September 7, 2017

Mr. Scott Dinwiddie
Associate Chief Counsel
Income Tax & Accounting
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Advance Payments Under Section 451

Dear Mr. Dinwiddie:

The American Institute of CPAs (AICPA) is pleased to submit comments with respect to Internal Revenue Code (IRC or "Code") section 451,[1] regarding the treatment of advance payments received by accrual basis taxpayers. We recommend that the Internal Revenue Service (IRS) and the United States Department of the Treasury ("Treasury") issue regulations or other guidance to provide a single uniform treatment for advance payments that includes the following:

- A single regulatory provision addressing advance payments received for the sale of goods, provision of services, use of certain intellectual property, including computer software; subscriptions; memberships, gift card sales, and any other types of identifiable revenue, that includes a financial statement conformity rule;
- Inclusion of advance rental payments that are not subject to IRC section 467 as advance payments eligible for deferral; and
- Automatic consent to change to the newly allowable method, and if such method is not promulgated (or until such time as it is promulgated), revise the automatic consent procedures currently in Rev. Proc. 2017-30 to include a change to defer advance payments in accordance with Treas. Reg. § 1.451-5.

These comments were developed by the AICPA Tax Methods and Periods Technical Resource Panel and approved by the Tax Executive Committee.

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[1] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

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We appreciate your consideration of our recommendations and welcome the opportunity to further discuss our comments. If you have any questions, please contact me at (408) 924-3508 or annette.nellen@sjsu.edu; Jennifer Kennedy, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (703) 918-6951, or jennifer.kennedy@pwc.com; or Ogochukwu Eke-Okoro, Lead Manager – AICPA Tax Policy & Advocacy, at (202) 434-9231, or ogo.eke-okoro@aicpa-cima.com.

Sincerely,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

cc: Mr. Christopher Call, Attorney-Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Mr. Tom Moffit, Acting Deputy Associate Chief Counsel, Income Tax & Accounting, Internal Revenue Service

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Comments on Advance Payments

Developed by the AICPA Tax Methods and Periods Technical Resource Panel
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Comments on Advance Payments

I. General Background

Income Recognition – Generally

Under section 451(a), the amount of any item of gross income is included in the gross income for the taxable year in which it is received by the taxpayer unless, under the method of accounting used in computing taxable income, the amount is properly accounted for as of a different period.

Treasury Reg. § 1.451-1(a) provides, in pertinent part, that under an accrual method of accounting, income is generally includible in gross income when all the events have occurred which fix the right to receive such income and the amount is determinable with reasonable accuracy. A taxpayer's right to receive income is generally fixed at the earlier of when (i) the required performance under the contract occurs, (ii) payment under the contract is due, or (iii) payment under the contract is received. Thus, an advance payment generally is currently recognized as income by an accrual method taxpayer. However, the IRS has provided certain exceptions to the general rule of section 451(a) for certain advance payments described in Treas. Reg. § 1.451-5, Rev. Proc. 2004-34 and sections 455 and 456.

Deferred Revenue Provisions

Treasury Reg. § 1.451-5

Treasury Reg. § 1.451-5(a)(1) defines an advance payment as an amount which is received in a taxable year by a taxpayer using an accrual method of accounting for purchases and sales pursuant to, and applicable against, an agreement for the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

Treasury Reg. § 1.451-5(b)(1) provides that:

> (1) In general, advance payments must be included in income either -
> (i) In the taxable year of receipt; or
> (ii) Except as provided in paragraph (c) of this section.
>
> (a) In the taxable year in which properly accruable under the taxpayer's method of accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all of his reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes, or
>
> (b) If the taxpayer's method of accounting for purposes of such reports results in advance payments (or any portion of such payments) being included in gross

receipts earlier than for tax purposes, in the taxable year in which includible in gross receipts pursuant to his method of accounting for purposes of such reports.

Treasury Reg. § 1.451-5(f) provides that if a taxpayer has adopted a method prescribed in Treas. Reg. § 1.451-5(b)(1)(ii), and "if in a taxable year the taxpayer dies, ceases to exist in a transaction other than one to which section 381(a) applies, or his liability under the agreement otherwise ends, then so much of the advance payment as was not includible in his gross income in preceding taxable years shall be included in his gross income for such taxable year."

Rev. Proc. 2004-34

Rev. Proc. 2004-34 allows taxpayers to defer recognition of advance payments arising from, among other things, the provision of services or the sale of goods (the Deferral Method). To qualify as an advance payment, section 4.01(2) of Rev. Proc. 2004-34 provides that the payment is recognized by the taxpayer (in whole or part) in revenues in its applicable financial statement for a subsequent taxable year or, for taxpayers without an applicable financial statement, the payment is earned by the taxpayer (in whole or part) in a subsequent taxable year.

