(ii) *Taxable years beginning prior to January 1, 2002.* An S corporation described in paragraph (c)(1) of this section that requests, in accordance with this paragraph, that a termination of its election under section 444 be disregarded will not be required to amend any prior Federal income tax returns, make any required payments under section 7519, or file any returns under §1.7519–2T, with respect to taxable years beginning on or after the date the termination of its section 444 election was effective and prior to January 1, 2002.

(iii) *Section 7519: required payments and returns.* The Internal Revenue Service waives any requirement for an S corporation described in paragraph (c)(1) of this section to file the federal tax returns and make any required payments under section 7519 for years prior to the taxable year of continuation as described in paragraph (c)(3)(i) of this section, if for such years the S corporation filed its federal income tax returns on the basis of its required taxable year.

[T.D. 8994, 67 FR 34394, May 14, 2002]

METHODS OF ACCOUNTING

METHODS OF ACCOUNTING IN GENERAL

§ 1.446–1 General rule for methods of accounting.

(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term ''method of accounting'' includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw

materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see section 263A, 471, and 472 and the regulations thereunder.)

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

(iii) In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

(b) *Exceptions.* (1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(2) A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

(c) *Permissible methods*—(1) In general. Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.* Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451–2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and paragraph (a)(1) of § 1.461–1.

(ii) *Accrual method.* (A) Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of § 1.461–1 for examples of liabilities that may not be taken into account until after the taxable year incurred, and see §§ 1.461–4 through 1.461–6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that a deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of § 1.263A–1(c)(3)) and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and related guidance.

(B) The term ''liability'' includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as

any other cost or expense. Thus, for example, an amount that a taxpayer expends or will expend for capital improvements to property must be incurred before the taxpayer may take the amount into account in computing its basis in the property. The term ''liability'' is not limited to items for which a legal obligation to pay exists at the time of payment. Thus, for example, amounts prepaid for goods or services and amounts paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred.

(C) No method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. For example, a taxpayer engaged in a manufacturing business may account for sales of the taxpayer's product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customers, whether or not billed, depending on the method regularly employed in keeping the taxpayer's books.

(iii) *Other permissible methods.* Special methods of accounting are described elsewhere in chapter 1 of the Code and the regulations thereunder. For example, see the following sections and the regulations thereunder: Sections 61 and 162, relating to the crop method of accounting; section 453, relating to the installment method; section 460, relating to the long-term contract methods. In addition, special methods of accounting for particular items of income and expense are provided under other sections of chapter 1. For example, see section 174, relating to research and experimental expenditures, and section 175, relating to soil and water conservation expenditures.

(iv) *Combinations of the foregoing methods.* (*a*) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

(*b*) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

(2) *Special rules.* (i) In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized under subdivision (ii) of this subparagraph.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the regulations in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such

method. See section 446(a) and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books, and section 446(e) and paragraph (e) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

(iii) The timing rules of § 1.1502–13 are a method of accounting for intercompany transactions (as defined in § 1.1502–13(b)(1)(i)), to be applied by each member of a consolidated group in addition to the member's other methods of accounting. *See* § 1.1502–13(a)(3)(i). This paragraph (c)(2)(iii) is applicable to consolidated return years beginning on or after November 7, 2001.

(d) *Taxpayer engaged in more than one business.* (1) Where a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business, provided the method used for each trade or business clearly reflects the income of that particular trade or business. For example, a taxpayer may account for the operations of a personal service business on the cash receipts and disbursements method and of a manufacturing business on an accrual method, provided such businesses are separate and distinct and the methods used for each clearly reflect income. The method first used in accounting for business income and deductions in connection with each trade or business, as evidenced in the taxpayer's income tax return in which such income or deductions are first reported, must be consistently followed thereafter.

(2) No trade or business will be considered separate and distinct for purposes of this paragraph unless a complete and separable set of books and records is kept for such trade or business.

(3) If, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer will not be considered to be separate and distinct.

(e) *Requirement respecting the adoption or change of accounting method.* (1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this section. See also section 446(a) and paragraph (a) of this section.

(2)(i) Except as otherwise expressly 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 is permitted under the Internal Revenue Code or the regulations thereunder.

(ii) (*a*) A change in the 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. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations under sections 471 and 472), a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.460–4), certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(*d*) of this

section), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations under the Internal Revenue Code specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(*b*) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and of items that are deducted as business expenses, but that are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts. Although such adjustment may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustment in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve (for example, for banks under section 585 of the Internal Revenue Code), see the regulations under section 166 of the Internal Revenue Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. For further guidance on changes involving depreciable or amortizable assets, see paragraph (e)(2)(ii)(*d*) of this section and § 1.1016–3(h).

(*c*) A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting.

(*d*) *Changes involving depreciable or amortizable assets*—(*1*) *Scope*. This paragraph (e)(2)(ii)(*d*) applies to property subject to section 167, 168, 197, 1400I, 1400L(c), to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168), or to an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)).

(*2*) *Changes in depreciation or amortization that are a change in method of accounting*. Except as provided in paragraph (e)(2)(ii)(*d*)(*3*) of this section, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in method of accounting. Additionally, a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting. Further, except as provided in paragraph (e)(2)(ii)(*d*)(*3*) of this section, the following changes in computing depreciation or amortization are a change in method of accounting:

(*i*) A change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset.

(*ii*) A change from not claiming to claiming the additional first year depreciation deduction provided by, for example, section 168(k), 1400L(b), or 1400N(d), for, and the resulting change to the amount otherwise allowable as a depreciation deduction for the remaining adjusted depreciable basis (or similar basis) of, depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property), provided the taxpayer did not make the election out of the additional first year depreciation deduction (or did not make a deemed election out of the additional first year depreciation deduction; for further guidance, for example, see Rev. Proc. 2002–33 (2002–1 C.B. 963), Rev. Proc. 2003–50 (2003–2 C.B. 119), Notice 2006–77 (2006–40 I.R.B. 590), and

§ 601.601(d)(2)(ii)(*b*) of this chapter) for the class of property in which the depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property) is included.

(*iii*) A change from claiming the 30-percent additional first year depreciation deduction to claiming the 50-percent additional first year depreciation deduction for depreciable property that qualifies for the 50-percent additional first year depreciation deduction, provided the property is not included in any class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction (for example, 50-percent bonus depreciation property or qualified Gulf Opportunity Zone property), or a change from claiming the 50-percent additional first year depreciation deduction to claiming the 30-percent additional first year depreciation deduction for depreciable property that qualifies for the 30-percent additional first year depreciation deduction, including property that is included in a class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction (for example, qualified property or qualified New York Liberty Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's remaining adjusted depreciable basis (or similar basis). This paragraph (e)(2)(ii)(*d*)(*2*)(*iii*) does not apply if a taxpayer is making a late election or revoking a timely valid election under the applicable additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)) (see paragraph (e)(2)(ii)(*d*)(*3*)(*iii*) of this section).

(*iv*) A change from claiming to not claiming the additional first year depreciation deduction for an asset that does not qualify for the additional first year depreciation deduction, including an asset that is included in a class of property for which the taxpayer elected not to claim any additional first year depreciation deduction (for example, an asset that is not qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's depreciable basis.

(*v*) A change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Internal Revenue Code (for example, section 168(b)(4)), the regulations under the Internal Revenue Code (for example, § 1.197–2(f)(1)(ii)), or other guidance published in the Internal Revenue Bulletin.

(*vi*) A change in the accounting for depreciable or amortizable assets from a single asset account to a multiple asset account (pooling), or vice versa, or from one type of multiple asset account (pooling) to a different type of multiple asset account (pooling).

(*vii*) For depreciable or amortizable assets that are mass assets accounted for in multiple asset accounts or pools, a change in the method of identifying which assets have been disposed. For purposes of this paragraph (e)(2)(ii)(*d*)(*2*)(*vii*), the term *mass assets* means a mass or group of individual items of depreciable or amortizable assets that are not necessarily homogeneous, each of which is minor in value relative to the total value of the mass or group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, with respect to which separate identification is impracticable, and placed in service in the same taxable year.

(*viii*) Any other change in depreciation or amortization as the Secretary may designate by publication in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(*3*) *Changes in depreciation or amortization that are not a change in method of accounting.* Section 1.446–1(e)(2)(ii)(*b*) applies to determine whether a change in depreciation or amortization is not a change in method of accounting. Further, the following changes in depreciation or amortization are not a change in method of accounting:

(*i*) *Useful life*. An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) is not a change in method of accounting. This paragraph (e)(2)(ii)(*d*)(*3*)(*i*) does not apply if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Internal Revenue Code (for example, section 167(f)(1), section 168(c), section 168(g)(2) or (3), section 197), the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin and, therefore, such change is a change in method of accounting (unless paragraph (e)(2)(ii)(*d*)(*3*)(*v*) of this section applies). See paragraph (e)(2)(ii)(*d*)(*5*)(*iv*) of this section for determining the taxable year in which to correct an adjustment in useful life that is not a change in method of accounting.

(*ii*) *Change in use*. A change in computing depreciation or amortization allowances in the taxable year in which the use of an asset changes in the hands of the same taxpayer is not a change in method of accounting.

