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## MEMORANDUM

From: Peter H. Winslow  
Gregory K. Oyler

Date: June 1, 2004

Re: Deferral of Advance Payments

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In Rev. Proc. 2004-34 the IRS has expanded the opportunities to defer recognition of prepaid service fee income. Under Rev. Proc. 71-21, 1971-2 C.B. 549, an accrual basis taxpayer was permitted to defer recognition of prepaid service fee income to the next taxable year as long as the services were to be completed by the end of that next year. Rev. Proc. 2004-34 liberalizes this long-standing rule by permitting deferral of recognition of prepaid service fee income whether or not the services will be completed in the succeeding year. However, deferral is limited to one year, even if performance of the services extends beyond the end of the next year.

Rev. Proc. 2004-34 may be beneficial for insurance companies in arrangements where they provide services but not insurance. For example, a company may provide administrative services for a plan that is self-insured or insured by another carrier or insurance pool. The company may collect the premium up-front, retain its fee, remit the premium to the insurer and set up an LAE liability for its own claims administration expenses. Under these facts, the IRS on audit has disallowed a deduction for the LAE on the ground that, because the company is not providing insurance in the arrangement, the liability must be accounted for on an accrual basis rather than a reserve basis. Rev. Proc. 2004-34 appears to allow a one-year deferral of the prepaid service fee income in these circumstances.

Some changes in method of accounting under Rev. Proc. 2004-34 are eligible to be implemented as an automatic change. If this issue may apply to your company, you should consider filing a Form 3115 with the 2003 tax return.

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Please call if you have any questions.