Under the Deferral Method described in Rev. Proc. 2004-34, a taxpayer with an applicable financial statement must include an advance payment in its gross income for the tax year of receipt to the extent the advance payment is recognized in revenues in its applicable financial statement for that tax year, and include the remaining amount of the advance payment in gross income in the next succeeding tax year, unless it is a short tax year of 92 days or less. If a taxpayer does not have an applicable financial statement or is unable to determine the extent to which an advance payment is recognized in financial statement revenues in the year of receipt, the taxpayer must include in the year of receipt the amount of the advance payment that is earned in that year.

Section 5.02(5)(b) of Rev. Proc. 2004-34 provides that a taxpayer using the Deferral Method must include in gross income for the taxable year of receipt all advance payments not previously included in gross income if, and to the extent that, in that taxable year, the taxpayer's obligation with respect to the advance payment is satisfied or otherwise ends other than in a transaction to which section 381(a) applies or a section 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 a consolidated group.

Section 455

Section 455 provides that a taxpayer may elect to include prepaid subscription income in gross income for the tax years during which a liability to furnish or deliver a periodical exists, rather than in the taxable year of receipt.

Section 455(b) designates two situations that will trigger the recognition of prepaid subscription income deferred by such an election. Under section 455(b)(1), if the liability ends, the prepaid subscription income that was not includible in gross income for preceding taxable years is included in gross income for the taxable year in which the liability ends. Section 455(b)(2) provides for a similar result if the taxpayer dies or ceases to exist.

Section 456

Section 456 allows a taxpayer to recognize certain prepaid dues as income ratably over the period of time that the taxpayer is required to render the services or make the membership privileges available.

Similar to the other provisions described above, section 456(b)(2) provides that if the liability to provide services or membership privileges ends, then so much of such income as was not includible in gross income for preceding taxable years, is included in gross income for the taxable year in which the liability ends. Further, if the taxpayer ceases to exist, then any prepaid dues not previously recognized as income is included in gross income for the taxable year in which such cessation of existence occurs.

II. Provide Uniform Safe Harbor Deferral Period for All Advance Payments

A. Replace Rev. Proc. 2004-34 and Treas. Reg. § 1.451-5 with an expansion of Treas. Reg. § 1.451-5

Recommendation

In order to provide more consistent guidelines to taxpayers, provide simplification, and reduce burdens and costs to taxpayers, the AICPA recommends that the IRS expand Treas. Reg. § 1.451-5 to address the treatment of all types of advance payments (other than those payments covered under sections 455 and 456), including those payments for services as well as goods, and to provide consistent periods for the deferral of income from advance payments.

Specifically, we recommend that the IRS permit a taxpayer with an applicable financial statement, which is prepared following Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS), to recognize advance payments as is recognized in its applicable financial statement. The IRS should permit the taxpayer to defer advance payments for goods, services or long-term contracts in accordance with the deferral for applicable financial statement purposes, and recognize the advance payments in the taxable year the advance payment is included in gross receipts for its applicable financial statement.

Alternatively, if the IRS does not agree with the proposal to defer advance payments in accordance with the deferral for applicable financial statement purposes, the AICPA recommends that a taxpayer that has an applicable financial statement and receives advance payments is permitted to recognize those advance payments by following its financial statement for the year of receipt and the succeeding taxable year, and recognize any remaining amount of an advance payment in the second taxable year following the year of receipt. We recommend that the deferral period for any type of advance payment is not less than the current maximum restriction for inventoriable goods under Treas. Reg. § 1.451-5(c)(3), which is two years. Permitting a deferral for two years would reduce the burden of creating separate records for tax purposes to track the advance payments and will permit greater conformity with books.

Additionally, we recommend that the IRS permit a taxpayer without an applicable financial statement that defers recognition of advance payments for book purposes, to recognize advance payments for goods and services as such amounts are recognized in its books. The IRS should permit such taxpayer, to the extent not fully included by the first taxable year after the advance payment is received, to include in taxable income the remainder of the advance payment in the first taxable year after receipt.

Background and Analysis

As outlined above, Treas. Reg. § 1.451-5(b)(1)(ii)(a) permits a taxpayer using an accrual method of accounting to defer an advance payment for goods or long-term contracts for tax purposes consistent with the recognition of the advance payment for financial reporting purposes.

In addition, Treas. Reg. §§ 1.451-5(b)(1)(ii) and 1.451-5(c) permit a taxpayer using an accrual method of accounting to defer substantial advance payments (as defined in Treas. Reg. § 1.451-5(c)(3)) for inventoriable goods up to the second taxable year following receipt of the substantial advance payments. Substantial advance payments received under an agreement are recognized for tax purposes as they are included in gross receipts for financial statement purposes. Any remaining advance payment not yet included in taxable income is included in the second taxable year following receipt of the advance payment.