(*iii*) *Elections*. Generally, the making of a late depreciation or amortization election or the revocation of a timely valid depreciation or amortization election is not a change in method of accounting, except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin. This paragraph (e)(2)(ii)(*d*)(*3*)(*iii*) also applies to making a late election or revoking a timely valid election made under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (107 Stat. 312, 540) (relating to amortizable section 197 intangibles). A taxpayer may request consent to make a late election or revoke a timely valid election by submitting a request for a private letter ruling. For making or revoking an election under section 179 of the Internal Revenue Code, see section 179(c) and § 1.179–5.

(*iv*) *Salvage value*. Except as provided under paragraph (e)(2)(ii)(*d*)(*2*)(*v*) of this section, a change in salvage value of a depreciable or amortizable asset is not treated as a change in method of accounting.

(*v*) *Placed-in-service date*. Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting. For example, if a taxpayer changes the placed-in-service date of a depreciable or amortizable asset because the taxpayer incorrectly determined the date on which the asset was placed in service, such a change is a change in the placed-in-service date of the asset and, therefore, is not a change in method of accounting. However, if a taxpayer incorrectly determines that a depreciable or amortizable asset is nondepreciable property and later changes the treatment of the asset to depreciable property, such a change is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(*d*)(*2*) of this section. Further, a change in the convention of a depreciable or amortizable asset is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(*d*)(*2*)(*i*) of this section. See paragraph (e)(2)(ii)(*d*)(*5*)(*v*) of this section for determining the taxable year in which to make a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting.

(*vi*) Any other change in depreciation or amortization as the Secretary may designate by publication in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(*4*) *Item being changed*. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(*d*) applies, the item being changed generally is the depreciation

treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to a depreciable asset for which depreciation is determined under §1.167(a)–11 (class life asset depreciation range (CLADR) property). Similarly, the item is the depreciable treatment of each general asset account with respect to a depreciable asset for which general asset account treatment has been elected under section 168(i)(4) or the item is the depreciation treatment of each mass asset account with respect to a depreciable asset for which mass asset account treatment has been elected under former section 168(d)(2)(A). Further, a change in computing depreciation or amortization under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) is permitted only with respect to all assets in a particular account (as defined in §1.167(a)–7) or vintage account.

(*5*) *Special rules*. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(*d*) applies—

(*i*) *Declining balance method to the straight line method for MACRS property*. For tangible, depreciable property subject to section 168 (MACRS property) that is depreciated using the 200-percent or 150-percent declining balance method of depreciation under section 168(b)(1) or (2), a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight line method of depreciation in the first taxable year in which the use of the straight line method with respect to the adjusted depreciable basis of the MACRS property as of the beginning of that year will yield a depreciation allowance that is greater than the depreciation allowance yielded by the use of the declining balance method. When the change is made, the adjusted depreciable basis of the MACRS property as of the beginning of the taxable year is recovered through annual depreciation allowances over the remaining recovery period (for further guidance, see section 6.06 of Rev. Proc. 87–57 (1987–2 C.B. 687) and §601.601(d)(2)(ii)(*b*) of this chapter).

(*ii*) *Depreciation method changes for section 167 property*. For a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))), see §1.167(e)–1(b), (c), and (d) for the changes in depreciation method that are permitted to be made without the consent of the Commissioner. For CLADR property, see §1.167(a)–11(c)(1)(iii) for the changes in depreciation method for CLADR property that are permitted to be made without the consent of the Commissioner. Further, see §1.167(a)–11(b)(4)(iii)(*c*) for how to correct an incorrect classification or characterization of CLADR property.

(*iii*) *Section 481 adjustment*. Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, no section 481 adjustment is required or permitted for a change from one permissible method of computing depreciation or amortization to another permissible method of computing depreciation or amortization for an asset because this change is implemented by either a cut-off method (for further guidance, for example, see section 2.06 of Rev. Proc. 97–27 (1997–1 C.B. 680), section 2.06 of Rev. Proc. 2002–9 (2002–1 C.B. 327), and §601.601(d)(2)(ii)(*b*) of this chapter) or a modified cut-off method (under which the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method of accounting), as appropriate. However, a change from an impermissible method of computing depreciation or amortization to a permissible method of computing depreciation or amortization for an asset results in a section 481 adjustment. Similarly, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable (or vice versa) or a change in the

treatment of an asset from expensing to depreciating (or vice versa) results in a section 481 adjustment.

(*iv*) *Change in useful life.* This paragraph (e)(2)(ii)(*d*)(*5*)(*iv*) applies to an adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) and that is not a change in method of accounting under paragraph (e)(2)(ii)(*d*) of this section. For this adjustment in useful life, no section 481 adjustment is required or permitted. The adjustment in useful life, whether initiated by the Internal Revenue Service (IRS) or a taxpayer, is corrected by adjustments in the taxable year in which the conditions known to exist at the end of that taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)–1(b) (or if the period of limitation for assessment under section 6501(a) has expired for that taxable year, in the first succeeding taxable year open under the period of limitation for assessment), and in subsequent taxable years. In other situations (for example, the useful life is incorrectly determined in the placed-in-service year), the adjustment in the useful life, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the correction in useful life, in lieu of filing amended Federal tax returns (for example, because the conditions known to exist at the end of a prior taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)–1(b)), the taxpayer may correct the adjustment in useful life by adjustments in the current and subsequent taxable years.

(*v*) *Change in placed-in-service date.* This paragraph (e)(2)(ii)(*d*)(*5*)(*v*) applies to a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting under paragraph (e)(2)(ii)(*d*) of this section. For this change in placed-in-service date, no section 481 adjustment is required or permitted. The change in placed-in-service date, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the change in placed-in-service date, in lieu of filing amended Federal tax returns, the taxpayer may correct the placed-in-service date by adjustments in the current and subsequent taxable years.

(iii) *Examples.* The rules of this paragraph (e) are illustrated by the following examples:

Example 1. Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example 2. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example 3. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to

the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example 4. From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example 5. A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change in method of accounting for inventories.

Example 6. A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations under the Internal Revenue Code. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example 7. A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a ''reserve for price changes.'' Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations under the Internal Revenue Code, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example 8. A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

Example 9. In 2003, A1, a calendar year taxpayer engaged in the trade or business of manufacturing knitted goods, purchased and placed in service a building and its components at a total cost of $10,000,000 for use in its manufacturing operations. A1 classified the $10,000,000 as nonresidential real property under section 168(e). A1 elected not to deduct the additional first year depreciation provided by section 168(k) on its 2003 Federal tax return. As a result, on its 2003, 2004, and 2005 Federal tax returns, A1 depreciated the $10,000,000 under the general depreciation system of section 168(a), using the straight line method of depreciation, a 39-year recovery period, and the mid-month convention. In 2006, A1 completes a cost segregation study on the building and its components and identifies items that cost a total of $1,500,000 as section 1245 property. As a result, the $1,500,000 should have been classified in 2003 as 5-year property under section 168(e) and depreciated on A1's 2003, 2004, and 2005 Federal tax returns under the general depreciation system, using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*i*) of this section, A1's change to this depreciation method, recovery period, and convention is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section does not apply because the assets are depreciated under section 168.

Example 10. In 2003, B, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $1,000,000 for use in its plant located outside the United States. The equipment is 15-year property under section 168(e) with a class life of 20 years. The equipment is required to be depreciated under the alternative depreciation system of section 168(g). However, B incorrectly depreciated the equipment under the general depreciation system of section 168(a), using the 150-percent declining balance method, a 15-year recovery period, and the half-year convention. In 2010, the IRS examines B's 2007 Federal income tax return and changes the depreciation of the equipment to the alternative depreciation system, using the straight line method of depreciation, a 20-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*i*) of this section, this change in depreciation method and recovery period made by the IRS is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section does not apply because the assets are depreciated under section 168.

Example 11. In May 2003, C, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. C never held this equipment for sale. However, C incorrectly treated the equipment as inventory on its 2003 and 2004 Federal tax returns. In 2005, C realizes that the equipment should have been treated as a depreciable asset. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*) of this section, C's change in the treatment of the equipment from inventory to a depreciable asset is a change in method of accounting. This method change results in a section 481 adjustment.

Example 12. Since 2003, D, a calendar year taxpayer, has used the distribution fee period method to amortize distributor commissions and, under that method, established pools to account for the distributor commissions (for further guidance, see Rev. Proc. 2000–38 (2000–2 C.B. 310) and § 601.601(d)(2)(ii)(*b*) of this chapter). A change in the accounting of distributor commissions under the distribution fee period method from pooling to single asset accounting is a change in method of accounting pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*vi*) of this section. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 13. Since 2003, E, a calendar year taxpayer, has accounted for items of MACRS property that are mass assets in pools. Each pool includes only the mass assets that are placed in service by E in the same taxable year. E is able to identify the cost basis of each asset in each pool. None of the pools are general asset accounts under section 168(i)(4) and the regulations under section 168(i)(4). E identified any dispositions of these mass assets by specific identification. Because of changes in E's recordkeeping in 2006, it is impracticable for E to continue to identify disposed mass assets using specific identification. As a result, E wants to change to a first-in, first-out method under which the mass assets disposed of in a taxable year are deemed to be from the pool with the earliest placed-in-service year in existence as of the beginning of the taxable year of each disposition. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*vii*) of this section, this change is a change in method of accounting. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 14. In August 2003, F, a calendar year taxpayer, purchased and placed in service a copier for use in its trade or business. F incorrectly classified the copier as 7-year property under section 168(e). F elected not to deduct the additional first year depreciation provided by section 168(k) on its 2003 Federal tax return. As a result, on its 2003 and 2004 Federal tax returns, F depreciated the copier under the general depreciation system of section 168(a), using the 200-percent declining balance method of depreciation, a 7-year recovery period, and the half-year convention. In 2005, F realizes that the copier is 5-year property and should have been depreciated on its 2003 and 2004 Federal tax returns under the general depreciation system using a 5-year recovery period rather than a 7-year recovery period. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*)(*i*) of this section, F's change in recovery period from 7 to 5 years is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section does not apply because the copier is depreciated under section 168.

