulation states that “advance rentals” are includible in gross income for the year of receipt (except as provided by § 467 and the regulations thereunder); the proposed regulation will allow the Commissioner to provide rules allowing for inclusion in gross income for a taxable year other than the taxable year of receipt.

The Service requests comments on the proposed revenue procedure provided in this notice. In particular, the Service requests comments regarding:

- whether the proposed revenue procedure should take into account the cost of goods sold in deferring advance payments from the sale of goods;
- a taxpayer’s ability to allocate advance payments between the deferral provisions in § 1.451-5 and this revenue procedure;
- the acceleration of advance payments pursuant to non-taxable transfers, such as transfers under § 351 or § 721, and the treatment of short tax years resulting from § 381(a) transactions; and
- the use of statistical methodologies for tracing advance payments if the taxpayer cannot 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.

All comments should be submitted by March 24, 2003, either to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044
Attn: CC:PA:T:CRU (ITA)
Room 5529

or electronically via the Service internet site at: *Notice.Comments@m1.irs.counsel.treas.gov* (the Service Comments e-mail address).

Rev. Proc. 2003-XX

SECTION 1. PURPOSE

This revenue procedure modifies and supersedes Rev. Proc. 71-21, 1971-2 C.B. 549, under which the Commissioner exercised his discretion under § 446 of the Internal Revenue Code to allow taxpayers using an accrual method of accounting to defer the inclusion in gross income for federal income tax purposes of certain advance payments for services in limited situations. This revenue procedure expands Rev. Proc. 71-21 to allow qualifying taxpayers to defer to the next succeeding taxable year the inclusion in gross income for federal income tax purposes of certain advance payments (as specified in section 4 of this revenue procedure) to the extent the advance payments are deferred for financial reporting purposes. This revenue procedure allows this deferral even if the advance payments are not included in gross receipts for financial reporting purposes by, or the income is not earned through performance by, the end of the next succeeding taxable year. However, in no event will this revenue procedure allow 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.

SECTION 2. BACKGROUND AND CHANGES

.01 In general, § 451 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 required performance takes place, (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 tax purposes if that method results in the payments being included in gross income no later than when they are includible in gross receipts under the taxpayer’s method of accounting for financial reporting purposes.

.03 Rev. Proc. 71-21 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 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, especially with regard to Forms 3115, *Application for Change in Accounting Method*, filed by taxpayers requesting to change to the method provided in Rev. Proc. 71–21. In particular, taxpayers and the Service frequently disagree about whether advance payments are for services, some type of non-service, or some mixture of services and non-services. Advance payments for non-services (and often, for mixed services and non-services) do not qualify for deferral under Rev. Proc. 71–21. Thus, the difficulty in defining “services” under Rev. Proc. 71–21 results in controversy over whether the Service should grant a taxpayer’s request to change to the method provided in Rev. Proc. 71–21. 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 controversy about 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 mixed services/non-services. Additionally, the Service has determined that it is appropriate to expand the scope 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 it is appropriate to retain the limited one-year deferral of Rev. Proc. 71–21 for taxpayers within the scope of this revenue procedure.

SECTION 3. SCOPE

This revenue procedure applies to taxpayers using an 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 is an “advance payment” if:

(1) the payment is received by the taxpayer in one taxable year;

(2) 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);

(3) the payment is included by the taxpayer (in whole or in part) in gross receipts for financial reporting purposes for a subsequent taxable year, whether or not the inclusion is contingent upon a future act by the taxpayer or any other party; and

(4) the payment is solely for:

(a) services (other than for service warranty contracts for which the taxpayer uses the accounting method provided in Rev. Proc. 97–38, 1997–2 C.B. 479);

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

(c) the use of intellectual property as defined in section 4.03 of this revenue procedure;

(d) the occupancy of space or the 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) guaranty or warranty contracts ancillary to the items described in subsections (a), (b), (c), and (d) of this section;

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

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

(h) any combination of subsections (a) through (g) of this section.

.02 *Exclusions from advance payment.* The term “advance payment” does not include:

(1) rent (except for amounts described in section 4.01(4)(c) and (d));

(2) insurance premiums; and

(3) payments with respect to financial instruments (for example, debt instruments, deposits, letters of credit, notional principal contracts, options, forwards, futures, foreign currency contracts, credit card

agreements, financial derivatives, etc.), including purported prepayments of interest.

