Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Robin Herrell
Senior Attorney
(Large & Mid-Size Business)

from: John P. Moriarty
Chief, Branch 1
(Income Tax & Accounting)

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subject: Change of Accounting Method under Rev. Proc. 2004-34

This Chief Counsel Advice responds to your request for assistance of June 5, 2009, in which you ask for help in determining whether a taxpayer that previously elected to defer advance payments under Rev. Proc. 2004-34, 2004-1 C.B. 991, is required to obtain consent under § 446(e) of the Internal Revenue Code if the taxpayer subsequently changes its applicable financial statements for deferred advance payments. For the reasons described below, we conclude that the taxpayer is required to obtain consent under § 446(e). If you have any questions concerning this memorandum or our conclusion, please call Nancy Lee at (202) 622-5020.

This advice may not be used or cited as precedent.

ISSUE

Is a taxpayer that previously elected to defer advance payments under Rev. Proc. 2004-34 required to obtain consent under § 446(e) if the taxpayer subsequently changes its applicable financial statements (book method) for deferred advance payments?

CONCLUSION

Yes. A taxpayer that previously elected to defer advance payments under Rev. Proc. 2004-34 is required to obtain consent under § 446(e) if the taxpayer subsequently changes its book method for the deferred advance payments.

FACTS

The taxpayer is in the business of providing services to clients and uses an overall accrual method of accounting for federal income tax purposes. It computes income using the calendar year for both federal income tax and financial accounting purposes. Clients make advance payments to the taxpayer for services that the taxpayer provides over a period of 15 months. The taxpayer performs most of the services in the first 10 months of the 15-month period.

Before Year 1, the taxpayer recognized advance payments in income under its book method of accounting on a pro rata basis over the first 10 months of the 15-month period during which it performed the services. For example, if the taxpayer received an advance payment by March, it recognized 100 percent of the payment in the year of receipt; if the taxpayer received an advance payment in July, it recognized 60 percent of the payment in the year of receipt and 40 percent in the following taxable year. Notwithstanding its book method of accounting, for federal income tax purposes the taxpayer included the entire amount of an advance payment in income in the year in which the advance payment was received. For example, if the taxpayer received an advance payment in July, it recognized 100 percent of the payment in the year of receipt for federal income tax purposes.

For its taxable year ending in Year 1, the taxpayer properly filed a Form 3115, Application for Change in Accounting Method, requesting permission to change its method of accounting for advance payments to the deferral method described in Rev. Proc. 2004-34. Under the deferral method, the taxpayer deferred to the next succeeding taxable year the inclusion in gross income for federal income tax purposes of advance payments to the extent the advance payments are not recognized in revenues in the taxpayer's applicable financial statement (as defined in sec. 4.06 of Rev. Proc. 2004-34) for the year of receipt. The Service granted consent to the change and the taxpayer properly adopted the new method of accounting under Rev. Proc. 2004-34. The taxpayer used the new method of accounting in computing its taxable income for Years 1 and 2.

In Year 3, the taxpayer's financial auditors determined that the taxpayer's book method of accounting for advance payments improperly overstated revenues. Therefore, the taxpayer changed its book method for advance payments in order to recognize the advance payments in income in its applicable financial statements on a pro rata basis over the entire 15-month period during which the taxpayer performs the services. For example, if the taxpayer receives an advance payment in March, it recognizes 67 percent of the payment in the year of receipt and 33 percent in the following taxable year; if the taxpayer receives an advance payment in July, it recognizes 40 percent of the payment in the year of receipt and 60 percent in the following taxable year. The taxpayer began using this new book method for advance payments in its applicable financial statement for Year 3 and restated its applicable financial statements for Years 1 and 2.

Beginning in Year 3, the taxpayer reported income from advance payments in its federal income tax return in the same manner as in its Year 3 applicable financial statement, i.e., consistent with the taxpayer's new book method. The taxpayer did not file a Form 3115 to request advance consent to change its method of accounting for advance payments for tax purposes with respect to Year 3.

LAW AND ANALYSIS

At issue is whether a change in a taxpayer's manner of computing deferrals of advance payments under Rev. Proc. 2004-34 to conform to a change in financial accounting constitutes an accounting method change for which the taxpayer was required to obtain consent. It has been asserted that a change in a taxpayer's underlying book method for advance payments is not a change in method of accounting under § 446(e) because the taxpayer has already received advance consent to change its method of accounting for advance payments to the deferral method, using its applicable financial statement, under Rev. Proc. 2004-34. However, this reasoning is not persuasive. For the reasons described below, a change in a taxpayer's manner of computing deferrals of advance payments under Rev. Proc. 2004-34 to conform to a change in financial accounting constitutes an accounting method change for which the taxpayer is required to obtain consent under § 446(e).

Background

Section 1.451-1(a) of the Income Tax Regulations provides that, under an accrual method of accounting, income is includible when all of 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 payment is earned through performance, (2) payment is due to the taxpayer, or (3) payment is received by the taxpayer, whichever happens earliest. See Rev. Rul. 84-31.