Example 15. In 2004, G, a calendar year taxpayer, purchased and placed in service an intangible asset that is not an amortizable section 197 intangible and that is not described in section 167(f). G amortized the cost of the intangible asset under section 167(a) using the straight line method of depreciation and a determinable useful life of 13 years. The safe harbor useful life of 15 or 25 years under § 1.167(a)–3(b) does not apply to the intangible asset. In 2008, because of changing conditions, G changes the remaining useful life of the intangible asset to 2 years. Pursuant to paragraph (e)(2)(ii)(*d*)(*3*)(*i*) of this section, G's change in useful life is not a change in method of accounting because the intangible asset is depreciated under section 167 and G is not changing to or from a useful life that is specifically assigned by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin.

Example 16. In July 2003, H, a calendar year taxpayer, purchased and placed in service ''off-the-shelf'' computer software and a new computer. The cost of the new computer and computer software are separately stated. H incorrectly included the cost of this software as part of the cost of the computer, which is 5-year property under section 168(e). On its 2003 Federal tax return, H elected to depreciate its 5-year property placed in service in 2003 under the alternative depreciation system of section 168(g) and H elected not to deduct the additional first year depreciation provided by section 168(k). The class life for a computer is 5 years. As a result, because H included the cost of the computer software as part of the cost of the computer hardware, H depreciated the cost of the software under the alternative depreciation system, using the straight line method of depreciation, a 5-year recovery period, and the half-year convention. In 2005, H realizes that the cost of the software should have been amortized under section 167(f)(1), using the straight line method of depreciation, a 36-month useful life, and a monthly convention. H's change from 5-years to 36-months is a change in

method of accounting because H is changing to a useful life that is specifically assigned by section 167(f)(1). The change in convention from the half-year to the monthly convention also is a change in method of accounting. Both changes result in a section 481 adjustment.

Example 17. On May 1, 2003, I2, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $500,000 for use in its business. The equipment is 5-year property under section 168(e) with a class life of 9 years and is qualified property under section 168(k)(2). I2 did not place in service any other depreciable property in 2003. Section 168(g)(1)(A) through (D) do not apply to the equipment. I2 intended to elect the alternative depreciation system under section 168(g) for 5-year property placed in service in 2003. However, I2 did not make the election. Instead, I2 deducted on its 2003 Federal tax return the 30-percent additional first year depreciation attributable to the equipment and, on its 2003 and 2004 Federal tax returns, depreciated the remaining adjusted depreciable basis of the equipment under the general depreciation system under 168(a), using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. In 2005, I2 realizes its failure to make the alternative depreciation system election in 2003 and files a Form 3115, ''Application for Change in Accounting Method,'' to change its method of depreciating the remaining adjusted depreciable basis of the 2003 equipment to the alternative depreciation system. Because this equipment is not required to be depreciated under the alternative depreciation system, I2 is attempting to make an election under section 168(g)(7). However, this election must be made in the taxable year in which the equipment is placed in service (2003) and, consequently, I2 is attempting to make a late election under section 168(g)(7). Accordingly, I2's change to the alternative depreciation system is not a change in accounting method pursuant to paragraph (e)(2)(ii)(*d*)(*3*)(*iii*) of this section. Instead, I2 must submit a request for a private letter ruling under § 301.9100–3 of this chapter, requesting an extension of time to make the alternative depreciation system election on its 2003 Federal tax return.

Example 18. On December 1, 2004, J, a calendar year taxpayer, purchased and placed in service 20 previously-owned adding machines. For the 2004 taxable year, J incorrectly classified the adding machines as items in its ''suspense'' account for financial and tax accounting purposes. Assets in this suspense account are not depreciated until reclassified to a depreciable fixed asset account. In January 2006, J realizes that the cost of the adding machines is still in the suspense account and reclassifies such cost to the appropriate depreciable fixed asset account. As a result, on its 2004 and 2005 Federal tax returns, J did not depreciate the cost of the adding machines. Pursuant to paragraph (e)(2)(ii)(*d*)(*2*) of this section, J's change in the treatment of the adding machines from nondepreciable assets to depreciable assets is a change in method of accounting. The placed-in-service date exception under paragraph (e)(2)(ii)(*d*)(*3*)(*v*) of this section does not apply because the adding machines were incorrectly classified in a nondepreciable suspense account. This method change results in a section 481 adjustment.

Example 19. In December 2003, K, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. However, K did not receive the invoice for this equipment until January 2004. As a result, K classified the equipment on its fixed asset records as being placed in service in January 2004. On its 2004 and 2005 Federal tax returns, K depreciated the cost of the equipment. In 2006, K realizes that the equipment was actually placed in service during the 2003 taxable year and, therefore, depreciation should have began in the 2003 taxable year instead of the 2004 taxable year. Pursuant to paragraph (e)(2)(ii)(*d*)(*3*)(*v*) of this section, K's change in the placed-in-service date of the equipment is not a change in method of accounting.

(3)(i) Except as otherwise provided under the authority of paragraph (e)(3)(ii) of this section, to secure the Commissioner's consent to a taxpayer's change in method of accounting the taxpayer generally must file an application on Form 3115, ''Application for Change in Accounting Method,'' with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. See §§ 1.381(c)(4)–1(d)(2) and 1.381(c)(5)–1(d)(2) for rules allowing additional time, in some circumstances, for the filing of an application on Form 3115 with respect to a transaction to which section 381(a) applies. To the extent applicable, the taxpayer must furnish all information requested on the Form 3115. This information includes all classes of items that will be treated differently under the new method of accounting, any amounts that will be duplicated or omitted as a result of the proposed change, and the taxpayer's computation of any adjustments necessary to prevent such duplications or omissions. The Commissioner may require such other information as may be necessary to determine whether the proposed change will be permitted.

Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer agrees to the Commissioner's prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is to be taken into account. See section 481 and the regulations thereunder, relating to certain adjustments resulting from accounting method changes, and section 472 and the regulations thereunder, relating to adjustments for changes to and from the last-in, first-out inventory method. For any Form 3115 filed on or after May 15, 1997, see §1.446–1T(e)(3)(i)(B).

(ii) Notwithstanding the provisions of paragraph (e)(3)(i) of this section, the Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted. The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or by an adjustment under section 481(a) to be taken into account in the taxable year or years prescribed by the Commissioner.

(iii) This paragraph (e)(3) applies to Forms 3115 filed on or after December 31, 1997. For other Forms 3115, see §1.446–1(e)(3) in effect prior to December 31, 1997 (§1.446–1(e)(3) as contained in the 26 CFR part 1 edition revised as of April 1, 1997).

(4) *Effective date*—(i) *In general.* Except as provided in paragraphs (e)(3)(iii), (e)(4)(ii), and (e)(4)(iii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.446–1(e) in effect prior to December 30, 2003 (§1.446–1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(ii) *Changes involving depreciable or amortizable assets.* With respect to paragraph (e)(2)(ii)(*d*) of this section, paragraph (e)(2)(iii) *Examples 9* through *19* of this section, and the language ''certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(*d*) of this section)'' in the last sentence of paragraph (e)(2)(ii)(*a*) of this section—

(A) For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003; and

(B) For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003.

(iii) *Effective/applicability date for paragraph (e)(3)(i).* The rules of paragraph (e)(3)(i) of this section apply to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after August 31, 2011.

[T.D. 6500, 25 FR 11708, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.446–1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov.*

§1.446–2 Method of accounting for interest.

(a) *Applicability*—(1) *In general.* This section provides rules for determining the amount of interest that accrues during an accrual period (other than interest described in paragraph (a)(2) of this section) and for determining the portion of a payment that consists of accrued interest. For purposes of this section, interest includes original issue discount and amounts treated as interest (whether stated or unstated) in any lending or deferred payment transaction. Accrued interest determined under this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method). Application of an exception described in paragraph (a)(2) of this section to one party to a transaction does not affect

the application of this section to any other party to the transaction.

(2) *Exceptions*—(i) *Interest included or deducted under certain other provisions.* This section does not apply to interest that is taken into account under—

(A) Sections 1272(a), 1275, and 163(e) (income and deductions relating to original issue discount);

(B) Section 467(a)(2) (certain payments for the use of property or services);

(C) Sections 1276 through 1278 (market discount);

(D) Sections 1281 through 1283 (discount on certain short-term obligations);

(E) Section 7872(a) (certain loans with below-market interest rates); or

(F) Section 1.1272–3 (an election by a holder to treat all interest on a debt instrument as original issue discount).