Revenue Proc. 2004-34 permits the deferral of income from certain advance payments. Specifically, the advance payments eligible for the Deferral Method under Rev. Proc. 2004-34 include:

- payments for services;
- the sale of goods (other than for the sale of goods for which the taxpayer uses a method of deferral provided in Treas. Reg. § 1.451-5(b)(1)(ii));
- the use (including by license or lease) of intellectual property;
- the occupancy or use of property if the occupancy or use is ancillary to the provision of services;
- the sale, lease, or license of computer software;
- guaranty or warranty contracts ancillary to an item or items described above;
- subscriptions (other than subscriptions for which an election under section 455 in effect), whether or not provided in a tangible or intangible format;
- memberships in an organization (other than memberships for which an election under section 456 is in effect); or
- an eligible gift card sale (collectively referred to as "services" in this letter).

The IRS should expand Treas. Reg. § 1.451-5 to consolidate the guidance related to the recognition of advance payments. The additional language should address the treatment of all types of advance payments that are presently addressed in Rev. Proc. 2004-34. Consolidation of the guidance would eliminate the need for the separate guidance in Rev. Proc. 2004-34.

Additionally, all types of advance payments, whether for goods, substantial advance payments for inventoriable goods, or services, should have the same deferral period, as opposed to the current guidance which provides differing deferral periods based on the type of advance payment.

Section 4.06 of Rev. Proc. 2004-34 defines an applicable financial statement as, 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 —

    1. credit purposes,
    2. reporting to shareholders, or
    3. 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 IRS).

Publicly traded companies are required to use GAAP or IFRS to prepare financial statements that are distributed outside the company. Many private companies also use GAAP in preparing their books and records. Generally, in determining its taxable income, a taxpayer starts with its books and records and makes the adjustments that are required by the Code. When the timing of reporting income or liabilities differs between books and taxes, those differences are reported on Schedule M-1, *Reconciliation of Income (Loss) and Analysis of Unappropriated Retained Earnings per Books* or Schedule M-3, *Net Income (Loss) Reconciliation for Corporations with Total Assets of $10 Million or More*.

A taxpayer may also have to create separate records for tax purposes when the timing of reporting income or liabilities is different between books and tax for several years. The focus of the accounting rules that govern revenue recognition related to advance payments for financial reporting purposes is to match the income recognized with the expenses incurred as the goods are delivered or the services are provided. Generally, applying the revenue recognition rules under GAAP should provide adequate assurance of when the advance payments are earned and allow for matching revenue recognition with the costs associated with the services performed or goods delivered. Additionally, while the revenue recognition standards may differ for taxpayers using IFRS, the same concept (allowing tax to equal books) should apply for taxpayers that prepare their financial statements using IFRS, especially in light of the imminent convergence between IFRS and GAAP revenue recognition standards.

When the current different deferral periods were implemented (the late 1960s and early 1970s) court cases influenced the decision to create different deferral periods. The Supreme Court's decisions in a trilogy of cases, *Automobile Club of Michigan v. Commissioner*,[2] *American*

[2] 353 US 180 (1957).

Automobile Association v. United States,[3] and *Schlude v. Commissioner*,[4] may have led to the limit on the deferral of advance payments for services to only one year where there are no specific terms or time frame for the provision of the services under the agreements. In these cases, the arrangements to provide services does not specify when, or if, those services are provided and are dependent on the customer requesting the service. However, several more recent court cases have permitted the deferral of advance payments in situations where an arrangement/contract provides for the time frame or event to establish when the advance payments are earned and recognized as income. Generally, GAAP uses similar criteria in determining the appropriate timing for recognizing an advance payment as being earned.

Artnell Co. v. Commissioner[5] considers whether advance sales of tickets for baseball games and prepayments for related future services (broadcasting and televising future games, and season parking) are deferred until the games are played and the services rendered. The Court of Appeals for the Seventh Circuit noted that "[t]he deferred income was allocable to games which were to be played on a fixed schedule. Except for rain dates, there was certainty."[6] It concluded that the Tax Court erred in deciding that the advance payments were income when received regardless of the merits of the method employed. On remand to the Tax Court to consider whether the method of accounting clearly reflected income, the court held that the taxpayer acted properly in not including in its taxable year ending May 31, 1962, the advance payments allocable to the games played thereafter.

Several years later, the Court of Claims concluded in *Boise Cascade Corp. v. United States*[7] that the method of accounting employed by an engineering services company, under which the recognition of advance payments was deferred until the related services were performed, clearly reflected income. The majority of the advance payments were for engineering services in the design and construction of electric generating plants. The taxpayer's services were absolutely necessary to complete the project. Many contracts contained fixed and specific dates for the taxpayer's performance, while others simply required the taxpayer to proceed as "expeditiously as possible" or used similar language. The court noted that the taxpayer had a fixed obligation to perform its services. The obligation to perform was definite and not subject to the demands of clients. Although performance was to occur within the year following receipt of payment, in some cases there were no fixed dates for performance.

