



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

September 7, 2004

Number: **INFO 2004-0167**

Release Date: 9/30/04

CONEX-141330-04/CC:ITA:B1

UIL: 451.13-00

The Honorable Don Nickles  
United States Senator  
3310 Mid-Continent Tower  
401 South Boston  
Tulsa, OK 74103-4007

Attention: Jone Williams

Dear Senator Nickles:

I am responding to your inquiry dated July 21, 2004, on behalf of your constituent, [REDACTED] filed a Form 3115, Application for Change in Accounting Method, on June 16, 2003, requesting to change its method of accounting for advance payments from annual licenses, for the taxable year ended December 31, 2002. Under its present method of accounting, [REDACTED] includes advance payments in gross income in the taxable year received. In its Form 3115, [REDACTED] asked to change to the method of including advance payments in gross income in the taxable year in which earned. [REDACTED] cited Rev. Proc. 71-21, 1971-2 C.B. 549, and Notice 2002-79, 2002-1 C.B. 964, as authority for its proposed method and did not submit a user fee with its request.

On February 25, 2004, the IRS national office sent a letter to [REDACTED], explaining that the taxpayer could not rely on Notice 2002-79 as authority to change its method of accounting for advance payments. The letter further noted that, because the taxpayer could not rely on Notice 2002-79, it could not change its accounting method for advance payments unless it filed a Form 3115 in accordance with the requirements of § 1.446-1(e)(3)(i) of the Income Tax Regulations (the regulations), and Rev. Proc. 97-27, 1997-1 C.B. 690. [REDACTED] asked us to clarify this letter.

The regulations require taxpayers to file a Form 3115 during the taxable year in which the taxpayer wants to make the change in method of accounting. [Section 1.446-1(e)(3)(i) of the regulations]. Taxpayers must also pay a user fee to request a change in accounting method. [Section 8.07 of Rev. Proc. 97-27]. The fee for a Form 3115 is \$1500, unless the particular method change is subject to the automatic consent method change provisions.

Under an accrual method of accounting, a taxpayer must include advance payments in gross income in the taxable year received. This general rule applies regardless of whether the taxpayer's advance payments are for the sale of goods, the provision of services, or the rental of tangible or intangible property. In certain circumstances, however, the IRS allows taxpayers to defer advance payments. For example, for taxable years prior to 2003, Rev. Proc. 71-21 permitted taxpayers to defer certain advance payments for the provision of services. Rev. Proc. 71-21 was not subject to the automatic consent method change provisions; therefore, the revenue procedure required a taxpayer requesting a method change under Rev. Proc. 71-21 for 2002 to file a Form 3115 during 2002 and pay a user fee of \$1500.

In 2002, we announced in Notice 2002-79 that we were proposing to issue a revenue procedure allowing taxpayers to defer certain advance payments for goods, services, and other items. The notice included a proposed revenue procedure and solicited comments from the public on various provisions of the proposal. The proposed revenue procedure, however, was only a draft that we published to solicit comments; it was not a final revenue procedure. The IRS national office letter dated February 25, 2004, stated that taxpayers could not rely on the proposed revenue procedure to request a change in accounting method.

We finalized the draft revenue procedure in Rev. Proc. 2004-34, 2004-22 I.R.B. 991. Beginning in 2003, Rev. Proc. 2004-34 supersedes Rev. Proc. 71-21 and permits taxpayers to defer certain advance payments, including advance payments for the license or lease of certain intellectual property, the license or lease of computer software, and certain subscriptions (whether provided in a tangible or intangible format). A taxpayer that qualifies to use Rev. Proc. 2004-34 generally is permitted to include advance payments in gross income in accordance with its financial accounting method, as long as the taxpayer includes all the advance payments in gross income by the end of the taxable year succeeding the taxable year of receipt. The automatic consent procedures for method changes generally apply to Rev. Proc. 2004-34 and, therefore, taxpayers do not have to pay a user fee in most circumstances. I am providing a copy of Rev. Proc. 2004-34 for your review.

In summary, no authority existed for taxpayers to make an automatic method change in 2002 for advance payments for annual licenses. However, Rev. Proc. 2004-34 now permits taxpayers to make an automatic method change for certain advance payments, beginning with taxable years ending on or after December 31, 2003. If

qualifies to defer advance payments under Rev. Proc. 2004-34, it may file a Form 3115 with its 2003 tax return to make an automatic change in accounting method. [See section 8.02 of Rev. Proc. 2004-34]. If has already filed its tax return for 2003, it is automatically granted an extension of 6 months from the due date of its tax return to obtain the automatic consent provided in Rev. Proc. 2004-34. [See section 8.06 of Rev. Proc. 2004-34].

I hope this information is helpful. Please call me or \_\_\_\_\_, Identification Number  
, at \_\_\_\_\_, if you have any questions.

Sincerely,

Robert M. Brown  
Associate Chief Counsel  
(Income Tax & Accounting)

Enclosure