(ii) *De minimis original issue discount.* This section does not apply to de minimis original issue discount (other than de minimis original issue discount treated as qualified stated interest) as determined under §1.1273–1(d). See §1.163–7 for the treatment of de minimis original issue discount by the issuer and §§1.1273–1(d) and 1.1272–3 for the treatment of de minimis original issue discount by the holder.

(b) *Accrual of qualified stated interest.* Qualified stated interest (as defined in §1.1273–1(c)) accrues ratably over the accrual period (or periods) to which it is attributable and accrues at the stated rate for the period (or periods).

(c) *Accrual of interest other than qualified stated interest.* Subject to the modifications in paragraph (d) of this section, the amount of interest (other than qualified stated interest) that accrues for any accrual period is determined under rules similar to those in the regulations under sections 1272 and 1275 for the accrual of original issue discount. The preceding sentence applies regardless of any contrary formula agreed to by the parties.

(d) *Modifications*—(1) *Issue price.* The issue price of the loan or contract is equal to—

(i) In the case of a contract for the sale or exchange of property to which section 483 applies, the amount described in §1.483–2(a)(1)(i) or (ii), whichever is applicable;

(ii) In the case of a contract for the sale or exchange of property to which section 483 does not apply, the stated principal amount; or

(iii) In any other case, the amount loaned.

(2) *Principal payments that are not deferred payments.* In the case of a contract to which section 483 applies, principal payments that are not deferred payments are ignored for purposes of determining yield and adjusted issue price.

(e) *Allocation of interest to payments*—(1) *In general.* Except as provided in paragraphs (e)(2), (e)(3), and (e)(4) of this section, each payment under a loan (other than payments of additional interest or similar charges provided with respect to amounts that are not paid when due) is treated as a payment of interest to the extent of the accrued and unpaid interest determined under paragraphs (b) and (c) of this section as of the date the payment becomes due.

(2) *Special rule for points deductible under section 461(g)(2).* If a payment of points is deductible by the borrower under section 461(g)(2), the payment is treated by the borrower as a payment of interest.

(3) *Allocation respected in certain small transactions.* [Reserved]

(4) *Pro rata prepayments.* Accrued but unpaid interest is allocated to a pro rata prepayment under rules similar to those for allocating accrued but unpaid original issue discount to a pro rata prepayment under §1.1275–2(f). For purposes of the preceding sentence, a pro rata prepayment is a payment that is made prior to maturity that—

(i) Is not made pursuant to the contract's payment schedule; and

(ii) Results in a substantially pro rata reduction of each payment remaining to be paid on the contract.

(f) *Aggregation rule.* For purposes of this section, all contracts calling for deferred payments arising from the same transaction (or a series of related transactions) are treated as a single contract. This rule, however, generally only applies to contracts involving a single borrower and a single lender.

(g) *Debt instruments denominated in a currency other than the U.S. dollar.* This section applies to a debt instrument

that provides for all payments denominated in, or determined by reference to, the functional currency of the taxpayer or qualified business unit of the taxpayer (even if that currency is other than the U.S. dollar). See § 1.988–2(b) to determine interest income or expense for debt instruments that provide for payments denominated in, or determined by reference to, a nonfunctional currency.

(h) *Example*. The following example illustrates the rules of this section.

Example. Allocation of unstated interest to deferred payments—(i) *Facts*. On July 1, 1996, A sells his personal residence to B for a stated purchase price of $1,297,143.66. The property is not personal use property (within the meaning of section 1275(b)(3)) in the hands of B. Under the loan agreement, B is required to make two installment payments of $648,571.83 each, the first due on June 30, 1998, and the second due on June 30, 2000. Both A and B use the cash receipts and disbursements method of accounting and use a calendar year for their taxable year.

(ii) *Amount of unstated interest*. Under section 483, the agreement does not provide for adequate stated interest. Thus, the loan's yield is the test rate of interest determined under § 1.483–3. Assume that both A and B use annual accrual periods and that the test rate of interest is 9.2 percent, compounded annually. Under § 1.483–2, the present value of the deferred payments is $1,000,000. Thus, the agreement has unstated interest of $297,143.66.

(iii) *First two accrual periods*. Under paragraph (d)(1) of this section, the issue price at the beginning of the first accrual period is $1,000,000 (the amount described in § 1.483–2(a)(1)(i)). Under paragraph (c) of this section, the amount of interest that accrues for the first accrual period is $92,000 ($1,000,000×.092) and the amount of interest that accrues for the second accrual period is $100,464 ($1,092,000×.092). Thus, $192,464 of interest has accrued as of the end of the second accrual period. Under paragraph (e)(1) of this section, the $648,571.83 payment made on June 30, 1998, is treated first as a payment of interest to the extent of $192,464. The remainder of the payment ($456,107.83) is treated as a payment of principal. Both A and B take the payment of interest ($192,464) into account in 1998.

(iv) *Second two accrual periods*. The adjusted issue price at the beginning of the third accrual period is $543,892.17 ($1,092,000+$100,464–$648,571.83). The amount of interest that accrues for the third accrual period is $50,038.08 ($543,892.17×.092) and the amount of interest that accrues for the final accrual period is $54,641.58, the excess of the amount payable at maturity ($648,571.83), over the adjusted issue price at the beginning of the accrual period ($593,930.25). As of the date the second payment becomes due, $104,679.66 of interest has accrued. Thus, of the $648,571.83 payment made on June 30, 2000, $104,679.66 is treated as interest and $543,892.17 is treated as principal. Both A and B take the payment of interest ($104,679.66) into account in 2000.

(i) [Reserved]

(j) *Effective date*. This section applies to debt instruments issued on or after April 4, 1994, and to lending transactions, sales, and exchanges that occur on or after April 4, 1994. Taxpayers, however, may rely on this section for debt instruments issued after December 21, 1992, and before April 4, 1994, and for lending transactions, sales, and exchanges that occur after December 21, 1992, and before April 4, 1994.

[T.D. 8517, 59 FR 4804, Feb. 2, 1994]

§ 1.446–3 Notional principal contracts.

(a) *Table of contents*. This paragraph (a) lists captioned paragraphs contained in § 1.446–3.

§ 1.446–3 Notional principal contracts.

(b) *Purpose*. The purpose of this section is to enable the clear reflection of the income and deductions from notional principal contracts by prescribing accounting methods that reflect the economic substance of such contracts.

(c) *Definitions and scope*—(1) *Notional principal contract*—(i) *In general*. A notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts. An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract because a taxpayer cannot enter into a contract with itself. Notional principal contracts governed by this section include interest rate swaps, currency swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, equity index swaps, and similar agreements. A collar is not itself a notional principal contract, but certain caps and floors that comprise a collar may be treated as a single notional principal contract under paragraph (f)(2)(v)(C) of this section. A contract may be a notional principal contract governed by this section even though the term of the contract is subject to termination or extension. Each confirmation under a master agreement to enter into agreements governed by this section is treated as a separate notional principal contract.

(ii) *Excluded contracts*. A contract described in section 1256(b), a futures contract, a forward contract, and an option are not notional principal contracts. An instrument or contract that constitutes indebtedness under general principles of Federal income tax law is not a notional principal contract. An option or forward contract that entitles or obligates a person to enter into a notional principal contract is not a notional principal contract, but payments made under such an option or forward contract may be governed by paragraph (g)(3) of this section.

(iii) *Transactions within section 475*. To the extent that the rules provided in paragraphs (e) and (f) of this section are inconsistent with the rules that apply to any notional principal contract that is governed by section 475 and regulations thereunder, the rules of section 475 and the regulations thereunder govern.

(iv) *Transactions within section 988*. To the extent that the rules provided in this section are inconsistent with the rules that apply to any notional principal contract that is also a section 988 transaction or that is integrated with other property or debt pursuant to section 988(d), the rules of section 988 and the regulations thereunder govern.

(2) *Specified index*. A specified index is—

(i) A fixed rate, price, or amount;

(ii) A fixed rate, price, or amount applicable in one or more specified periods followed by one or more different fixed rates, prices, or amounts applicable in other periods;

(iii) An index that is based on objective financial information (as defined in paragraph (c)(4)(ii) of this section); and

(iv) An interest rate index that is regularly used in normal lending transactions between a party to the contract and unrelated persons.

(3) *Notional principal amount.* For purposes of this section, a notional principal amount is any specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract, but is not borrowed or loaned between the parties as part of the contract. The notional principal amount may vary over the term of the contract, provided that it is set in advance or varies based on objective financial information (as defined in paragraph (c)(4)(ii) of this section).

(4) *Special definitions*—(i) *Related person and party to the contract.* A related person is a person related (within the meaning of section 267(b) or 707(b)(1)) to one of the parties to the notional principal contract or a member of the same consolidated group (as defined in § 1.1502–1(h)) as one of the parties to the contract. For purposes of this paragraph (c), a related person is considered to be a party to the contract.