Rev. Proc. 2004-34 states that the deferral method described in section 5.02 of the revenue procedure is a proper method of accounting under § 1.451-1. Under the deferral method, for federal income tax purposes, the taxpayer must, among other things, include advance payments in gross income for the taxpayer year of receipt to the extent recognized in revenues for that taxable year in its applicable financial statement as defined in section 4.06 of the revenue procedure. The remaining amount of the advance payment must be included in income in the next taxable year.

There is no dispute in this case about the taxpayer's application of Rev. Proc. 2004-34 during Years 1 and 2. Rather, the dispute centers on whether the taxpayer must obtain consent to use its new book method for advance payments beginning in Year 3.

Change in Method of Accounting

Under § 1.446-1(e)(2)(ii)(a), a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item that involves the proper time for the inclusion of an item in income or the taking of a deduction.

Section 446(e) generally requires that a taxpayer who changes the method of accounting on the basis of which it regularly keeps its books must, before computing taxable income under the new method, secure the consent of the Secretary. Section 1.446-1(e)(2)(i) similarly provides that a taxpayer that changes its book method of accounting must secure the Commissioner's consent before applying its new book method of accounting for tax purposes. Specifically, the regulation states that:

> Except as otherwise provided in Chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or permitted under the Internal Revenue Code or the regulations thereunder.

Section 1.446-1(e)(2)(i). In short, a taxpayer must secure the Commissioner's consent before applying its new book method of accounting for tax purposes. The taxpayer must secure consent even if the new method is a proper method of accounting. Section 1.446-1(e)(2)(i); see Diebold, Inc. v. United States, 891 F.2d 1579, 1583 (Fed. Cir. 1989), citing Witte v. Commissioner, 513 F.2d 391, 394 (D.C. Cir. 1975). In the instant case, the taxpayer changed its book method of accounting. Under § 1.446-1(e)(2)(i), the taxpayer must obtain consent before using its new book method for tax purposes. This conclusion is further supported by an analysis of the rules governing methods of accounting.

Section 481 prescribes the rules to be followed in computing taxable income where the taxpayer's taxable income is computed under a method of accounting different from that under which the taxable income was previously computed. See also § 1.481-1(a)(1). Taxpayers are required to make an adjustment under § 481 to prevent any duplication or omission of amounts attributable to previous years that would otherwise result from any change in a method of accounting.

This request for advice concerns the proper time for inclusion of an item (advance payments for services) in income. In Year 1 the taxpayer adopted a method of accounting for inclusion of advance payments pursuant to which it included the payments in income on a pro rata basis over the first 10 months of the 15-month period during which it performed services. This method of including advance payments in income conformed to the taxpayer's method of recognizing the payments in revenues for financial purposes, as required by section 5.02 of Rev. Proc. 2004-34.

In Year 3, in conjunction with changing its method of recognizing revenues for financial purposes, the taxpayer began including advance payments in income for tax purposes on a pro rata basis over 15 months. Thus, it changed the timing of including an item in income from the timing of including that item in income in the previous two years. The taxpayer's treatment of advance payments is a material item under § 446 because both methods determine in which taxable year the income is included and neither method creates a permanent change in the taxpayer's lifetime taxable income. Accordingly, the change in timing of inclusion of the advance payments constituted a change in a method of accounting under § 1.446-1(e)(2)(ii)(a). As a result, the taxpayer was required to file a Form 3115 to obtain consent to make this change in method of accounting. See § 1.446-1(e)(2)(i).

Requiring a taxpayer that previously elected to defer advance payments under Rev. Proc. 2004-34 to obtain consent under § 446(e) if the taxpayer subsequently changes its book method for deferred advance payments has the advantage of permitting application of § 481(a). We note that a change in a taxpayer's book method for deferred advance payments can result in omission of income or double inclusion of income absent an adjustment under § 481(a). Such omission or double inclusion can be avoided under § 481(a) only if the change is attributable to a change in the method of accounting. See § 481(a)(1).

The taxpayer asserts that the use of its new book method for purposes of Rev. Proc. 2004-34 should not be treated as a change in method of accounting because any omission or duplication can be avoided by making an adjustment on a cut-off basis. This is not persuasive as use of the cut-off basis is premised on the existence of a change in method of accounting under § 446(e). Accordingly, a taxpayer that implements an accounting method change on a cut-off basis still would be required to obtain consent from the Commissioner under § 1.446-1(e)(2)(i).[1]

cc: Jeffrey G. Mitchell
Chief, Branch 6
(Income Tax & Accounting)

[1] While we address this argument in order to provide a complete analysis, we found no authority that explicitly allows a taxpayer that changes its method of accounting under Rev. Proc. 2004-34 to make the change on a cut-off basis. Indeed, we are unaware of any case in which permission to make a change under Rev. Proc. 2004-34 on a cut-off basis was granted.