.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.

SECTION 5. PERMISSIBLE METHODS OF ACCOUNTING FOR ADVANCE PAYMENTS

.01 *Full Inclusion Method.* As provided in section 4.01(2), 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 received is using a proper method of accounting under § 1.451–1, regardless of whether the taxpayer includes the full amount of advance payments in gross receipts for that taxable year for financial reporting purposes.

.02 *Deferral Method.*

(1) *In general.* Except as otherwise provided in this revenue procedure, a taxpayer within the scope of this revenue procedure that uses the Deferral Method described in this section is using a proper method of accounting under § 1.451–1. Under the Deferral Method, for federal income tax purposes the taxpayer must include the advance payment in gross income for the taxable year of receipt to the extent the advance payment is included in gross receipts for financial reporting purposes for that year. The remaining amount of the advance payment must be included in gross income for the next succeeding taxable year.

(2) *Tracing advance payments.* To be eligible to use the Deferral Method, the taxpayer must have in place a methodology for determining that advance payments are included in gross income by the end of the next succeeding taxable year. In the case of goods or services that are not traced, a tax-

payer may generally use the methodology used for financial reporting purposes provided that

(a) the methodology used for financial reporting purposes provides a basis for determining how much of the current year's advance payments are included in gross receipts for financial reporting purposes in the current year; and

(b) the portion of an advance payment not included in gross income in the taxable year of receipt is included in gross income in the next succeeding taxable year.

(3) *Acceleration of advance payments.* Notwithstanding section 5.02(1) of this revenue procedure, the taxpayer must include in gross income for the taxable year of receipt:

(a) all advance payments if, in that year, the taxpayer either dies or ceases to exist in a transaction other than one to which § 381(a) applies;

(b) advance payments with respect to any one or more of the items listed in section 4.01 of this revenue procedure if, and to the extent that, the taxpayer's obligation to provide the item or items otherwise ends in that year.

.03 Examples. In each example below, the taxpayer uses an accrual method of accounting and files its returns on a calendar year basis.

(1) On November 1, 2003, *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 2003 and another 35 lessons in 2004 before the contract expires. For financial reporting purposes, *A* includes 1/6 of the payment in gross receipts for 2003, and 5/6 of the payment in gross receipts for 2004. *A* uses the Deferral Method. For federal income tax purposes, *A* must include 1/6 of the payment in gross income for 2003, and the remaining 5/6 of the payment in gross income for 2004.

(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 2003, 48 lessons in 2004, and 40 lessons in 2005. For financial reporting purposes, *A* includes 1/12 of the payment in gross receipts for 2003, 6/12 of the payment in gross receipts for 2004, and 5/12 of the payment in gross receipts for 2005. For federal income tax purposes, *A* must include 1/12 of the payment in gross income for 2003, and the remaining 11/12 of the payment in gross income for 2004.

(3) On June 1, 2003, *B*, a landscape architecture firm, receives an advance payment for goods and services that, under the terms of the agreement, must be completed by December 2004. On December 31, 2003, *B* estimates that 3/4 of the work under the agreement has been completed. For financial reporting purposes, *B* includes 3/4 of the payment in gross receipts

for 2003 and 1/4 of the payment in gross receipts for 2004. *B* uses the Deferral Method. For federal income tax purposes, *B* must include 3/4 of the payment in gross income for 2003, and the remaining 1/4 of the payment in gross income for 2004, regardless of whether *B* is for any reason unable to complete the job in 2004.

(4) On July 1, 2003, *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 certain parts in the customer's television set if those parts fail to function properly. For financial reporting purposes, *C* includes 1/4 of the payment in gross receipts for 2003, 1/2 of the payment in gross receipts for 2004, and 1/4 of the payment in gross receipts for 2005. *C* uses the Deferral Method. For federal income tax purposes, *C* must include 1/4 of the payment in gross income for 2003 and the remaining 3/4 of the payment in gross income for 2004.

