

The best news coming from Revenue Ruling 2004-23 may be for tax practitioners, who may no longer have to guard against what their clients say to the press about enhancing shareholder value when discussing an impending spin-off. Indeed, what may have once been an unspoken motivation behind some corporate spin-off transactions

may in some situations now be plastered all over the press with impunity. In addition, the interests of tax practitioners and investment bankers, which were so often at loggerheads, may by virtue of Revenue Ruling 2004-23 become more closely aligned in planning corporate separations.

1. 2004-11 I.R.B. 585.
2. 293 U.S. 465(1935).
3. Treas. Reg. § 1.355-2(b)(1).
4. Treas. Reg. § 1.355-2(b)(2).
5. Treas. Regs. §§ 1.355-2(b)(3), (b)(5), examples (3)-(5).
6. 1996-1 C.B. 696.
7. Rev. Proc. 2003-48, 2003-29 I.R.B. 86.
8. Treas. Reg. § 1.355-2(b)(2).
9. See *Estate of Parshelsky v. Comm.*, 303 F.2d 14 (2d Cir. 1962) and *Rafferty*

- v. Commissioner*, 452 F.2d 767, 770 (1st Cir. 1971); Treas. Reg. § 1.355-2(b)(2).
10. Rev. Proc. 96-30, Appendix A at § 2.01(1).
11. See, e.g., Priv. Ltr. Rul. 200215049 (Jan. 7, 2002); Priv. Ltr. Rul. 200047020 (Aug. 22, 2000); Priv. Ltr. Rul. 199924013 (Mar. 16, 1999); and Priv. Ltr. Rul. 199917026 (Jan. 27, 1999).
12. See, e.g., Priv. Ltr. Rul. 200133034 (May 15, 2001); and Priv. Ltr. Rul. 200116025 (Jan. 19, 2001).
13. Rev. Proc. 96-30, Appendix A at § 2.08.
14. *Id.*

Tax Accounting

By James E. Salles

The Internal Revenue Service's (IRS's) promised rewrite of Revenue Procedure 71-21, the long-standing procedure allowing deferral of advance payments for services, appeared in May. Revenue Procedure 2004-34¹ generally resembles the proposed revenue procedure that was included in Notice 2002-79 (2002 proposed procedure).² The accompanying Announcement 2004-48³ discusses some of the considerations taken into account and the choices made in drafting.

Eligible "Advance Payments"

Revenue Procedure 2004-34 substantially modernizes Revenue Procedure 71-21 and expands its coverage. The earlier procedure was issued contemporaneously with Treasury Regulations Section 1.451-5, which addressed advance payments for goods. Apart from items relating to long-term contracts, relief under Treasury Regulations Section 1.451-5 is confined to accrual taxpayers.⁴ Such taxpayers normally recognize income when an amount is received, or becomes currently due, or upon performance, whichever happens first.⁵ The regulation provides relief when an amount is received (or becomes due) before performance.⁶ Similar rules applied under Revenue Procedure 71-21.⁷

Revenue Procedure 2004-34, however, is not

limited to accrual taxpayers and introduces some technical innovations. Revenue Procedure 71-21 determined whether a potentially deferrable "advance payment" existed by reference to actual performance, but then limited the deferral to the amount deferred on the taxpayer's books.⁸ Revenue Procedure 2004-34 tidies up the analysis by using the same definition of "earned" in determining whether an amount is an "advance payment" and determining when it should be reported. An amount that has not been earned as of the end of the year in which it would normally be reportable as income is potentially deferrable.⁹

The definition of the taxpayer's "books" has also evolved. Revenue Procedure 71-21, similar to Treasury Regulations Section 1.451-5, looked to "books and records and all reports . . . to shareholders, partners, other proprietors or beneficiaries and for credit purposes."¹⁰ The 2002 proposed procedure referred somewhat ambiguously to the date that amounts were includable "for financial reporting purposes."¹¹ Revenue Procedure 2004-34 sets forth a hierarchy of "applicable financial statements" derived from the rules under the former AMT "book income adjustment."¹² In descending order of priority, a taxpayer's "applicable financial statement" is:

- A statement that is required to be provided to the Securities and Exchange Commission (SEC);

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- A "certified audited financial statement" used for credit purposes, shareholder reporting, or other "substantial non-tax purpose"; or
- A statement that is required to be provided to a federal or state agency apart from the SEC or the IRS.¹³

When a payment is earned is determined by reference to the "applicable financial statement" if possible, or otherwise based on when the taxpayer provides the goods, services, or other consideration.¹⁴

