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Mr. Andrew Keyso, Jr.
Associate Chief Counsel
(Income Tax & Accounting)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Recommendations for Modification of Rev. Proc. 2004-34 and Treas. Reg. § 1.451-5 Concerning the Deferral of Advance Payments

Dear Mr. Keyso:

The American Institute of Certified Public Accountants (AICPA) appreciates this opportunity to submit comments with respect to the treatment of advance payments deferred under Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5 when the stock of the taxpayer is acquired, as well as the application of Rev. Proc. 2004-34 to advance payments received from members of an affiliated group. These comments were developed by the AICPA's Tax Methods and Periods Technical Resource Panel and approved by the Tax Executive Committee.

The AICPA is the world's largest member association representing the accounting profession, with more than 400,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on Federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

**Executive Summary**

This letter addresses two interpretive issues that we have identified in the application of Rev. Proc. 2004-34 and Treas. Reg. § 1.451-5.[1] Specifically, this letter addresses issues related to the treatment of advance payments deferred under Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5 when the stock of the taxpayer is acquired and the application of Rev. Proc. 2004-34 to advance payments received from members of an affiliated group. The AICPA recommends that the Department of the Treasury ("Treasury") and Internal Revenue Service (IRS) issue additional guidance to clarify these rules with our suggestions below to prevent further controversy in this area.

[1] All references to "section" or "§" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" and "regulations" are to U.S. Treasury regulations promulgated thereunder.

- *Write down of deferred revenue to fair value.* The IRS and Treasury should issue guidance to clarify that the acquirer will recognize revenue from advance payments that were deferred under Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5 for federal income tax purposes to the extent not previously taken into account by the target when the amount of the deferred revenue obligation is adjusted in a stock acquisition.

- *Deferral of advance payments received from members of an affiliated group.* The AICPA recommends that the IRS and Treasury issue guidance to clarify that such advance payments are eligible for deferral under Rev. Proc. 2004-34.

## Background

*Section 451*

Section 451(a) of the Internal Revenue Code provides that the amount of any item of gross income shall be included in the 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.

*Treasury Reg. § 1.451-1*

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 can be determined with reasonable accuracy. In general, 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.[2] Thus, an accrual method taxpayer must generally recognize an advance payment as income. However, the IRS has provided exceptions to the general rule of section 451(a) for certain advance payments described in Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34.

*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 to be applied 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 his trade or business.

Treasury Reg. § 1.451-5(b)(1) generally provides that "advance payments must be included in income either (i) in the taxable year of receipt, or (ii) except as provided in Treas. Reg. § 1.451-

[2] See Rev. Rul. 2004-52, 2004-1 C.B. 973; Rev. Rul. 2003-10, 2003-1 C.B. 288; Rev. Rul. 84-31, 1984-1 C.B. 127.

5(c), (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 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."

*Rev. Proc. 2004-34*

Rev. Proc. 2004-34 allows taxpayers to defer the recognition of advance payments arising from the provision of services, the sale of goods, or certain other payments identified in the revenue procedure (the "Deferral Method"). To qualify as an advance payment under section 4.01(2) of Rev. Proc. 2004-34, the taxpayer must recognize the payment (in whole or part) in revenues in its applicable financial statement[3] for a subsequent taxable year. For taxpayers without an applicable financial statement, they must earn the payment (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. The taxpayer would include the remaining amount of the advance payment in gross income in the next succeeding tax year.

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.

Rev. Proc. 2011-18 modified the list of advance payments qualifying to use the Deferral Method to include "eligible gift card sales" and added two new sections to Rev. Proc. 2004-34.[4] New section 4.07 defined "eligible gift card sale" as the sale of a gift card (or gift certificate) if:

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[3] An applicable financial statement is a financial statement that is (i) a financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders); (ii) a certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for credit purposes, reporting to shareholders, partners, or similar persons, or any other substantial non-tax purpose; or (iii) a financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the Internal Revenue Service).

[4] Rev. Proc. 2011-18, 2011-5 I.R.B. 443.

(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.

New section 4.08 provides that if the taxpayer is a member of an affiliated group of corporations that files a consolidated return for federal income tax purposes, the group's financial statement (as defined in section 4.06 of this revenue procedure) is an applicable financial statement of the taxpayer.

