

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Third Party Communication: None

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CC:ITA:B02

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Date:

February 01, 2006

## LEGEND

The Taxpayer =

Dear :

This responds to a request submitted by your authorized representative for a ruling letter on whether Rev. Proc. 2004-34, 2004-22 I.R.B. 991, modifying and superseding Rev. Proc. 71-21, 1971-2 C.B. 549, requires the Taxpayer to file a Form 3115, *Application for Change in Accounting Method*, for the taxable year at issue.

## FACTS:

The Taxpayer (a parent corporation and its subsidiaries) offers home service contracts to consumers that provide repair or replacement services for existing home appliances and mechanical systems that fail to function properly due to normal wear and tear. The Taxpayer authorizes repairs through contractors that are dispatched by the Taxpayer in response to customer requests for service. The Taxpayer is the primary obligor for services provided pursuant to its home service contracts and authorizes its service contractors to provide such services. The service contracts generally have a term of one year, and the customer makes a payment in full upon execution of the contract or, in some cases, on a monthly or quarterly basis in advance of the corresponding coverage period.

For financial accounting purposes, the Taxpayer recognizes revenue from the service contracts over the term of the contracts in proportion to the expected direct costs (in accordance with Staff Accounting Bulletin (SAB) 101, *Revenue Recognition in Financial Statements*, and FASB Technical Bulletin (FTB) 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*), based on historical evidence

as to when service requests are made and when costs are incurred, rather than on a straight line basis.

The Taxpayer has been following the financial accounting method described above for federal income tax purposes; the Taxpayer represents that this tax treatment meets the requirements of Rev. Proc. 71-21. It also appears that members of Taxpayer's controlled group either adopted the method in the first year advance payments were received or received permission from the IRS to change its method of accounting to the deferral method under Rev. Proc. 71-21.

The Taxpayer does not intend to change its method of financial accounting.

#### DISCUSSION:

In general, § 451 of the Internal Revenue Code 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 in a different period. Section 1.451-1(a) of the Income Tax Regulations provides that, under an accrual method of accounting, income is includible in gross income when all 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, 1984-1 C.B. 127.

Rev. Proc. 71-21 was published to allow accrual method taxpayers to defer the inclusion of advance payments in certain specified and limited circumstances. Section 3.02 of Rev. Proc. 71-21 provides:

An accrual method taxpayer who, pursuant to an agreement ..., receives a payment in one taxable year for services, where all of the services under such agreement are required by the agreement as it exists at the end of the taxable year of receipt to be performed by him before the end of the next succeeding taxable year, may include such payment in gross income as earned through the performance of the services ....

Section 3.06(a) of Rev. Proc. 71-21 further provided that if the agreement requires *contingent* services, the amount of the payment that is earned in a taxable year may be determined on a statistical basis if adequate data are available to the taxpayer.

Rev. Proc. 2004-34 was published to expand the scope of Rev. Proc. 71-21 (see section 2.04 of Rev. Proc. 2004-34) by, for example, allowing income deferral for items other than services. The new procedure allows income deferral for agreements that extend beyond the next succeeding taxable year following receipt (although income deferral not is allowable beyond the next succeeding taxable year following receipt).

Because Rev. Proc. 2004-34 represents an expansion of Rev. Proc. 71-21, service agreements that have qualified for income deferral under Rev. Proc. 71-21 generally continue to qualify under Rev. Proc. 2004-34. Thus, a taxpayer that is properly using

Rev. Proc. 71-21, and that does not intend to change its method of accounting, generally is not required by Rev. Proc. 2004-34 to file a Form 3115, *Application for Change in Accounting Method*.

Accordingly, based on the Taxpayer's representation that its method of accounting for advance payments has been in compliance with Rev. Proc. 71-21, the Taxpayer's method of accounting for advance payments meets the requirements of Rev. Proc. 2004-34, and the Taxpayer will not need to file a Form 3115, as the taxpayer is not changing its method of accounting. No opinion is expressed, however, on whether the Taxpayer has been in compliance with Rev. Proc. 71-21.<sup>1</sup>

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Clifford M. Harbourt  
Senior Technician Reviewer, Branch 2  
(Income Tax & Accounting)

Enclosure:

Copy of this letter  
Copy for § 6110 purposes

cc:

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<sup>1</sup> If, in fact, the Taxpayer's method of accounting has not been in compliance with Rev. Proc. 71-21, the Taxpayer's method of accounting may nevertheless be in compliance with Rev. Proc. 2004-34, in which case the audit protection provided in section 7 of Rev. Proc. 2004-34 would apply for prior years.