More recently, in *Tampa Bay Devil Rays, Ltd., et. al. v. Commissioner*,[8] the Tax Court addressed whether deposits a partnership received in 1995 and 1996 for advance 1998 major league baseball games season tickets and private suite reservations (the first year the team played baseball), were includable in income in the year received or in 1998 (the year to which the advance season tickets and private suite reservations related). The court noted that the facts in *Artnell* are very similar to those in *Tampa Bay*, and agreed with *Tampa Bay* that their facts fall within the narrow fact pattern of *Artnell*. The court agreed that the partnership's deferral of reporting the deposits in income until 1998 more clearly matches the partnership's related expenses that were incurred and deducted in 1998. The court did not comment on the fact that

[3] 367 US 687 (1961).
[4] 372 US 128 (1963).
[5] 400 F2d 981 (7th Cir. 1968).
[6] *Id*.
[7] 530 F2d 1367 (Ct. Cl. 1976), cert. denied, 429 US 867 (1976).
[8] TC Memo. 2002-248 (2002).

the deferral permitted in *Tampa Bay* was for periods of up to three years, unlike the one-year deferral permitted in *Arntell*.

These cases show the courts' willingness to consider the specific circumstances of the taxpayer and allow taxpayers to defer advance payments in situations where the taxpayer can establish a fixed time or event for the recognition of the advance payment as income. In light of these cases, and in order to reduce the complexity in calculating book and tax differences and reduce the burden of creating separate records for tax purposes, the IRS should provide consistent periods for the deferral of income from advance payments under Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34.

B. Advance rentals not subject to section 467

Recommendation

The AICPA requests that the IRS provide that rents, which are not subject to section 467, qualify as an allowable payment that an accrual method taxpayer is entitled to defer.

Analysis

Generally, Rev. Proc. 2004-34 does not allow for the deferral of advance rentals, except for advance payments for the use of certain intellectual property, including computer software, and certain short-term rentals (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).[9]

Revenue Proc. 71-21, the predecessor to Rev. Proc. 2004-34, was designed to reconcile the tax and financial accounting treatment of certain payments for services without extending deferral beyond the next succeeding tax year. Revenue Proc. 2004-34 had a similar purpose and expanded the scope of the types of payments and agreements that are deferrable with the overarching tax policy of permitting a relatively brief deferral period for nearly all advance payments, subject only to a few limited carve outs. The carve outs generally were for certain types of payments governed by special rules for federal income tax purposes, including rent, insurance, and financial instruments.

For example, certain rent payments are subject to the special matching rules of section 467, which generally match the income and expense recognition of the landlord and the lessee during the lease term. However, outside the context of section 467, rent payments received by a landlord are subject to the general rules under sections 61 and 451 and the regulations thereunder. From the lessee's perspective, the payments are subject to section 461 and the regulations thereunder. These rules generally produce a mismatch for advance rentals, as shown below.

Treasury Reg. § 1.61-8(b) provides the general rule that, except as provided in section 467 and the regulations thereunder, "gross income includes advance rentals, which must be included in

[9] See section 4.01(3)(c), (d), and (e) for items deferrable under Rev. Proc. 2004-34 and section 4.02(1) for the general rule excluding all other rents under Rev. Proc. 2004-34.

income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer." Therefore, generally no deferral is allowed for advance rentals, although these amounts generally are deferred for book purposes by an accrual method taxpayer.

Treasury Reg. § 1.461-(d)(3)(i) provides the general rule that, if the liability of a taxpayer arises out of the use of property by the taxpayer, economic performance occurs ratably over the period of time the taxpayer is entitled to use the property (taking into account any reasonably expected renewal periods when necessary to carry out the purposes of section 461(h)). In the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, the all events test (including economic performance) is considered met in the taxable year in which the liability is taken into account under section 467 and the regulations thereunder. Therefore, generally for payments not subject to section 467, an accrual method taxpayer must defer the deduction for prepayments of rent over the period that the property is used. Generally, the book treatment will similarly defer the deduction of prepayments, although there are some book/tax differences in the amounts that are deducted each year due to interest.

To provide simplification and reduce this mismatch, the AICPA requests that rents that are not subject to section 467 are included as an allowable payment which is deferred by an accrual method taxpayer. T.D. 9135 authorized the Commissioner of the IRS to provide, through administrative guidance, rules for deferring income inclusion of advance rentals to a taxable year other than the year of receipt. The amendment was specifically included to allow Rev. Proc. 2004-34 to provide deferral rules for the use of intellectual property and computer software; however, the authorization permits the issuance of more broadly applicable guidance on advance rentals.

Broadening the scope to all rents that are not subject to section 467 would provide simplification and reduce controversy. For example, it would remove the potential discrepancy in treatment for embedded software that is leased as part of tangible property depending on whether the software is separately stated in the lease agreement. It would also provide for better matching of the revenues and expenses to the extent allowed and desired under the limited deferral provisions of Rev. Proc. 2004-34. Finally, it would better achieve the overarching tax policy of permitting a relatively brief deferral period for nearly all advance payments, as it would include all rents that are not subject to the special rules under section 467.

