Deferring taxes on advance payments

An advance payment is one received by a business before it provides whatever is being paid for. For federal income tax purposes, generally advance payments must be reported as taxable income in the year received. This treatment always applies if your business uses the cash method of accounting for tax purposes. But, if your business uses the accrual method, it may qualify for favorable tax deferral treatment.

Tax deferral privilege

Accrual-basis businesses can elect to postpone including all or part of an eligible advance payment in taxable income until the year *after* it's received. To be eligible for the deferral election, among other requirements, an advance payment must:

- At least partially be included in revenue for a later year according to your business's applicable financial statement (AFS) or, if your business doesn't have an AFS, treated as earned in a later year, and
- Be received for goods, services or other eligible items listed in IRS guidance.

If your accrual-basis business received eligible advance payments in 2025, you potentially can elect to defer reporting some or all of that income until 2026 for federal tax purposes.

What is an AFS?

An AFS can be an audited financial statement used for credit or financial reporting purposes or certain reports submitted to federal or state agencies. A form filed with the Securities and Exchange Commission, such as a 10-K or annual report, also can be an AFS.

If your business doesn't have an AFS and elects to use the deferral method for advance payments, the payment must be included in taxable income in the year received to the extent of the amount that is treated by your business as earned in that year. The remaining portion of the advance payment must be included in taxable income the following year.

What types of payments are eligible?

Advance payments that *may* be eligible for deferral include payments for:

- Services,
- The sale of goods,
- Gift cards,
- The use of intellectual property,
- The sale or use of computer software,
- Warranty contracts, and
- Subscriptions.

Other payments specified in IRS guidance also may be eligible.

Eligible advance payments *don't* include rents (with some exceptions), certain insurance premiums, payments for financial instruments, payments for certain service warranty contracts, and other payments specified in IRS guidance.

Some examples

The following examples illustrate how eligible advance payments can be deferred for federal income tax purposes:

Taxpayer has an AFS. A calendar-year accrual method S corporation provides tennis facilities and lessons. On November 15, 2025, it received payment for a one-year contract for 48 one-hour tennis lessons beginning on that date. Eight lessons were given in 2025. On its AFSs, the business recognizes one-sixth (8/48) of the advance payment as revenue for 2025 and five-sixths (40/48) as revenue for 2026. Making the advance payment deferral method election, the business includes only one-sixth of the advance payment in taxable income for 2025. The remaining five-sixths must be included in taxable income for 2026.

Taxpayer doesn't have an AFS. A calendar-year accrual method LLC provides online security protection services for computers, tablets and cell phones. On September 1, 2025, it received payment for two years of protection services beginning on that date. The business determines that four months of its services should be treated as earned in 2025. Making the advance payment deferral election, the business includes only one-sixth (4/24) of the advance payment in taxable income for 2025. The remaining five-sixths (20/24) must be included in taxable income for 2026.

Can you benefit?

We've only scratched the surface of complicated tax rules and regulations that apply to the treatment of advance payments. Contact us for help determining if your business is eligible to defer 2025 advance payments. We can also calculate the possible current tax savings.

© 2026