(ii) *Objective financial information.* For purposes of this paragraph (c), objective financial information is any current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances (such as one party's dividends, profits, or the value of its stock). Thus, for example, a notional principal amount may be based on a broadly-based equity index or the outstanding balance of a pool of mortgages, but not on the value of a party's stock.

(iii) *Dealer in notional principal contracts.* A dealer in notional principal contracts is a person who regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in notional principal contracts with customers in the ordinary course of a trade or business.

(d) *Taxable year of inclusion and deduction.* For all purposes of the Code, the net income or net deduction from a notional principal contract for a taxable year is included in or deducted from gross income for that taxable year. The net income or net deduction from a notional principal contract for a taxable year equals the total of all of the periodic payments that are recognized from that contract for the taxable year under paragraph (e) of this section and all of the nonperiodic payments that are recognized from that contract for the taxable year under paragraph (f) of this section.

(e) *Periodic payments*—(1) *Definition.* Periodic payments are payments made or received pursuant to a notional principal contract that are payable at intervals of one year or less during the entire term of the contract (including any extension periods provided for in the contract), that are based on a specified index described in paragraph (c)(2)(i), (iii), or (iv) of this section (appropriately adjusted for the length of the interval), and that are based on either a single notional principal amount or a notional principal amount that varies over the term of the contract in the same proportion as the notional principal amount that measures the other party's payments. Payments to purchase or sell a cap or a floor, however, are not periodic payments.

(2) *Recognition rules*—(i) *In general.* All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a periodic payment for the taxable year to which that portion relates.

(ii) *Rate set in arrears.* If the amount of a periodic payment is not determinable at the end of a taxable year because the value of the specified index is not fixed until a date that occurs after the end of the taxable year, the ratable daily portion of a periodic payment that relates to that taxable year is generally based on the specified index that would have applied if the specified index were fixed as of the last day of the taxable year. If a taxpayer determines that the value of the specified index as of the last day of the taxable year does not provide a reasonable estimate of the specified index that will apply when the payment is fixed, the taxpayer may use a reasonable estimate of the specified index each year, provided that the taxpayer (and any related person that is a party to the contract) uses the same method to make the estimate consistently from year to

year and uses the same estimate for purposes of all financial reports to equity holders and creditors. The taxpayer's treatment of notional principal contracts with substantially similar specified indices will be considered in determining whether the taxpayer's estimate of the specified index is reasonable. Any difference between the amount that is recognized under this paragraph (e)(2)(ii) and the corresponding portion of the actual payment that becomes fixed under the contract is taken into account as an adjustment to the net income or net deduction from the notional principal contract for the taxable year during which the payment becomes fixed.

(iii) *Notional principal amount set in arrears.* Rules similar to the rules of paragraph (e)(2)(ii) of this section apply if the amount of a periodic payment is not determinable at the end of a taxable year because the notional principal amount is not fixed until a date that occurs after the end of the taxable year.

(3) *Examples.* The following examples illustrate the application of paragraph (e) of this section.

Example 1. Accrual of periodic swap payments. (a) On April 1, 1995, *A* enters into a contract with unrelated counterparty *B* under which, for a term of five years, *A* is obligated to make a payment to *B* each April 1, beginning April 1, 1996, in an amount equal to the London Interbank Offered Rate (LIBOR), as determined on the immediately preceding April 1, multiplied by a notional principal amount of $100 million. Under the contract, *B* is obligated to make a payment to *A* each April 1, beginning April 1, 1996, in an amount equal to 8% multiplied by the same notional principal amount. *A* and *B* are calendar year taxpayers that use the accrual method of accounting. On April 1, 1995, LIBOR is 7.80%.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and both LIBOR and a fixed interest rate of 8% are specified indices under paragraph (c)(2) of this section. All of the payments to be made by *A* and *B* are periodic payments under paragraph (e)(1) of this section because each party's payments are based on a specified index described in paragraphs (c)(2)(iii) and (c)(2)(i) of this section, respectively, are payable at periodic intervals of one year or less throughout the term of the contract, and are based on a single notional principal amount.

(c) Under the terms of the swap agreement, on April 1, 1996, *B* is obligated to make a payment to *A* of $8,000,000 (8%×$100,000,000) and *A* is obligated to make a payment to *B* of $7,800,000 (7.80%×$100,000,000). Under paragraph (e)(2)(i) of this section, the ratable daily portions for 1995 are the amounts of these periodic payments that are attributable to *A*'s and *B*'s taxable year ending December 31, 1995. The ratable daily portion of the 8% fixed leg is $6,010,929 (275 days/366 days×$8,000,000), and the ratable daily portion of the floating leg is $5,860,656 (275 days/366 days×$7,800,000). The net amount for the taxable year is the difference between the ratable daily portions of the two periodic payments, or $150,273 ($6,010,929—$5,860,656). Accordingly, *A* has net income of $150,273 from this swap for 1995, and *B* has a corresponding net deduction of $150,273.

(d) The $49,727 unrecognized balance of the $200,000 net periodic payment that is made on April 1, 1996, is included in *A*'s and *B*'s net income or net deduction from the contract for 1996.

(e) If the parties had entered into the contract on February 1, 1995, the result would not change because no portion of either party's obligation to make a payment under the swap relates to the period prior to April 1, 1995. Consequently, under paragraph (e)(2) of this section, neither party would accrue any income or deduction from the swap for the period from February 1, 1995, through March 31, 1995.

Example 2. Accrual of periodic swap payments by cash method taxpayer. (a) On April 1, 1995, *C* enters into a contract with unrelated counterparty *D* under which, for a period of five years, *C* is obligated to make a fixed payment to *D* each April 1, beginning April 1, 1996, in an amount equal to 8% multiplied by a notional principal amount of $100 million. *D* is obligated to make semi-annual payments to *C* each April 1 and October 1, beginning October 1, 1995, in an amount equal to one-half of the LIBOR amount as of the first day of the preceding 6-month period multiplied by the notional principal amount. The payments are to be calculated using a 30/360 day convention. *C* is a calendar year taxpayer that uses the accrual method of accounting. *D* is a calendar year taxpayer that uses the cash receipts and disbursements method of accounting. LIBOR is 7.80% on April 1, 1995, and 7.46% on October 1, 1995.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and LIBOR and the fixed interest rate of 8% are each specified indices under paragraph (c)(2) of this section. All of the payments to be made by *C* and *D* are periodic payments under paragraph (e)(1) of this section because they are each based on appropriate specified indices, are payable at periodic intervals of one year or less

throughout the term of the contract, and are based on a single notional principal amount.

(c) Under the terms of the swap agreement, *D* pays *C* $3,900,000 (0.5×7.8%×$100,000,000) on October 1, 1995. In addition, *D* is obligated to pay *C* $3,730,000 (0.5×7.46%×$100,000,000) on April 1, 1996. *C* is obligated to pay *D* $8,000,000 on April 1, 1996. Under paragraph (e)(2)(i) of this section, *C*'s and *D*'s ratable daily portions for 1995 are the amounts of the periodic payments that are attributable to their taxable year ending December 31, 1995. The ratable daily portion of the 8% fixed leg is $6,000,000 (270 days/360 days×$8,000,000), and the ratable daily portion of the floating leg is $5,765,000 ($3,900,000 + (90 days/180 days×$3,730,000)). Thus, *C*'s net deduction from the contract for 1995 is $235,000 ($6,000,000—$5,765,000) and *D* reports $235,000 of net income from the contract for 1995.

(d) The net unrecognized balance of $135,000 ($2,000,000 balance of the fixed leg—$1,865,000 balance of the floating leg) is included in *C*'s and *D*'s net income or net deduction from the contract for 1996.

Example 3. Accrual of swap payments on index set in arrears. (a) The facts are the same as in *Example 1,* except that *A*'s obligation to make payments based upon LIBOR is determined by reference to LIBOR on the day each payment is due. LIBOR is 8.25% on December 31, 1995, and 8.16% on April 1, 1996.

(b) On December 31, 1995, the amount that *A* is obligated to pay *B* is not known because it will not become fixed until April 1, 1996. Under paragraph (e)(2)(ii) of this section, the ratable daily portion of the periodic payment from *A* to *B* for 1995 is based on the value of LIBOR on December 31, 1995 (unless *A* or *B* determines that the value of LIBOR on that day does not reasonably estimate the value of the specified index). Thus, the ratable daily portion of the floating leg is $6,198,770 (275 days/366 days×8.25%×$100,000,000), while the ratable daily portion of the fixed leg is $6,010,929 (275 days/366 days×$8,000,000). The net amount for 1995 on this swap is $187,841 ($6,198,770—$6,010,929). Accordingly, *B* has $187,841 of net income from the swap in 1995, and *A* has a net deduction of $187,841.

(c) On April 1, 1996, *A* makes a net payment to *B* of $160,000 ($8,160,000 payment on the floating leg—$8,000,000 payment on the fixed leg). For purposes of determining their net income or net deduction from this contract for the year ended December 31, 1996, *B* and *A* must adjust the net income and net deduction they recognized in 1995 by $67,623 (275 days/366 days×($8,250,000 presumed payment on the floating leg—$8,160,000 actual payment on the floating leg)).