The other carve outs from Rev. Proc. 2004-34 are targeted rather than broad-based. For example, gross receipts from insurance premiums are excluded only to the extent that the recognition of those premiums is governed by Subchapter L. The exclusion for financial instruments may appear broad, but the special rules for recognizing gross receipts from the instruments are more similar to the timing rules for book purposes than the usual accrual rules under section 451. Rent subject to section 467 similarly fit this pattern for carve outs subject to special rules. However, advance rents governed broadly by section 451 are more closely aligned with the other advance payments covered by Rev. Proc. 2004-34.

C. Provide a Standard for Eligibility and Recognition that Does Not Require Inclusion in Financial Statement Revenues

Recommendation

To reduce the need for special rules in cases where the applicable financial statement eliminates or does not ever recognize the advance payment (e.g., as in the case of purchase accounting adjustments or where advance payments are received for the sale of gift cards redeemable by an unrelated taxpayer), the AICPA recommends basing the point of recognition standard under a Deferral Method on when the income is recognized in the financial statement, but no later than when it is earned if there is no financial statement recognition.

Background and Analysis

Under Rev. Proc. 2004-34, a taxpayer with an applicable financial statement generally does not qualify for the Deferral Method unless the payment is recognized in whole or in part in the applicable financial statement in a year subsequent to the year of receipt. In contrast, generally under Treas. Reg. § 1.451-5, advance payments are included when earned under the all-events test, but no later than when included in the financial statements. Although intended to produce a similar result, this subtle difference in terminology has yielded several significant fact patterns in which taxpayers intending to benefit from the Deferral Method under Rev. Proc. 2004-34 are unable to use it because the advance payments are not included in "financial statement revenues" in either the year of receipt or a future year. Accordingly, there has been a need for special guidance to allow the Deferral Method in these situations (e.g., the issuance of Rev. Proc. 2011-18).

The situations that have created a need for special guidance generally do not arise in the case of taxpayers eligible to use Treas. Reg. § 1.451-5 because there is no explicit requirement that the advance payments are included in the financial statement revenues in a future year. The only requirement is that they are included in the financial statement revenues in a future year and they are reported for tax purposes no later than such year. This standard generally achieves the intended objective of preventing unwarranted deferral for taxpayers with an applicable financial statement.

Additionally, under Rev. Proc. 2004-34, if a taxpayer does not have an applicable financial statement, the taxpayer is able to defer advance payments and report the revenue when earned (and not necessarily when recognized for book purposes). Similarly, the IRS should allow a taxpayer with an applicable financial statement to similarly defer advance payments, to the extent not earned, in cases where the advance payments are neither included in the applicable financial statement in the year of receipt nor in a future year.

Consequently, the IRS should not base eligibility for the Deferral Method on whether the advance payment is included in financial statement revenue if the taxpayer has an applicable financial statement. Rather, the IRS should generally base the point of recognition on when the item is included in the financial statement revenues; if the advance payment is not ever included in financial statement revenues, the IRS should base the point of recognition on when performance takes place under the all-events test.

D. Provide Consistent Rules for Gift Card Sales

Recommendation

To reduce complexity and to align with modern business practices for gift card sales, the AICPA recommends that the IRS modify the rules under Treas. Reg. § 1.451-5 to include situations where a taxpayer operates its gift card program in a manner similar to the programs described in section 2.06 of Rev. Proc. 2011-18, to allow taxpayers with such programs to apply the Deferral Method in Treas. Reg. § 1.451-5(c) for the sale of goods.

Background and Analysis

Historically, the tax rules surrounding the recognition of income from the sale of gift cards has created confusion for taxpayers and controversy between taxpayers and the IRS. The exponential growth of gift card sales in the past several years has heightened these issues. Some of the controversy was mitigated with the issuance of Rev. Proc. 2011-18 and later Rev. Proc. 2013-29, both of which modified Rev. Proc. 2004-34 to adapt the requirements of Rev. Proc. 2004-34 to the modern business practices associated with gift card sales.

Section 2.06 of Rev. Proc. 2011-18 noted that many taxpayers that sell gift cards (gift card entities) typically operate their gift card programs under service agreements with participating merchants. Common examples noted include:

- Members of an affiliated group of corporations may establish a gift card subsidiary to sell gift cards that are redeemed for goods or services provided by the gift card subsidiary or other members of the affiliated group;
- A franchisor, purchasing cooperative, not-for-profit membership organization, or franchisee may sell gift cards that are redeemed for goods or services provided by independently-owned franchisees or members;
- A restaurant management company may sell gift cards that are redeemed by participating restaurants in different geographic locations or with different trade names; or
- A retailer may issue gift cards that are redeemed for merchandise at the retailer's stores, retail stores operated by a related party, or retail stores operated by unrelated parties.