(5) *D*, a video arcade operator, receives payments in 2003 for game tokens that are used by customers to play the video games offered by *D*. 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 financial reporting purposes, *D* completed a study that determined 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 *z* percent of tokens are never expected to be used. Based on the study, *D* includes in gross receipts for 2003 the percentage of the payments for tokens that are used in that year (*x* percent) as well as the *z* percent for tokens that are never expected to be used; *D* includes the remaining *y* percent in gross receipts for 2004. *D* uses the Deferral Method. Because *D* does not trace which tokens are used in any given taxable year, *D* may include these payments in gross income in accordance with its financial reporting method, provided that any portion of the payment not included in income in the year of receipt is included in gross income for the next succeeding taxable year. *D* includes *x* percent and *z* percent in gross income for 2003, and *D* includes *y* percent in gross income for 2004.

(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, 2003, *E* receives payments for 2 mailers; one of the mailers is submitted for film processing and is processed by *E* on September 1, 2003, and the other is submitted and processed on February 1, 2005. For financial reporting purposes, *E* includes the payment for the September 1, 2003, processing in gross receipts for 2003 and the payment for the February 1, 2005, processing in gross receipts for 2005. *E* uses the Deferral Method. For federal income tax purposes, *E* must include the payment for the September 1, 2003, processing in gross income for 2003 and the payment for the February 1, 2005, processing in gross income for 2004.

(7) *F*, a hair styling salon, receives advance payments from selling gift certificates that may later be redeemed at the salon for hair styling services or hair care products at the face value of the gift certi-

cate. The gift certificates look like standard credit cards, and each certificate has a magnetic strip that, in connection with *F*'s computer system, identifies the balance of the gift credit. The gift certificates may not be redeemed for cash, and they have no expiration date. *F* does not have in place a methodology for determining the extent to which the current year's advance payments are included in gross receipts for financial reporting purposes for the current year. *F* may not use the Deferral Method, and *F* must include the advance payments in gross income for the taxable year of receipt.

(8) *G* 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, 2003, *G* receives an advance payment from a subscriber for 1 year of access to its online database. For financial reporting purposes, *G* includes 1/3 of the payment in gross receipts for 2003 and the remaining 2/3 in gross receipts for 2004. *G* uses the Deferral Method. For federal income tax purposes, *G* must include 1/3 of the payment in gross income for 2003 and the remaining 2/3 of the payment in gross income for 2004.

(9) On December 1, 2003, *H*, 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 receives an identification card that allows access for a 1-year period to *H*'s stores, which offer discounted merchandise and services. For financial reporting purposes, *H* includes 1/12 of the payment in gross receipts for 2003 and 11/12 of the payment in gross receipts for 2004. *H* uses the Deferral Method. For federal income tax purposes, *H* must include 1/12 of the payment in gross income for 2003, and the remaining 11/12 of the payment in gross income for 2004.

(10) *I*, a professional sports franchise, is a member of a sports league that enters into contracts with television networks for the sale of broadcasting rights to the games played between the member teams. The money received under the contracts is divided equally among the member teams. On April 1, 2003, the league enters into a 3-year broadcasting contract. *I* receives three equal installment payments on October 1 of each contract year, beginning in 2003. For financial reporting purposes, *I* includes 1/4 of the first installment payment in gross receipts for 2003 and 3/4 in gross receipts for 2004; *I* includes 1/4 of the second installment in gross receipts for 2004 and 3/4 in gross receipts for 2005; *I* includes 1/4 of the third installment in gross receipts for 2005 and 3/4 in gross receipts for 2006. *I* uses the Deferral Method. Under section 4 of this revenue procedure, each installment payment constitutes an "advance payment." Thus, for federal income tax purposes, *I* must include 1/4 of the first installment payment in gross income for 2003 and 3/4 in gross income for 2004; 1/4 of the second installment in gross income for 2004 and 3/4 in gross income for 2005; and 1/4 of the third installment in gross income for 2005 and 3/4 in gross income for 2006.

(11) *J* is a cable television provider that enters into contracts with subscribers to provide cable services for a monthly fee (paid prior to the service month). For those subscribers without a "cable ready" television set, *K* provides, for an additional monthly charge (also paid prior to the service month), a cable converter box with a remote control. Pursuant to the con-

tract, *J* will replace or repair the cable converter box if it proves defective during the contract period. *J* will not allow a non-subscriber to rent a converter box. In December 2003, *J* receives payments from subscribers for January 2004 cable service and converter box use. For financial reporting purposes, *J* includes these payments in gross receipts for 2004. *J* uses the Deferral Method. The payments for cable services are included in gross income for 2004. Because a subscriber's use of a converter box is ancillary to the provision of cable services by *J*, and because the converter box warranty is ancillary to the use of the converter box, *J* must include the entire advance payment in gross income for 2004.