(f) *Nonperiodic payments*—(1) *Definition.* A nonperiodic payment is any payment made or received with respect to a notional principal contract that is not a periodic payment (as defined in paragraph (e)(1) of this section) or a termination payment (as defined in paragraph (h) of this section). Examples of nonperiodic payments are the premium for a cap or floor agreement (even if it is paid in installments), the payment for an off-market swap agreement, the prepayment of part or all of one leg of a swap, and the premium for an option to enter into a swap if and when the option is exercised.

(2) *Recognition rules*—(i) *In general.* All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a nonperiodic payment for the taxable year to which that portion relates. Generally, a nonperiodic payment must be recognized over the term of a notional principal contract in a manner that reflects the economic substance of the contract.

(ii) *General rule for swaps.* A nonperiodic payment that relates to a swap must be recognized over the term of the contract by allocating it in accordance with the forward rates (or, in the case of a commodity, the forward prices) of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount. For purposes of this allocation, the forward rates or prices used to determine the amount of the nonperiodic payment will be respected, if reasonable. See paragraph (f)(4) *Example 7* of this section.

(iii) *Alternative methods for swaps.* Solely for purposes of determining the timing of income and deductions, a nonperiodic payment made or received with respect to a swap may be allocated to each period of the swap contract using one of the methods described in this paragraph (f)(2)(iii). The alternative methods may not be used by a dealer in notional principal contracts (as defined in paragraph (c)(4)(iii) of this section) for swaps entered into or acquired in its capacity as a dealer.

(A) *Prepaid swaps.* An upfront payment on a swap may be amortized by assuming that the nonperiodic payment represents the present value of a series of equal payments made throughout the term of the swap contract (the level payment method), adjusted as appropriate to take account

of increases or decreases in the notional principal amount. The discount rate used in this calculation must be the rate (or rates) used by the parties to determine the amount of the nonperiodic payment. If that rate is not readily ascertainable, the discount rate used must be a rate that is reasonable under the circumstances. Under this method, an upfront payment is allocated by dividing each equal payment into its principal recovery and time value components. The principal recovery components of the equal payments are treated as periodic payments that are deemed to be made on each of the dates that the swap contract provides for periodic payments by the payor of the nonperiodic payment or, if none, on each of the dates that the swap contract provides for periodic payments by the recipient of the nonperiodic payment. The time value component is needed to compute the amortization of the nonperiodic payment, but is otherwise disregarded. See paragraph (f)(4) *Example 5* of this section.

(B) *Other nonperiodic swap payments.* Nonperiodic payments on a swap other than an upfront payment may be amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties. The discount rate (or rates) used in determining the deemed upfront payment and the time value component of the deemed loan is the same as the rate (or rates) used in the level payment method. The single upfront payment is then amortized under the level payment method described in paragraph (f)(2)(iii)(A) of this section. The time value component of the loan is not treated as interest, but, together with the amortized amount of the deemed upfront payment, is recognized as a periodic payment. See paragraph (f)(4) *Example 6* of this section. If both parties make nonperiodic payments, this calculation is done separately for the nonperiodic payments made by each party.

(iv) *General rule for caps and floors.* A payment to purchase or sell a cap or floor must be recognized over the term of the agreement by allocating it in accordance with the prices of a series of cash-settled option contracts that reflect the specified index and the notional principal amount. For purposes of this allocation, the option pricing used by the parties to determine the total amount paid for the cap or floor will be respected, if reasonable. Only the portion of the purchase price that is allocable to the option contract or contracts that expire during a particular period is recognized for that period. Thus, under this paragraph (f)(2)(iv), straight-line or accelerated amortization of a cap premium is generally not permitted. See paragraph (f)(4) *Examples 1* and *2* of this section.

(v) *Alternative methods for caps and floors that hedge debt instruments.* Solely for purposes of determining the timing of income and deductions, if a cap or floor is entered into primarily to reduce risk with respect to a specific debt instrument or group of debt instruments held or issued by the taxpayer, the taxpayer may amortize a payment to purchase or sell the cap or floor using the methods described in this paragraph (f)(2)(v), adjusted as appropriate to take account of increases or decreases in the notional principal amount. The alternative methods may not be used by a dealer in notional principal contracts (as defined in paragraph (c)(4)(iii) of this section) for caps or floors entered into or acquired in its capacity as a dealer.

(A) *Prepaid caps and floors.* A premium paid upfront for a cap or a floor may be amortized using the ''level payment method'' described in paragraph (f)(2)(iii)(A) of this section. See paragraph (f)(4) *Example 3* of this section.

(B) *Other caps and floors.* Nonperiodic payments on a cap or floor other than an upfront payment are amortized by treating the contract as if it provided for a single upfront payment (equal to the present value of the nonperiodic payments) and a loan between the parties as described in paragraph (f)(2)(iii)(B) of this section. Under the level payment method, a cap or floor premium paid in level annual installments over the term of the contract is effectively included or deducted from income ratably, in accordance with the level payments. See paragraph (f)(4) *Example 4* of this section.

(C) *Special method for collars.* A taxpayer may also treat a cap and a floor

that comprise a collar as a single notional principal contract and may amortize the net nonperiodic payment to enter into the cap and floor over the term of the collar in accordance with the methods prescribed in this paragraph (f)(2)(v).

(vi) *Additional methods.* The Commissioner may, by a revenue ruling or a revenue procedure published in the Internal Revenue Bulletin, provide alternative methods for allocating nonperiodic payments that relate to a notional principal contract to each year of the contract. See § 601.601(d)(2)(ii)(*b*) of this chapter.

(3) *Term of extendible or terminable contracts.* For purposes of this paragraph (f), the term of a notional principal contract that is subject to extension or termination is the reasonably expected term of the contract.

(4) *Examples.* The following examples illustrate the application of paragraph (f) of this section.

Example 1.Cap premium amortized using general rule. (a) On January 1, 1995, when LIBOR is 8%, *F* pays unrelated party *E* $600,000 for a contract that obligates *E* to make a payment to *F* each quarter equal to one-quarter of the excess, if any, of three-month LIBOR over 9% with respect to a notional principal amount of $25 million. Both *E* and *F* are calendar year taxpayers. *E* provides *F* with a schedule of allocable premium amounts indicating that the cap was priced according to a reasonable variation of the Black-Scholes option pricing formula and that the total premium is allocable to the following periods:

	Pricing allocation
1995	$55,000
1996	225,000
1997	320,000
	$600,000

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and LIBOR is a specified index under paragraph (c)(2)(iii) of this section. Any payments made by *E* to *F* are periodic payments under paragraph (e)(1) of this section because they are payable at periodic intervals of one year or less throughout the term of the contract, are based on an appropriate specified index, and are based on a single notional principal amount. The $600,000 cap premium paid by *F* to *E* is a nonperiodic payment as defined in paragraph (f)(1) of this section.

(c) The Black-Scholes model is recognized in the financial industry as a standard technique for pricing interest rate cap agreements. Therefore, because *E* has used a reasonable option pricing model, the schedule generated by *E* is consistent with the economic substance of the cap, and may be used by both *E* and *F* for calculating their ratable daily portions of the cap premium. Under paragraph (f)(2)(iv) of this section, *E* recognizes the ratable daily portion of the cap premium as income, and *F* recognizes the ratable daily portion of the cap premium as a deduction based on the pricing schedule. Thus, *E* and *F* account for the contract as follows:

	Ratable daily portion
1995	$55,000
1996	225,000
1997	320,000
	$600,000

(d) Any periodic payments under the cap agreement (that is, payments that *E* makes to *F* because LIBOR exceeds 9%) are included in the parties' net income or net deduction from the contract in accordance with paragraph (e)(2) of this section.

Example 2. Cap premium allocated to proper period. (a) The facts are the same as in *Example 1,* except that the cap is purchased by *F* on November 1, 1994. The first determination date under the cap agreement is January 31, 1995 (the last day of the first quarter to which the contract relates). LIBOR is 9.1% on December 31, 1994, and is 9.15% on January 31, 1995.

(b) *E* and *F* recognize $9,192 (61 days/365 days×$55,000) as the ratable daily portion of the nonperiodic payment for 1994, and include that amount in their net income or net deduction from the contract for 1994. If *E*'s pricing model allocated the cap premium to each quarter covered by the contract, the ratable daily portion would be 61 days/92 days times the premium allocated to the first quarter.

(c) Under paragraph (e)(2)(ii) of this section, *E* and *F* calculate the payments using LIBOR as of December 31, 1994. *F* recognizes as income the ratable daily portion of the presumed payment, or $4,144 (61 days/92 days×.25×.001×$25,000,000). Thus, *E* reports $5,048 of net income from the contract for 1994 ($9,192–$4,144), and *F* reports a net deduction from the contract of $5,048.

(d) On January 31, 1995, *E* pays *F* $9,375 (.25×.0015×$25,000,000) under the terms of the cap agreement. For purposes of determining their net income or net deduction from this contract for the year ended December 31, 1995, *E* and *F* must adjust their respective net income and net deduction from the cap

by $2,072 (61 days/92 days×($9,375 actual payment under the cap on January 31, 1995—$6,250 presumed payment under the cap on December 31, 1994)).