Section 2.07 of Rev. Proc. 2011-18 further noted that, while gift card entity structures and gift card service agreements can vary widely, it is common for a gift card entity to receive and hold the proceeds from gift card sales until a customer uses the card to purchase merchandise or services. In such situations, if a customer uses a gift card to purchase merchandise or services from a participating merchant, the participating merchant is obligated to accept the gift card as payment for its goods or services and the gift card entity is obligated to reimburse the participating merchant for the sales price of the goods or services purchased with the gift card.

As modified by Rev. Proc. 2011-18 and Rev. Proc. 2013-29, section 4.07 of Rev. Proc. 2004-34 defines an eligible gift card sale as follows:

> An eligible gift card sale is the sale of a gift card (or gift certificate) if: (1) the taxpayer is primarily liable to the customer (or holder of the gift card) for the value of the card until redemption or expiration, and (2) the gift card is redeemable by the taxpayer or by any other entity that is legally obligated to the taxpayer to accept the gift card from a customer as payment for items listed in sections 4.01(3)(a)-(j) of this revenue procedure. For purposes of sections 4.01(2), 5.02(1)(b)(i), and 5.02(3)(a) of this revenue procedure, if a gift card is redeemable by an entity described in this section 4.07 whose financial results are not included in the taxpayer's applicable financial statement, a payment will be treated as recognized by the taxpayer in revenues in its applicable financial statement to the extent the gift card is redeemed by the entity during the taxable year. For a taxpayer without an applicable financial statement, for purposes of sections 4.01(2), 5.02(1)(b)(ii), and 5.02(3)(b) of this revenue procedure, if a gift card is redeemable by an entity described in this section 4.07, including an entity whose financial results are not included in the taxpayer's financial statement, a payment will be treated as earned by the taxpayer to the extent the gift card is redeemed by the entity during the taxable year.

In contrast, the rules provided in Treas. Reg. § 1.451-5 are not as flexible with respect to taxpayers that sell gift cards redeemable for goods through such arrangements. In relevant part, Treas. Reg. § 1.451-5(a)(1) defines an advance payment as "any amount which is received in a taxable year by a taxpayer using an accrual method of accounting for purchases and sales…pursuant to, and to be applied against, an agreement for the sale of other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Treasury Reg. § 1.451-5(a)(2)(i) provides that "the term 'agreement' includes (a) a gift certificate that can be redeemed for goods, and (b) an agreement which obligates a taxpayer to perform activities described in subparagraph (1)(i) or (ii) of this paragraph and which also contains an obligation to perform services that are to be performed as an integral part of such activities."

Consequently, for a taxpayer to use the Deferral Method provided by Treas. Reg. § 1.451-5(c) for its otherwise eligible gift card sales, the taxpayer must have sole responsibility for ultimately satisfying the obligation when the gift card holder redeems the gift card. As noted above, this requirement is not practical for many modern businesses and, thus, many taxpayers are precluded from using the Deferral Method provided by Treas. Reg. § 1.451-5(c) with respect to gift cards.

The modifications made to Rev. Proc. 2004-34 by Rev. Proc. 2011-18 and Rev. Proc. 2013-29 were significant to taxpayers that issue gift cards eligible for the Deferral Method under Rev. Proc. 2004-34. Given the continued growth of the sale of gift cards for taxpayers across many industries, aligning this aspect of the Rev. Proc. 2011-18 and Treas. Reg. § 1.451-5(c) reduces complexity and is appropriate in this modern era of gift card sales.

III. Revise Procedural Guidance to Ensure Conformity Between Rev. Proc. 2004-34 and Treas. Reg. § 1.451-5

A. Provide for an Automatic Method Change to the Deferral Method of Treas. Reg. § 1.451-5(b)(1)(ii)

Recommendations

In order to reduce administrative burdens on taxpayers, provide consistency between Rev. Proc. 2004-34 and Treas. Reg. § 1.451-5, and simplify procedural rules, the AICPA recommends that the IRS expand the automatic method change for advance payments (to use the Deferral Method) under section 16.07 of Rev. Proc. 2017-30 to include a change to the Deferral Method under Treas. Reg. § 1.451-5(b)(1)(ii).

Background and Analysis

Pursuant to section 16.07 of Rev. Proc. 2017-30, IRB 2017-17, a taxpayer using an overall accrual method of accounting which receives advance payments as defined in Rev. Proc. 2004-34, as modified and clarified, may request an automatic method change to switch to either the full inclusion method or the Deferral Method of Rev. Proc. 2004-34. Additionally, a taxpayer using an overall accrual method of accounting that receives advance payments as defined in Treas. Reg. § 1.451-5(a)(1) may request an automatic method change to switch to the full inclusion method under Treas. Reg. § 1.451-5(b)(1)(i). However, a taxpayer may not use the automatic method change procedures to switch to the Deferral Method provided by Treas. Reg. § 1.451-5(b)(1)(ii).