The new way of arriving at the deferrable amount can make a difference in some cases. For example, tour operators were formerly generally ineligible for deferral. As their services are normally performed when the tour is booked, their receipts would not be "advance payments" under Revenue Procedure 71-21 even if the tour did not actually take place until a later year.¹⁵ Revenue Procedure 2004-34 allows deferral if the taxpayer's "applicable financial statement" reports the income on the tour date.¹⁶

Types of Payments Covered

Revenue Procedure 71-21 was generally limited to payments for services, although it covered service contracts if the taxpayer commonly offered them separately from the associated goods.¹⁷ Revenue Procedure 2004-34 permits deferral of a broader array of payments for:

- Goods, services, and software;
- The license, lease, or other use of intellectual property;
- Rentals "ancillary" to the provision of services;
- Guaranties or warranties "ancillary" to any of the above;
- Subscriptions and memberships; or
- Any combination of the foregoing.¹⁸

This list has essentially carried over from the 2002 proposed procedure, except for the addition of payments for software as a separate item, probably to head off classification controversies.¹⁹ Payments that are actually—not merely potentially—accounted for under alternative methods, including Treasury Regulations Section 1.451-5, are excluded. Overall, the drafters seem to have taken some care to avoid unnecessary disputes about the new procedure's scope.

Revenue Procedure 2004-34 generally covers prepayments for goods, except when the taxpayer elects Treasury Regulations Section 1.451-5. Some sellers may choose the new procedure over the regulation, especially since it may be used—as the regulation cannot—by sellers that the IRS has recently allowed to report on the cash basis.²⁰ Of course, when a taxpayer does elect to account for goods under Treasury Regulations Section 1.451-5, combined payments will still have to be apportioned between the two deferral regimes. After soliciting comments,²¹ the IRS has allowed taxpayers to allocate receipts between items accounted for under the procedure and items that are not—or between items that are accounted under the procedure but subject to different deferral schedules—based on "objective criteria." An allocation that is based on the taxpayer's separate charges for the different components is generally "deemed" to be based on objective criteria.²² Other allocation methods have to obtain the IRS's approval.²³

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The new procedure thus covers a lot of miscellaneous payments that were previously excluded. Specific examples address broadcasting rights,²⁴ and "shopping club" membership fees,²⁵ both ruled ineligible for deferral under Revenue Procedure 71-21.

Revenue Procedure 71-21 provided special rules for "bus and streetcar tokens or transportation tickets with open dates" and prepaid photographic mailers.²⁶ These rules basically allowed one year's deferral, while waiving the usual requirement that redemption be contractually required within one year. As that requirement has now been eliminated, the special rule is no longer necessary.²⁷

Moreover, the new procedure is also available for other prepaid entitlements, such as gift cards, videogame tokens, and cruise packages.²⁸ Tickets to sports and entertainment events, which were

previously controversial,²⁹ seem likely to be covered. A typical gambling package is arguably covered if non-redeemable casino tokens represent future gambling "services" rather than cash.³⁰ The IRS does not seem to have addressed the potential overlap with Treasury Regulations Section 1.451-4's obscure but mandatory accounting method for "trading stamps or premium coupons" that are redeemable in "merchandise, cash, or other property."³¹

Exclusions

The procedure covers most common types of advance payments, but is not comprehensive. For example, commenters³² had suggested extending deferral to payments relating to the *recipient's* future goods purchases,³³ but the IRS has not gone that far.

Revenue Procedure 2004-34, similar to Revenue Procedure 71-21, does not cover most rentals.³⁴ The earlier procedure included an exception allowing deferral of payments for the use of "rooms and other space" if "significant services" (within the meaning of the subchapter S rules for "passive income") were provided to the occupant.³⁵ The new procedure allows deferral if "the occupancy or use [of property] is ancillary to the provision of services." The two standards probably amount to much the same thing so far as rentals of space are concerned. The new formulation, however, can apply in other situations, such as when a cable company rents modems "ancillary" to Internet services.³⁶

Payments "with respect to" financial instruments are specifically excepted from coverage. Among other things, this clause codifies the IRS's long-standing denial of deferral under Revenue Procedure 71-21 to credit card companies' annual fees, which are now addressed in separate guidance.³⁷ Other exceptions cover insurance premiums received by taxpayers subject to subchapter L, and warranties and guaranty payments under which a third party is the primary obligor, so that the taxpayer is basically an agent.³⁸

The final procedure also added exclusions for payments subject to Internal Revenue Code (IRC) Section 83, and payments to nonresidents that are potentially subject to withholding under the rules for "periodic" income not connected with a trade or business.³⁹ The IRS explained that it wanted to avoid overriding (and complicating) IRC Section 83's specific timing rules, which apply to non-cash "property" transferred in connection with services.⁴⁰ As to the second exception,

a nonresident taxpayer reports such payments on a cash basis, and the withholding normally settles the tax liability.⁴¹ Deferral would require the nonresident to claim a refund and then report income and pay the tax in a later year. This approach would both be complicated and defeat the purpose of withholding, which is to ensure collection of the tax.