Example 3. Cap premium amortized using alternative method. (a) The facts are the same as in *Example 1*, except that the cap provides for annual payments by *E* and is entered into by F primarily to reduce risk with respect to a debt instrument issued by *F*. *F* elects to amortize the cap premium using the alternative level payment method provided under paragraph (f)(2)(v)(A) of this section. Under that method, *F* amortizes the cap premium by assuming that the $600,000 is repaid in 3 equal annual payments of $241,269, assuming a discount rate of 10%. Each payment is divided into a time value component and a principal component, which are set out below.

	Level payment	Time value component	Principal component
1995	$241,269	$60,000	$181,269
1996	241,269	41,873	199,396
1997	241,269	21,934	219,335
	$723,807	$123,807	$600,000

(b) The net of the ratable daily portions of the principal component and the payments, if any, received from *E* comprise *F*'s annual net income or net deduction from the cap. The time value components are needed only to compute the ratable daily portions of the cap premium, and are otherwise disregarded.

Example 4. Cap premium paid in level installments and amortized using alternative method. (a) The facts are the same as in *Example 3*, except that *F* agrees to pay for the cap in three level installments of $241,269 (a total of $723,807) on December 31, 1995, 1996, and 1997. The present value of three payments of $241,269, discounted at 10%, is $600,000. For purposes of amortizing the cap premium under the alternative method provided in paragraph (f)(2)(v)(B) of this section, *F* is treated as paying $600,000 for the cap on January 1, 1995, and borrowing $600,000 from *E* that will be repaid in three annual installments of $241,269. The time value component of the loan is computed as follows:

	Loan balance	Time value component	Principal component
1995	$600,000	$60,000	$181,269
1996	418,731	41,873	199,396
1997	219,335	21,934	219,335
		$123,807	$600,000

(b) *F* is treated as making periodic payments equal to the amortized principal components from a $600,000 cap paid in advance (as described in *Example 3*), increased by the time value components of the $600,000 loan, which totals $241,269 each year. The time value components of the $600,000 loan are included in the periodic payments made by *F*, but are not characterized as interest income or expense. The effect of the alternative method in this situation is to allow *F* to amortize the cap premium in level installments, the same way it is paid. The net of the ratable daily portions of *F*'s deemed periodic payments and the payments, if any, received from *E* comprise *F*'s annual net income or net deduction from the cap.

Example 5. Upfront interest rate swap payment amortized using alternative method. (a) On January 1, 1995, *G* enters into an interest rate swap agreement with unrelated counterparty *H* under which, for a term of five years, *G* is obligated to make annual payments at 11% and H is obligated to make annual payments at LIBOR on a notional principal amount of $100 million. At the time *G* and *H* enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, on January 1, 1995, *H* pays *G* a yield adjustment fee of $3,790,786. *G* provides *H* with information that indicates that the amount of the yield adjustment fee was determined as the present value, at 10% compounded annually, of five annual payments of $1,000,000 (1%×$100,000,000). *G* and *H* are calendar year taxpayers.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section. The yield adjustment fee is a nonperiodic payment as defined in paragraph (f)(1) of this section.

(c) Under the alternative method described in paragraph (f)(2)(iii)(A) of this section, the yield adjustment fee is recognized over the life of the agreement by assuming that the

$3,790,786 is repaid in five level payments. Assuming a constant yield to maturity and annual compounding at 10%, the ratable daily portions are computed as follows:

	Level payment	Time value component	Principal component
1995	$1,000,000	$379,079	$620,921
1996	1,000,000	316,987	683,013
1997	1,000,000	248,685	751,315
1998	1,000,000	173,554	826,446
1999	1,000,000	90,909	909,091
	$5,000,000	$1,209,214	$3,790,786

(d) *G* also makes swap payments to *H* at 11%, while *H* makes swap payments to *G* based on LIBOR. The net of the ratable daily portions of the 11% payments by *G*, the LIBOR payments by *H*, and the principal component of the yield adjustment fee paid by *H* determines the annual net income or net deduction from the contract for both *G* and *H*. The time value components are needed only to compute the ratable daily portions of the yield adjustment fee paid by *H*, and are otherwise disregarded.

Example 6. Backloaded interest rate swap payment amortized using alternative method. (a) The facts are the same as in *Example 5*, but *H* agrees to pay *G* a yield adjustment fee of $6,105,100 on December 31, 1999. Under the alternative method in paragraph (f)(2)(iii)(B) of this section, *H* is treated as paying a yield adjustment fee of $3,790,786 (the present value of $6,105,100, discounted at a 10% rate with annual compounding) on January 1, 1995. Solely for timing purposes, *H* is treated as borrowing $3,790,786 from *G*. Assuming annual compounding at 10%, the time value component is computed as follows:

	Loan balance	Time value component	Principal component
1995	$3,790,786	$379,079	0
1996	4,169,865	416,987	0
1997	4,586,852	458,685	0
1998	5,045,537	504,554	0
1999	5,550,091	555,009	6,105,100

(b) The amortization of *H*'s yield adjustment fee is equal to the amortization of a yield adjustment fee of $3,790,786 paid in advance (as described in *Example 5*), increased by the time value component of the $3,790,786 deemed loan from *G* to *H*. Thus, the amount of *H*'s yield adjustment fee that is allocated to 1995 is $1,000,000 ($620,921 + $379,079). The time value components of the $3,790,786 loan are included in the periodic payments paid by *H*, but are not characterized as interest income or expense. The net of the ratable daily portions of the 11% swap payments by *G*, and the LIBOR payments by H, added to the principal components from *Example 5* and the time value components from this *Example 6*, determines the annual net income or net deduction from the contract for both *G* and *H*.

Example 7. Nonperiodic payment on a commodity swap amortized under general rule. (a) On January 1, 1995, *I* enters into a commodity swap agreement with unrelated counterparty *J* under which, for a term of three years, *I* is obligated to make annual payments based on a fixed price of $2.35 per bushel times a notional amount of 100,000 bushels of corn and *J* is obligated to make annual payments equal to the spot price times the same notional amount. Assume that on January 1, 1995, the price of a one year forward for corn is $2.40 per bushel, of a two year forward $2.55 per bushel, and of a 3 year forward $2.75 per bushel. To compensate for the below-market fixed price provided in the swap agreement, *I* pays *J* $53,530 for entering into the swap. *I* and *J* are calendar year taxpayers.

(b) This contract is a notional principal contract as defined by paragraph (c)(1) of this section, and $2.35 and the spot price of corn are specified indices under paragraphs (c)(2)(i) and (iii) of this section, respectively. The $53,530 payment is a nonperiodic payment as defined by paragraph (f)(1) of this section.

(c) Assuming that *I* does not use the alternative methods provided under paragraph (f)(2)(iii) of this section, paragraph (f)(2)(ii) of this section requires that *I* recognize the nonperiodic payment over the term of the agreement by allocating the payment to each forward contract in accordance with the forward price of corn. Solely for timing purposes, *I* treats the $53,530 nonperiodic payment as a loan that *J* will repay in three

installments of $5,000, $20,000, and $40,000, the expected payouts on the in-the-money forward contracts. With annual compounding at 8%, the ratable daily portions are computed as follows:

	Expected forward payment	Time value component	Principal component
1995	$5,000	$4,282	$718
1996	20,000	4,225	15,775
1997	40,000	2,963	37,037
	$65,000	$11,470	$53,530

(d) The ratable daily portion of the principal component is added to *I*'s periodic payments in computing its net income or net deduction from the notional principal contract for each taxable year. The time value components are needed only to compute the principal components, and are otherwise disregarded.

(g) *Special rules*—(1) *Disguised notional principal contracts.* The Commissioner may recharacterize all or part of a transaction (or series of transactions) if the effect of the transaction (or series of transactions) is to avoid the application of this section.

(2) *Hedged notional principal contracts.* If a taxpayer, either directly or through a related person (as defined in paragraph (c)(4)(i) of this section), reduces risk with respect to a notional principal contract by purchasing, selling, or otherwise entering into other notional principal contracts, futures, forwards, options, or other financial contracts (other than debt instruments), the taxpayer may not use the alternative methods provided in paragraphs (f)(2)(iii) and (v) of this section. Moreover, where such positions are entered into to avoid the appropriate timing or character of income from the contracts taken together, the Commissioner may require that amounts paid to or received by the taxpayer under the notional principal contract be treated in a manner that is consistent with the economic substance of the transaction as a whole.

(3) *Options and forwards to enter into notional principal contracts.* An option or forward contract that entitles or obligates a person to enter into a notional principal contract is subject to the general rules of taxation for options or forward contracts. Any payment with respect to the option or forward contract is treated as a nonperiodic payment for the underlying notional principal contract under the rules of paragraphs (f) and (g)(4) or (g)(5) of this section if and when the underlying notional principal contract is entered into.

(4) *Swaps with significant nonperiodic payments.* A swap with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan is not included in the net income or net deduction from the swap under paragraph (d) of this section, but is recognized as interest for all purposes of the Internal Revenue Code. See paragraph (g)(6) *Example* 3 of this section. For purposes of section 956, the Commissioner may treat any nonperiodic swap payment, whether or not it is significant, as one or more loans.

(5) *Caps and floors that are significantly in-the-money.* [Reserved]

(6) *Examples.* The following examples illustrate the application of paragraph (g) of this section.