Rev. Proc. 2013-29 further modified Rev. Proc. 2004-34. Specifically, Rev. Proc. 2013-29 clarified the definition of "eligible gift card sales" provided in Rev. Proc. 2011-18 by adding that if a gift card is redeemable by an entity whose financial results are not included in the taxpayer's applicable financial statement then the payment is treated as recognized by the taxpayer in revenues of its applicable financial statement to the extent the gift card is redeemed by the entity during the tax year. The same rule applies for taxpayers without an applicable financial statement.[5]

*Financial reporting considerations in stock acquisitions*

When a business combination (such as an acquisition of stock) occurs, financial accounting standards require the measurement of assets acquired and liabilities assumed at their acquisition-date fair values. Deferred revenue in the context of a business combination represents an obligation to provide products or services to a customer when payment has been received in advance and delivery or performance has not yet occurred. The deferred revenue amount recorded on the target's financial accounting balance sheet generally represents the cash received in advance, less the amount of income recognized for services performed or goods provided to date, rather than a fair value amount. The fair value of a deferred revenue liability typically reflects an amount that an acquirer is willing to pay a third party to assume the liability (a transfer of the liability). Thus, the target's deferred revenue liability at the acquisition date is rarely the fair value amount required to transfer the underlying contractual obligation.

Currently, two methods of measuring the fair value of a deferred revenue liability are commonly used.

1. Bottom-up approach – this approach measures the liability as the direct, incremental costs to fulfill the legal performance obligation, plus a reasonable profit margin if associated with goods or services being provided, and a premium for risks associated with price variability.
2. Top-down approach – this approach relies on market indicators of expected revenue for any obligation not yet satisfied, and starts with the amount that an entity would receive in a transaction, less the cost of the selling effort (which has

[5] Rev. Proc. 2013-29, 2013-33 I.R.B. 141.

already been performed) including a profit margin on that selling effort. This method is used less frequently, but is commonly used for measuring the fair value of remaining post-contract customer support for licensed software.

Thus, in a stock acquisition, the acquirer does not record the full amount of the target's deferred revenue liability, but rather the fair value of the deferred revenue liability, on its initial post-acquisition financial accounting balance sheet. Importantly, this adjustment does not result in the recognition of revenue for financial statement purposes. Rather, the difference between the stated value of deferred revenue liability at the closing date and the fair value of such liability is recorded though purchase accounting as an adjustment to retained earnings of the target.

*Financial reporting considerations resulting from intercompany transactions*

Traditionally, Generally Accepted Accounting Principles ("GAAP") require a reporting entity to consolidate an entity if it holds the "controlling financial interest" of that entity. Holding a majority of the voting shares of an entity is the most common condition for a controlling financial interest. Thus, an entity must consolidate all majority-owned subsidiaries (i.e., all companies in which a parent has a controlling financial interest through direct or indirect ownership of a majority voting interest) unless control does not rest with the majority owner. For example, control would not rest with the majority owner where the subsidiary is in legal reorganization or in bankruptcy, or if the majority owner's voting rights are restricted by approval or veto rights granted to the non-controlling shareholder. However, in certain circumstances a focus on voting rights is ineffective in determining which party, if any, to an entity may have the "controlling financial interest" in which case other factors are taken into account in determining whether consolidation of the financial reporting results of an entity is required.

In addition, there are important distinctions between consolidated financial reporting and consolidated group reporting for U.S. federal income tax purposes. In particular, a consolidated group of corporations for purposes of section 1502 may consist only of members of an affiliated group of corporations under section 1504. Thus, the group of entities included in consolidated financial reports is generally more expansive than what is included in determining consolidated taxable income.

Financial accounting standards generally require the elimination of intra-entity (or intercompany) profit or loss arising from transactions with a consolidated entity. As a result, transactions that involve advance payments between entities that are consolidated for financial reporting purposes are not recognized in the taxpayer's applicable financial statements. However, if stand-alone financial statements were prepared, such advance payments would be reflected and taken into account in determining the income of the stand-alone entity.

**Issues under Existing Guidance**

The AICPA commends the IRS and Treasury for continuing to provide guidance to clarify issues related to the scope and application of Rev. Proc. 2004-34. We are concerned with the lack of clarity surrounding the treatment of advance payments deferred under Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5, and suggest guidance is needed in two areas, explained below.

*Write down of deferred revenue to fair value*

As discussed above, when a business combination (such as an acquisition of stock) occurs, financial accounting standards require the measurement of assets acquired and liabilities assumed at their acquisition-date fair values. In the context of deferred revenue, this requirement often results in a write down in the amount of deferred revenue recorded on the post-acquisition opening balance sheet.

Treasury Reg. § 1.451-5(b) permits a taxpayer to defer the recognition of advance payments when such advance payments are included in gross receipts for financial reporting purposes in a subsequent year. Similarly, Rev. Proc. 2004-34 permits a taxpayer to defer the recognition of advance payments to the extent that the payment is recognized by the taxpayer (in whole or in part) in revenues in its applicable financial statement for a subsequent taxable year (provided the other requirements of Rev. Proc. 2004-34 have been met). However, in a situation where the revenue is never recognized (i.e., because of a write down of the deferred revenue obligation to fair value), it is not clear whether:

1. The target is required to accelerate the recognition of income from such advance payments;
2. The acquirer is required to accelerate the recognition of such advance payment; or
3. The advance payments are still eligible for deferral because such amounts are recognized "in part" for financial statement purposes in a subsequent taxable year.