Many taxpayers that wish to avail themselves of the longer deferral period provided by Treas. Reg. § 1.451-5(b)(ii) lack the resources to request a non-automatic method change under the procedures of Rev. Proc. 2015-13, which requires a user fee and more onerous procedural requirements, such as the submission of a legal basis supporting the proposed accounting method. Additionally, it is not clear what policy rationale is the basis for requiring the change to the non-automatic method change procedures, which is more administratively burdensome.

Although Treas. Reg. § 1.451-5 has certain requirements and limitations[10] beyond those provided in Rev. Proc. 2004-34, the use of the Deferral Method under Treas. Reg. § 1.451-5 is not controversial or complex enough to require taxpayers to request non-automatic consent to change to such method.

First, due to the complexity of tracking revenue separately for book and tax purposes, many taxpayers' established method for recognizing revenue from the sale of goods is already in accordance with their method used for financial statement purposes. Thus, if the IRS is concerned that taxpayers may not appropriately implement the Deferral Method by failing to take advance payments into account under their established method of accounting (assuming

[10] For example, the requirement to include advance payments into income under the taxpayer's regular method of accounting if the method results in the recognition of advance payments earlier than when recognized for financial statement purposes, and a two-year limitation for certain substantial advance payments.

it results in the recognition of advance payments earlier than that for financial statement purposes), the concern may not have practical application in many circumstances.

Alternatively, if the IRS is concerned that taxpayers subject to long-term contract accounting rules will improperly rely on Treas. Reg. § 1.451-5 to defer advance payments that otherwise are included into income under section 460, the automatic method change could specifically exclude advance payments received under long-term contracts subject to the rules of section 460.

Any concerns regarding the limited two-year deferral for substantial advance payments related to certain inventoriable items is eliminated by requiring taxpayers to identify whether substantial advance payments with respect to an agreement (e.g., such as gift cards) are received for goods in the course of the taxpayer's business. The IRS could also, in addition or as a substitute, require a representation that to the extent substantial advance payments are received that meet the requirements of Treas. Reg. § 1.451-5(c), such advance payments (and related expenses if applicable) are recognized no later than the last day of the second taxable year following the year in which such substantial advance payments are received.

As with any other accounting method issue, the proper implementation and use of the method is evaluated as part of an examination of the taxpayer. Thus, any concerns the IRS has regarding the proper implementation or application of the deferral of advance payments under Treas. Reg. § 1.451-5 is alleviated by the fact that an examining agent may challenge any improper use of the method.

Finally, allowing for an automatic method change to use the Deferral Method under Treas. Reg. § 1.451-5 would not only reduce taxpayer burden but would also support the current Administration's goals of reducing costs and simplifying tax rules. Specifically, IRS administrative burdens will decrease by reducing the costs and resources needed to formally review and rule on the method change. Additionally, allowing for an automatic method change in accordance with the automatic method changes already available for both the deferral and full inclusion methods under Rev. Proc. 2004-34 and full inclusion method under Treas. Reg. § 1.451-5 support the simplification of current procedural rules and will result in a less complex path for taxpayers to follow to avail themselves of existing rules.

Permitting taxpayers to change to the Deferral Method under Treas. Reg. § 1.451-5 under the automatic consent procedures will not only achieve increased conformity with the Deferral Method under Rev. Proc. 2004-34, but it will allow taxpayers to evaluate and choose which Deferral Method is most optimal for their business and operations without factoring in procedural concerns around changing to such method.

B. Eliminate the Information Schedule Requirement of Treas. Reg. § 1.451-5(d)

Recommendation

The AICPA recommends that the IRS modify Treas. Reg. § 1.451-5 to eliminate the information schedule requirement under Treas. Reg. § 1.451-5(d).

Background and Analysis

Pursuant to Treas. Reg. § 1.451-5(d), if a taxpayer accounts for advance payments pursuant to Treas. Reg. § 1.451-5(b)(1)(ii), an information schedule is attached to the taxpayer's income tax return for each year in which the Deferral Method is used. This information schedule must provide the total amount of advance payments received during the year, the total amount of advance payments received in prior taxable years which have not been included in gross income before the current taxable year, and the total amount of such payments received in prior years which have been included in gross income for the current taxable year.

In contrast, Rev. Proc. 2004-34 contains no comparable requirement. Section 8 of Notice 2002-79, 2002-2 CB 964 (which provides the proposed revenue procedure that was eventually finalized as Rev. Proc. 2004-34) required that taxpayers maintain adequate books and records, to make verifiable, the amount deferred on the federal income tax return for any year. However, in Announcement 2004-48, 2004-22 IRB 998, the IRS stated that this provision was not included in Rev. Proc. 2004-34 because it did not add to the general recordkeeping rules applicable to all taxpayers and was determined unnecessary. The announcement also states that although the final revenue procedure does not include this provision, the recordkeeping rules in section 6001 and the regulations thereunder continue to apply to taxpayers that use a method of accounting provided by the final revenue procedure.