Mechanics of Deferral

One of Revenue Procedure 71-21's most significant drawbacks was its limitation on the duration of the agreements covered. In most cases, deferral was only available when the agreement expressly required all of the services to be performed before the end of the taxable year following the payment.⁴² This limitation necessitated an anti-avoidance rule collapsing "substantially consecutive" agreements providing for "substantially similar" performance,⁴³ and produced arbitrary results.

The new procedure scraps the limitation on the *agreement* and just requires that any particular advance payment be deferred no more than one year after the year in which it would otherwise be reported.⁴⁴ Parallel examples illustrate the effects of this change. A taxpayer gives dancing lessons under a two-year contract that spans three taxable years. Under Revenue Procedure 71-21, no deferral was possible.⁴⁵ Under Revenue Procedure 2004-34, payment is reported partially in the year of receipt and partially in the following year.⁴⁶ Reacting to public comments, the IRS also added a special provision that extends the deferral period when the second year is made up of three months or less.⁴⁷

Allowing deferral for multiple-year contracts raises issues about allocating particular payments to particular services (or other performance). Taxpayers must establish the portion of each advance payment that is "unearned" and therefore potentially deferrable. If three taxable years are involved because of the special rule for short taxable years, then the taxpayer must also establish the amount that is "earned," and therefore must be reported, during the short taxable year.⁴⁸ These determinations are made by reference to the taxpayer's "applicable financial statement," if possible, or otherwise based on actual performance.

The new procedure adapts and carries over Revenue Procedure 71-21's rules for agreements for contingent services, such as service contracts and the like.⁴⁹ If the taxpayer is determining "earnings" based on actual performance and the extent to which

a particular payment is "earned" cannot be determined directly, the taxpayer is entitled to assume that income is earned ratably if the contract calls for a fixed term and that assumption is not "unreasonable." Alternatively, it may use statistical methods or "any other basis that in the opinion of the Commissioner results in a clear reflection of income."⁵⁰

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As under Revenue Procedure 71-21, the taxpayer must report deferred income immediately if it is no longer obliged to perform or if its existence terminates, with certain exceptions. Revenue Procedure 71-21 allowed for continued deferral in corporate reorganizations subject to IRC Section 381(a).⁵¹ Revenue Procedure 2004-34 adds an exception for certain transfers of a trade or business within a corporate consolidated group if the transferee also defers receipts under the procedure.⁵²

Revenue Procedure 2004-34 is a bit more liberal and easy to use than its predecessor. It is not, however, as advantageous as Treasury Regulations Section 1.451-5 for sales where performance takes place over an extended period. As discussed previ-

ously, deferral under the procedure will normally be limited to one year. Furthermore, although the IRS requested⁵³ and received⁵⁴ suggestions that sellers be allowed to estimate future performance costs when they include income, as they generally can under the regulation,⁵⁵ the final procedure does not provide such a deduction.⁵⁶ The procedure does not, therefore, as some practitioners had hoped, effectively supersede the regulation.⁵⁷

Method Changes

The final version of the new procedure added detailed rules for changes in accounting method. Changes to deferring—or not deferring—income under the procedure are generally eligible for automatic consent under normal rules.⁵⁸ The usual limitations on such changes are generally waived for changes during 2004 or 2005, so long as the taxpayer's method of accounting for advance payments is not "under consideration" in an ongoing examination.⁵⁹ Changes of method involving either: (1) allocations of combined payments that are not based on the taxpayer's charges for the different components; or (2) statistical or other non-ratable methods of determining how much of a payment is earned are not eligible for automatic consent and have to be applied for under the rules for discretionary changes.⁶⁰ A special rule permits a deferral election otherwise eligible for automatic consent to be combined with a pending application for a change to an accrual method.⁶¹

1. 2004-22 I.R.B. 991.

2. 2002-2 C.B. 964, discussed in J. Salles, "Tax Accounting," 3(5) *Corp. Bus. Tax'n Monthly* 36 (February, 2003).