(12) On January 1, 2003, *K* enters into, and receives advance payments pursuant to, a 5-year license agreement for its computer software. Under the contract, the licensee pays *K* both the first-year (2003) license fee and the fifth-year (2007) 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. For financial reporting purposes, *K* includes the fees in gross receipts for the respective license year. *K* uses the Deferral Method. For federal income tax purposes, *K* must include the first-year license fee in gross income for 2003, the second-year and the fifth-year license fee in gross income for 2004, the third-year license fee in gross income for 2005, and the fourth-year license fee in gross income for 2006.

(13) On July 1, 2003, *L*, who is in the business of selling off-the-shelf computer software and providing computer support, receives an advance payment for a 2-year "software maintenance contract" under which *L* will provide software updates if it develops an update within the contract period, as well as online and telephone customer support. For financial reporting purposes, *L* includes 1/4 of the payment in gross receipts for 2003, 1/2 in gross receipts for 2004, and the remaining 1/4 in gross receipts for 2005, regardless of when *L* provides updates or customer support. *L* uses the Deferral Method. For federal income tax purposes, *L* must include 1/4 of the payment in gross income for 2003 and 3/4 in gross income for 2004.

(14) Assume the same facts as *Example 13*, but *L* ceases to exist, on December 1, 2003, in a transaction to which § 381(a) does not apply. For federal income tax purposes, *L* must include the entire fee in gross income on December 1, 2003.

SECTION 6. AUDIT PROTECTION FOR TAXPAYERS CURRENTLY USING THE DEFERRAL METHOD

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 method of accounting for such advance payments under the Deferral Method will not be raised as an issue by the Service in a taxable year that ends before [insert date of publication of final revenue procedure]. 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 [insert date of publication of final revenue procedure], that issue will not be further pursued by the Service.

SECTION 7. CHANGE IN METHOD OF ACCOUNTING

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. Therefore, a taxpayer within the scope of this revenue procedure that wants to use one of the methods of accounting provided in section 5 of this revenue procedure, and that does not currently use that method, must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (or its successor), as modified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696, Announcement 2002-17, 2002-8 I.R.B. 561, and Rev. Proc. 2002-54, 2002-35 I.R.B. 432, with the following modifications:

.01 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 [insert date of publication of final revenue procedure] 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 Form 3115 is filed with the national office;

.02 A taxpayer that wants to change its method for its first taxable year ending on or after [insert date of publication of final revenue procedure], that on or before [insert date 30 days from date of publication of final revenue procedure] files its original federal income tax return for that year is not required to comply with the filing requirement in section 6.02(3)(a) of Rev. Proc. 2002-9, provided the taxpayer complies with the following filing requirements. The taxpayer must complete and file a Form 3115 in duplicate. The original must be attached to an amended federal income

tax return for the taxpayer's first taxable year ending on or after [insert date of publication of final revenue procedure]. This amended return must be filed no later than [insert date 180 days from date of publication of final revenue procedure]. A copy of the Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 2002-9 for the address) no later than when the taxpayer's amended return is filed; and

(3) When filing the Form 3115, taxpayers must complete all applicable parts of the form and, in lieu of the label required by section 6.02(4) of Rev. Proc. 2002-9, are instructed to write "Change to [Full Inclusion Method or Deferral Method] under Rev. Proc. [insert rev. proc. number]" at the top of the form.

SECTION 8. RECORD KEEPING

Section 6001 provides that every person liable for any tax imposed by the Code, or for the collection thereof, must keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. The books or records required by § 6001 must be kept at all times available for inspection by authorized internal revenue officers or employees, and must be retained so long as the contents thereof may become material in the administration of any internal revenue law. Section 1.6001-1(e). In order to satisfy the record keeping requirements of § 6001 and the regulations thereunder, a taxpayer that uses the Deferral Method must maintain adequate books and records so that the amount deferred on the federal income tax return for any year can be verified from those books and records.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 71-21 is modified and superseded. Rev. Proc. 2002-9 is modified and amplified to include this automatic change in the APPENDIX. 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. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after [insert date of publication of final revenue procedure].

SECTION 11. 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).