The requirement to attach an information schedule to the taxpayer's tax return creates an administrative burden on taxpayers that is often missed without the assistance of experienced tax advisers. The consequences of failing to comply with this requirement are significant as the taxpayer is deemed to have an improper method of accounting, either forcing the taxpayer to protect itself by requesting an accounting method change, or creating exposure for an examining agent to challenge the method and place the taxpayer on the less favorable full inclusion method (see, e.g., CCA 200901032). Additionally, as with Rev. Proc. 2004-34, section 6001 should provide the recordkeeping requirements to ensure that taxpayers maintain enough documentation allowing examining agents to evaluate the use of the Deferral Method under Treas. Reg. § 1.451-5.

Thus, the IRS should modify Treas. Reg. § 1.451-5 to eliminate the information schedule requirement under Treas. Reg. § 1.451-5(d). This modification will align the regulation with Rev. Proc. 2004-34, and prevent taxpayers who comply substantively with the regulation from unwittingly adopting an improper accounting method merely by failing to attach an informational statement to their return. Additionally, eliminating this requirement does not disadvantage the IRS because the record keeping requirements under section 6001 ensure that taxpayers maintain adequate records.

C. Modify the Acceleration Rules of Treas. Reg. § 1.451-5 to Conform with Rev. Proc. 2004-34

Recommendation

In order to reduce the disparity between Rev. Proc. 2004-34 and Treas. Reg. § 1.451-5 and to reduce complexity for taxpayers, the AICPA recommends that the IRS modify Treas. Reg. § 1.451-5(f) to allow, as an exception to the general acceleration rule, section 351 transfers within a consolidated group identical to the rule provided in Rev. Proc. 2004-34. We also suggest expanding that rule (under both Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34) to transfers under section 721 to a partnership wholly owned by members of the same consolidated group.

Background and Analysis

Pursuant to section 5.02(5) of Rev. Proc. 2004-34, a taxpayer using the Deferral Method must include in gross income for the taxable year of receipt all advance payments not previously included in gross income:

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

2. 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
    a. a transaction to which section 381(a) applies, or
    b. a section 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 sections 1504-1564.

In Announcement 2004-48, the IRS noted that several commentators suggested "step-into-the-shoes" treatment under Rev. Proc. 2004-34 for certain non-taxable transactions while others suggested an exception similar to the exception provided in the method change procedures for section 481(a) adjustments for transfers under section 351 within a consolidated group. The IRS did not provide a step-into-the-shoes rule for non-taxable transfers due to the complexity such treatment would create. However, in Rev. Proc. 2004-34, the IRS did provide for the limited exception for section 351 transactions similar to the one provided for with respect to section 481(a) adjustments.

In contrast, under Treas. Reg. § 1.451-5(f), if a taxpayer has deferred revenue under Treas. Reg. § 1.451-5(b)(1)(ii), and the taxpayer dies or ceases to exist during a taxable year in which a transaction other than the one in which section 381 applies, or his liability under the agreement otherwise ends, then the amount of the advance payment that was not includible in gross income in the preceding taxable years is included in gross income for such taxable year. Treasury Reg. § 1.451-5 does not contain any exceptions for transfers within a consolidated group.

In order to reduce disparity between Rev. Proc. 2004-34 and Treas. Reg. § 1.451-5, the IRS should modify Treas. Reg. § 1.451-5(f) to allow, as an exception to the general acceleration rule, section 351 transfers within a consolidated group identical to the rule provided for in Rev. Proc. 2004-34. The reasoning for allowing a limited exception to the acceleration rule for certain section 351 transfers within a consolidated group under Rev. Proc. 2004-34 is equally applicable to the deferral of advance payments provided under Treas. Reg. § 1.451-5.

Additionally, many taxpayers engaging in section 351 transactions within their consolidated group will have concerns regarding the need to accelerate advance payments deferred under Treas. Reg. § 1.451-5. Requiring such acceleration not only contradicts the tax-free nature of a section 351 transaction, but it may inhibit taxpayers from engaging in section 351 transactions, causing more complexity in determining and implementing restructurings. Because transfers under section 721 to a wholly owned partnership are closely analogous insofar as the tax-free basis carryover treatment, the IRS should expand the rule to cover this fact pattern. Finally, providing for this limited exception allows taxpayers deferring revenue under Treas. Reg. § 1.451-5, for the sale of goods while using the Deferral Method under Rev. Proc. 2004-34 for other items, to avoid having to separately track such advance payments in the case of section 351 transfers in which revenue deferred under Treas. Reg. § 1.451-5 is accelerated, but revenue deferred under Rev. Proc. 2004-34 is not accelerated.