3. 2004-22 C.B. 998.

4. Treas. Reg. § 1.451-5(a)(1).

5. *E.g.*, Charles Schwab Corporation. v. Commissioner, 107 T.C. 282, 292 (1996), *aff'd*, 161 F.3d 1231 (9th Cir. 1998), *cert. denied*, 528 U.S. 822 (1999); Rev. Rul. 74-607, 1974-2 C.B. 149, 150.

6. See Treas. Reg. § 1.451-5(a)(1), (a)(2)(ii) ("Amounts due and payable are considered 'received.'").

7. Rev. Proc. 71-21, §§ 1, 3.02; see also, *e.g.*, unnumbered FSA (Apr. 1999), 1999 WL 33520481; NSAR 5066 (Apr. 10, 1999), 1999 WL 33459116 (Rev. Proc. 71-21 potentially applies to amounts "due" but unpaid).

8. Rev. Proc. 71-21, §§ 3.02, 3.11.

9. Rev. Proc. 2004-34, § 4.01(1)-(2).

10. Treas. Reg. § 1.451-5(b)(1)(ii); Rev. Proc. 71-21, § 3.11.

11. 2002 Proposed Revenue Procedure §§ 4.01, 4.04, Notice 2002-79, 2002-2 C.B. 964, 965; see 3(5) *Corp. Bus. Tax'n Monthly* at 38.

12. See former I.R.C. § 56(f)(3); Treas. Reg. § 1.56-1(c).

13. Rev. Proc. 2004-34, § 4.06.

14. Rev. Proc. 2004-34, § 5.02(3)(b).

15. IRS INFO 2004-0067 (December 16, 2003), 2004 WL 635132.

16. Compare Rev. Proc. 2002-34, § 5.03, Exs. (13) and (14).

17. Rev. Proc. 71-21, § 3.07; compare *id.*, § 3.12, Ex. (4) with Rev. Proc. 2004-34, § 5.03, Ex. (4).

18. Rev. Proc. 2004-34, § 4.01; compare 2002 Proposed Revenue Procedure § 4.01, 2002-2 C.B. at 965.

19. Compare, *e.g.*, PLR 9231002 (Apr. 3, 1992); FSA, 1998 WL 1984180 (payments for updates of "shrinkwrapped" software eligible "advance payments" under Treas. Reg. § 1.451-5) with, *e.g.*, Treas. Reg. § 1.861-18(i)(2) Ex. (2) (custom software contract "assumed" eligible for deferral under Rev. Proc. 71-21).

20. See Rev. Proc. 2002-28, 2002-1 C.B. 815, discussed in J. Salles, "Of Merchandise, Accruals, and Administrative Grace," 95 *Tax Notes* 1778 (June 17, 2002).

21. 2002-2 C.B. at 964.

22. Rev. Proc. 2004-34, § 5.02(4).

23. See Rev. Proc. 2004-34, § 8.03.

24. Rev. Proc. 2004-34, § 5.03, Ex. (15); compare MSSP, Audit Techniques Guide for Sports Franchises (Aug. 1999), 1999-2000 CCH IRS Positions ¶ 217,951 at 116,069, discussing Rev. Proc. 71-21; see also, *e.g.*, GCM 39177 (Dec. 15, 1982); PLR 8331053 (Apr. 29, 1983).

25. Rev. Proc. 2004-34, § 5.03, Ex. (12); compare LTR 200102034 (Oct. 12, 2000), reconsidering and superseding LTR 200005031 (Nov. 3, 1999).

26. Rev. Proc. 71-21, §§ 3.04-3.05.

27. See Rev. Proc. 2004-34, § 5.03 Ex. (6).

28. Rev. Proc. 2004-34, § 5.03 Exs. (7)-(10), (13).

29. Cf. Tampa Bay Devil Rays, Ltd. v. Commissioner, 84 T.C.M. (CCH) 394 (2002), discussed in J. Salles, "Tax Accounting," 3(3) *Corp. Bus. Tax'n Monthly* 18, 19-20 (Dec. 2002).

