

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

Number: **201619009**

Release Date: 5/6/2016

CC:ITA:B01:JKristall

POSTN-106723-16

UILC: 61.00-00, 451.13-00

date: March 11, 2016

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subject: Proper Tax Treatment of Deferred Revenue in a Taxable Stock Acquisition

This memorandum responds to your request for advice. This advice may not be used or cited as precedent

ISSUE

What amount of an advance payment does a taxpayer that (1) has deferred recognizing revenue into income under Rev. Proc. 2004-34, 2004-1 C.B. 991, and (2) subsequently has all of its stock acquired by an unrelated corporation that, for financial accounting purposes, writes down the associated deferred revenue liability to its fair value as of the date of the acquisition, include in gross income for the next succeeding taxable year?

CONCLUSION

A taxpayer that (1) has deferred recognizing revenue into income under Rev. Proc. 2004-34 and (2) subsequently has all of its stock acquired by an unrelated corporation that, for financial accounting purposes, writes down the associated deferred revenue liability to its fair value as of the date of the acquisition, must include the advance payment in its gross income for federal income tax purposes in the year of receipt to the extent the payment is recognized in revenues in its Applicable Financial Statement

(“AFS”) for that taxable year, and must include the remaining amount of the advance payment in its gross income in the next succeeding taxable year, irrespective of any write-down of the deferred revenue liability for financial accounting purposes.

FACTS

On May 1, 2015, T, a corporation that files its federal income tax return on a calendar year basis, received 120x as an advance payment for a 2-year contract to provide services. For federal income tax purposes, T uses the Deferral Method described in section 5.02 of Rev. Proc. 2004-34 as its method of accounting for advance payments. For financial accounting purposes, T recorded 120x as a deferred revenue liability on its AFS, expecting to report 1/3 of the advance payment in revenues in its AFS for 2015, 1/2 for 2016, and 1/6 for 2017. On August 31, 2015, P, an unrelated corporation that files its federal income tax return on a calendar year basis, acquired all of the stock of T, and T joined P’s consolidated group. T’s short taxable year ended on August 31, 2015, and, as of that date, T had recognized only 1/6 (20x) of the advance payment in revenues in its AFS. On September 1, 2015, after the stock acquisition, and in accordance with purchase accounting rules under Generally Accepted Accounting Principles (GAAP), P wrote down T’s deferred revenue liability to its fair value of 10x as of the date of the acquisition. That 10x will be recognized in revenues on T’s AFS in accordance with the method of accounting T uses for financial accounting purposes. The remaining 90x of the advance payment will never be recognized in revenues on T’s AFS.

LAW AND ANALYSIS

Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided in subtitle A, gross income means all income from whatever source derived. See also § 1.61-1(a) of the Income Tax Regulations. Gross income is an undeniable accession to wealth, clearly realized, over which a taxpayer has complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

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.

Rev. Proc. 2004-34 permits certain taxpayers using an overall accrual method of accounting to defer including advance payments in income in some circumstances. An advance payment for purposes of Rev. Proc. 2004-34 is a payment received by a taxpayer if –

- (1) Including the payment in gross income for the taxable year of receipt is a permissible method of accounting for federal income tax purposes;

- (2) The payment is recognized by the taxpayer (in whole or in part) in revenues in its AFS (as defined in section 4.06 of Rev. Proc. 2004-34) for a subsequent taxable year; and
- (3) The payment is for one of several listed items, including services.

A taxpayer within the scope of Rev. Proc. 2004-34 may elect to use the Deferral Method under which the taxpayer must include the advance payment in gross income for the taxable year of receipt (and, if applicable, in gross income for a short taxable year described in section 5.02(2) of Rev. Proc. 2004-34) to the extent recognized in revenues in its AFS for that taxable year. The taxpayer must include the remaining amount of the advance payment in gross income for the next succeeding taxable year.

Income is computed based on all of a taxpayer's transactions during a taxable year. To require taxpayers to reflect events occurring after the end of the taxable year would be disruptive and would violate the spirit of the annual accounting system. Healy v. Commissioner, 345 U.S. 278, 284-85 (1953). See also Burnet v. Sanford & Brooks Co., 282 U.S. 359, 363 (1931) (“[Tax is assessed] on the basis of . . . all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt”).

In this case, the advance payment T received was an accession to wealth that T must include in its income under § 61 under its proper method of accounting. The advance payment T received satisfied the definition of an advance payment in section 4.01 of Rev. Proc. 2004-34 because as of the end of T's short taxable year ending August 31, 2015, 100x would be recognized in T's AFS for a subsequent taxable year under T's method of accounting. Subsequent factual developments occurring after year-end, such as P's write-down of T's deferred revenue liability, do not affect this determination.

For T's short taxable year ending August 31, 2015, T had reported 1/6 (20x) of the payment in revenues on its AFS. P wrote down T's deferred revenue liability to its fair value of 10x as of September 1, 2015, the first day of T's next succeeding taxable year. T is eligible for deferral and under T's deferral method must take 1/6 (20x) of the advance payment into income for its short taxable year ending August 31, 2015, in accordance with § 451 and Rev. Proc. 2004-34. The remainder (100x) of the advance payment must be included in income for T's next succeeding taxable year in accordance with section 5.02 of Rev. Proc. 2004-34, even though 90x of the 100x will never be recognized in revenues in T's AFS. This follows from the language of section 5.02(1)(a)(ii) of Rev. Proc. 2004-34, which requires a deferring taxpayer to “include the remaining amount of the advance payment in gross income for the next succeeding taxable year.” Indeed, § 451 and Rev. Proc. 2004-34 provide rules only for determining the taxable year(s) during which T must include the entire 120x in gross income. Rev. Proc. 2004-34 neither authorizes nor permits T to exclude from gross income any part of the 120x of advance payments T received under the service

contract. In addition, GAAP purchase accounting rules do not override the mandate under § 61 that T include in gross income the entire 120x accession to wealth it received under the service contract.

Accordingly, 20x must be included in income on T's short-year return for its taxable year ending August 31, 2015, and 100x must be included in income for T as part of P's consolidated return for the taxable year ending December 31, 2015, irrespective of P's write-down of the deferred revenue liability.

Please contact Jason Kristall at (202) 317-7003 if you would like further assistance or have any questions about the contents of this memorandum.