Furthermore, the different definitions of "advance payment" provided by Treas. Reg. § 1.451-5(b) and Rev. Proc. 2004-34 arguably provide a taxpayer with different results depending upon which deferral regime is used. Specifically, advance payments deferred under Rev. Proc. 2004-34 are likely accelerated because:

1. The advance payments are not recognized as income in the taxpayer's applicable financial statement in a subsequent year; or
2. The acquirer may not prepare an applicable financial statement for the target's post-acquisition results and may not be able to determine the extent to which the advance payment is earned in that period.

However, advance payments deferred under Treas. Reg. § 1.451-5, are likely not accelerated when the deferred revenue liability is adjusted to its fair value. The AICPA believes advance payments should receive similar treatment, regardless of whether such amounts are deferred under Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5.

In our view, when a business combination occurs and an adjustment to the value of the deferred revenue obligation is warranted, the acquirer, not the target, should recognize the revenue. The adjustment to the deferred revenue balance occurs in the opening financial statements prepared by the acquirer. In addition, the target ordinarily does not have access to the amount of the adjustment until after the target files its federal income tax return for the taxable year in which the transaction occurs. Further, the AICPA is concerned that requiring the target to recognize that difference imposes an undue administrative burden on the purchaser to provide detail to the target, who could be an adverse party, regarding the adjustments that were made in the acquirer's financial statements.

Therefore, the IRS and Treasury should issue guidance to clarify that the acquirer will recognize revenue from advance payments that were deferred under Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5 for federal income tax purposes to the extent not previously taken into account by the target when the amount of the deferred revenue obligation is adjusted in a stock acquisition.

*Deferral of advance payments received from members of an affiliated group*

As noted above, for financial statement purposes, intercompany transactions are eliminated in the preparation of consolidated financial statements. Therefore, when a taxpayer receives an advance payment from a related party (such as a controlled foreign corporation) whose financial results are included in the same worldwide financial statements, the advance payment is not recognized in the taxpayer's applicable financial statements. Consequently, such advance payments are not eligible for deferral under Rev. Proc. 2004-34.

This issue is similar to the question addressed in Rev. Proc. 2013-29. Rev. Proc. 2013-29 allows taxpayers to defer advance payments from eligible gift card sales even though the taxpayer will never recognize any portion of the gift card sale proceeds in revenues in its applicable financial statement because the revenue is accounted for only by the unrelated redeeming entity upon the sale of goods or services. Similarly, for a taxpayer without an applicable financial statement, the payment is never earned by the taxpayer because the payment is earned by the unrelated redeeming entity.

The AICPA believes that a similar view should apply to transactions between related parties whose financial results are consolidated and where the intercompany transactions are eliminated in the preparation of financial statements. A taxpayer should not be precluded from using the deferral method of accounting provided by Rev. Proc. 2004-34 solely because:

1. The taxpayer never recognizes payments from a qualifying sale of goods or the provision of services in revenues in its applicable financial statements; or
2. Taxpayers (without an applicable financial statement) never earn payments from a qualifying sale of goods or the provision of services solely as a result of intercompany eliminating entries.

Thus, the AICPA recommends that the IRS and Treasury issue guidance to clarify that such advance payments are eligible for deferral under Rev. Proc. 2004-34.

**Conclusions**

Despite the recent issuance of guidance addressing the treatment of advance payments, additional guidance would further eliminate the current ambiguity in the existing rules. Therefore, the AICPA recommends that the IRS and Treasury issue guidance to clarify that the acquirer may continue to defer the recognition of income from advance payments under Rev. Proc. 2004-34 or Treas. Reg. § 1.451-5 for federal income tax purposes notwithstanding the fact that the amount of the deferred revenue obligation is adjusted in a stock acquisition. In addition, the AICPA recommends that the IRS and Treasury issue guidance to clarify that advance payments from a related party (such as a controlled foreign corporation) whose financial results are included in the same worldwide financial statements are eligible for deferral under Rev. Proc. 2004-34 even though such advance payments are not recognized in the taxpayer's applicable financial statements.

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We appreciate your consideration of our recommendations and believe they require minor, but important, changes to ensure proper application of the deferral rules under Treas. Reg. § 1.451-5 and Rev. Proc. 2004-34. We welcome a further discussion of these issues and our recommendations, and members of the task force are available to meet with government officials in this regard. If you have any questions, please contact Jane Rohrs, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 370-2290, or jrohrs@deloitte.com; or Melanie Lauridsen, AICPA Technical Manager, at (202) 434-9235, or mlauridsen@aicpa.org.

Respectfully submitted,

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