30. *Cf. Zarin v. Commissioner*, 916 F.3d 110 (3d Cir. 1990), *rev'g* 92 T.C. 1084 (1989), discussed 3(5) *Corp. Bus. Tax'n Monthly* at 39.
 31. *See* 3(5) *Corp. Bus. Tax'n Monthly* at 39.
 32. *E.g.*, Comments by Carol Conjura and Scott Vance of KPMG LLP, Mar. 24, 2003, Tax Notes Doc. No. 2003-8373, 2003 TNT 64-107.
 33. *Cf.*, *Westpac Foods v. Commissioner*, 82 T.C.M. (CCH) 175 (2001).
 34. Announcement 2004-48, 2004-22 I.R.B. at 1000.
 35. Rev. Proc. 71-21, § 3.08, citing former Treas. Reg. § 1.1372-4(b)(5)(vi) (current counterpart at Treas. Reg. § 1.1362-2(c)(5)(i)(B)).
 36. Rev. Proc. 2004-34, § 5.03 Ex. (17).
 37. *See* Rev. Rul. 2004-52, 2004-22 I.R.B. 988; Rev. Proc. 2004-32, 2004-22 I.R.B. 988; Rev. Proc. 2004-33, 2004-22 I.R.B. 989.
 38. Rev. Proc. 2004-34, § 4.02(2), (5); *compare* 2002 Proposed Revenue Procedure § 4.02(2), 2002-2 C.B. at 965; *see* Ann. 2004-48, 2004-22 I.R.B. at 1000.
 39. Rev. Proc. 2004-34, § 4.02(6)-(7).
 40. Announcement 2004-48, 2004-22 I.R.B. at 1000.
 41. *See generally* I.R.C. §§ 871, 881, 1441, 1442.
 42. Rev. Proc. 71-21, § 3.03.
 43. Rev. Proc. 71-21, § 3.09.

44. Rev. Proc. 2004-34, § 5.02(1).
 45. Rev. Proc. 71-21, § 3.12 (Ex. 2).
 46. Rev. Proc. 2004-34, § 5.03 (Ex. 2).
 47. Rev. Proc. 2004-34, § 5.02(2); *see* Ann. 2004-48, 2004-22 I.R.B. at 998-999.
 48. Rev. Proc. 2004-34, § 5.02(1)(b).
 49. *See* Rev. Proc. 71-21, § 3.06.
 50. Rev. Proc. 2004-34, § 5.02(3).
 51. Rev. Proc. 71-21, § 3.13.
 52. Rev. Proc. 2004-34, § 5.05; *see* Ann. 2004-48, 2004-22 I.R.B. at 999; *compare* 2002 Proposed Revenue Procedure § 5.02(3), 2002-2 C.B. 964, 966.
 53. Notice 2002-79, 2002-2 C.B. at 964.
 54. *E.g.*, Comments by Carol Conjura and Scott Vance of KPMG LLP, Mar. 24, 2003, Tax Notes Doc. No. 2003-8373, 2003 TNT 64-107.
 55. *See* Treas. Reg. § 1.451-5(c)(1)(ii).
 56. *See* Announcement 2004-48, 2004-22 I.R.B. at 1000 (COGS).
 57. *See* Announcement 2004-48, 2004-22 I.R.B. at 998.
 58. Rev. Proc. 2004-34, § 8.02.
 59. Rev. Proc. 2004-34, § 8.02(1).
 60. Rev. Proc. 2004-34, § 8.03.
 61. Rev. Proc. 2004-34, § 8.04.

Multistate Taxation

By Randy Holloway and Nicole Schreck

The New Jersey Division of Taxation (NJDT) issued a technical bulletin that outlines the NJDT's interpretation of the sales and use tax treatment of software transfers.¹ The NJDT bulletin generally provides as follows:

- Retail sales of non-custom software contained in discs, CDs, and other tangible storage media are subject to tax.
- The sale of a license to use software or the rental of software is treated as the "sale" of software.
- Modified pre-written software is taxable, except for a separately stated, commercially reasonable charge for the professional service of modifying the software. If the vendor fails to identify a separate fee for customization and charges a lump sum, the entire charge is subject to tax.
- Software that is "entirely custom-made" for the

exclusive use of a specific customer is treated as a nontaxable professional service. This result applies even though the customer may receive the software in some tangible medium.

- The download or electronic transmission of any kind of software to a customer is nontaxable. However, if the vendor delivers a copy of the program in a tangible medium as a follow-up, the transaction is subject to tax, unless the program is designed for the exclusive use of the specific purchaser.
- "Load-and-leave" and related transactions (*e.g.*, load and mail), when a tangible storage medium is used in the installation, are subject to tax, except for custom software and modifications when separately stated.
- Charges for the sale of maintenance contracts for non-custom software are generally subject to tax. However, software maintenance contracts that cover only the provision of updates by electronic means, or only the provision of training, consultation, or advice, help, and customer support via telephone or online are nontaxable.

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¹ N.J. Div. Taxn., TB-51, 1/20/04.