Example 1. Cap hedged with options. (a) On January 1, 1995, *K* sells to unrelated counterparty *L* three cash settlement European-style put options on Eurodollar time deposits with a strike rate of 9%. The options have exercise dates of January 1, 1996, January 1, 1997, and January 1, 1998, respectively. If LIBOR exceeds 9% on any of the exercise dates, *L* will be entitled, by exercising the relevant option, to receive from *K* an amount that corresponds to the excess of LIBOR over 9% times $25 million. *L* pays *K* $650,000 for the three options. Furthermore, *K* is related to *F*, the cap purchaser in paragraph (f)(4) *Example 1* of this section.

(b) *K*'s option agreements with *L* reduce risk with respect to *F*'s cap agreement with *E*. Accordingly, under paragraph (g)(2) of this

section, *F* cannot use the alternative methods provided in paragraph (f)(2)(v) of this section to amortize the premium paid under the cap agreement. *F* must amortize the cap premium it paid in accordance with paragraph (f)(2)(iv) of this section.

(c) The method that *E* may use to account for its agreement with *F* is not affected by the application of paragraph (g)(2) of this section to *F*.

Example 2. Nonperiodic payment that is not significant. (a) On January 1, 1995, *G* enters into an interest rate swap agreement with unrelated counterparty *H* under which, for a term of five years, *G* is obligated to make annual payments at 11% and *H* is obligated to make annual payments at LIBOR on a notional principal amount of $100 million. At the time *G* and *H* enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, on January 1, 1995, *H* pays *G* a yield adjustment fee of $3,790,786. *G* provides *H* with information that indicates that the amount of the yield adjustment fee was determined as the present value, at 10% compounded annually, of five annual payments of $1,000,000 (1%×$100,000,000). *G* and *H* are calendar year taxpayers. (These facts are the same as in paragraph (f)(4) *Example 5* of this section.)

(b) In this situation, the yield adjustment fee of $3,790,786 is not a significant nonperiodic payment within the meaning of paragraph (g)(4) of this section, in light of the amount of the fee in proportion to the present value of the total amount of fixed payments due under the contract. Accordingly, no portion of the swap is recharacterized as a loan for purposes of this section.

Example 3. Significant nonperiodic payment. (a) On January 1, 1995, unrelated parties *M* and *N* enter into an interest rate swap contract. Under the terms of the contract, *N* agrees to make five annual payments to *M* equal to LIBOR times a notional principal amount of $100 million. In return, *M* agrees to pay *N* 6% of $100 million annually, plus $15,163,147 on January 1, 1995. At the time *M* and *N* enter into this swap agreement the rate for similar on- market swaps is LIBOR to 10%, and *N* provides *M* with information that the amount of the initial payment was determined as the present value, at 10% compounded annually, of five annual payments from *M* to *N* of $4,000,000 (4% of $100,000,000).

(b) Although the parties have characterized this transaction as an interest rate swap, the $15,163,147 payment from *M* to *N* is significant when compared to the present value of the total fixed payments due under the contract. Accordingly, under paragraph (g)(4) of this section, the transaction is recharacterized as consisting of both a $15,163,147 loan from *M* to *N* that *N* repays in installments over the term of the agreement, and an interest rate swap between *M* and *N* in which *M* immediately pays the installment payments on the loan back to *N* as part of its fixed payments on the swap in exchange for the LIBOR payments by *N*.

(c) The yield adjustment fee is recognized over the life of the agreement by treating the $15,163,147 as a loan that will be repaid with level payments over five years. Assuming a constant yield to maturity and annual compounding at 10%, *M* and *N* account for the principal and interest on the loan as follows:

	Level payment	Interest component	Principal component
1995	$4,000,000	$1,516,315	$2,483,685
1996	4,000,000	1,267,946	2,732,054
1997	4,000,000	994,741	3,005,259
1998	4,000,000	694,215	3,305,785
1999	4,000,000	363,636	3,636,364
	$20,000,000	$4,836,853	$15,163,147

(d) *M* recognizes interest income, and *N* claims an interest deduction, each taxable year equal to the interest component of the deemed installment payments on the loan. These interest amounts are not included in the parties' net income or net deduction from the swap contract under paragraph (d) of this section. The principal components are needed only to compute the interest component of the level payment for the following period, and do not otherwise affect the parties' net income or net deduction from this contract.

(e) *N* also makes swap payments to *M* based on LIBOR, and receives swap payments from *M* at a fixed rate that is equal to the sum of the stated fixed rate and the rate calculated by dividing the deemed level annual payments on the loan by the notional principal amount. Thus, the fixed rate on this swap is 10%, which is the sum of the stated rate of 6% and the rate calculated by dividing the annual loan payment of $4,000,000 by the notional principal amount of $100,000,000, or 4%. Using the methods provided in paragraph (e)(2) of this section, the swap payments from *M* to *N* of $10,000,000 (10% of

$100,000,000) and the LIBOR swap payments from *N* to *M* are included in the parties' net income or net deduction from the contract for each taxable year.

Example 4. Swaps recharacterized as a loan. (a) The facts are the same as in *Example 3*, except that on January 1, 1995, *N* also enters into an interest rate swap agreement with unrelated counterparty *O* under which, for a term of five years, *N* is obligated to make annual payments at 12% and *O* is obligated to make annual payments at LIBOR on a notional principal amount of $100 million. At the time *N* and *O* enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, *O* pays *N* an upfront yield adjustment fee of $7,581,574. This yield adjustment fee equals the present value, at 10% compounded annually, of five annual payments of $2,000,000 (2% of $100,000,000).

(b) In substance, these two interest rate swaps are the equivalent of a fixed rate borrowing by *N* of $22,744,721 ($15,163,147 from *M* plus $7,581,574 from *O*). Under paragraph (g)(2) of this section, if these positions were entered into to avoid interest character on a net loan position, the Commissioner may recharacterize the swaps as a loan which *N* will repay with interest in five annual installments of $6,000,000 each (the difference between the 12% *N* pays under the swap with *O* and the 6% *N* receives under the swap with *M*, multiplied by the $100,000,000 notional principal amount).

(c) *N* recognizes no net income or net deduction from these contracts under paragraph (d) of this section because, as to *N*, there is no notional principal contract income or expense. However, the recharacterization of *N*'s separate transactions as a loan has no effect on the way *M* and *O* must each account for their notional principal contracts under paragraphs (d) through (g) of this section.

(h) *Termination payments*—(1) *Definition.* A payment made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract is a termination payment to the party making the termination payment and the party receiving the payment. A termination payment includes a payment made between the original parties to the contract (an extinguishment), a payment made between one party to the contract and a third party (an assignment), and any gain or loss realized on the exchange of one notional principal contract for another. Where one party assigns its remaining rights and obligations to a third party, the original nonassigning counterparty realizes gain or loss if the assignment results in a deemed exchange of contracts and a realization event under section 1001.

(2) *Taxable year of inclusion and deduction by original parties.* Except as otherwise provided (for example, in section 453, section 1092, or §1.446–4), a party to a notional principal contract recognizes a termination payment in the year the contract is extinguished, assigned, or exchanged. When the termination payment is recognized, the party also recognizes any other payments that have been made or received pursuant to the notional principal contract, but that have not been recognized under paragraph (d) of this section. If only a proportionate part of a party's rights and obligations is extinguished, assigned, or exchanged, then only that proportion of the unrecognized payments is recognized under the previous sentence.

(3) *Taxable year of inclusion and deduction by assignees.* A termination payment made or received by an assignee pursuant to an assignment of a notional principal contract is recognized by the assignee under the rules of paragraphs (f) and (g)(4) or (g)(5) of this section as a nonperiodic payment for the notional principal contract that is in effect after the assignment.

(4) *Special rules*—(i) *Assignment of one leg of a contract.* A payment is not a termination payment if it is made or received by a party in exchange for assigning all or a portion of one leg of a notional principal contract at a time when a substantially proportionate amount of the other leg remains unperformed and unassigned. The payment is either an amount loaned, an amount borrowed, or a nonperiodic payment, depending on the economic substance of the transaction to each party. This paragraph (h)(4)(i) applies whether or not the original notional principal contract is terminated as a result of the assignment.

(ii) *Substance over form.* Any economic benefit that is given or received by a taxpayer in lieu of a termination payment is a termination payment.

(5) *Examples*. The following examples illustrate the application of this paragraph (h). The contracts in the examples are not hedging transactions as defined in § 1.1221–2(b), and all of the examples assume that no loss-deferral rules apply.

Example 1. Termination by extinguishment. (a) On January 1, 1995, *P* enters into an interest rate swap agreement with unrelated counterparty *Q* under which, for a term of seven years, *P* is obligated to make annual payments based on 10% and *Q* is obligated to make semi-annual payments based on LIBOR and a notional principal amount of $100 million. *P* and *Q* are both calendar year taxpayers. On January 1, 1997, when the fixed rate on a comparable LIBOR swap has fallen to 9.5%, *P* pays *Q* $1,895,393 to terminate the swap.

(b) The payment from *P* to *Q* extinguishes the swap contract and is a termination payment, as defined in paragraph (h)(1) of this section, for both parties. Accordingly, under paragraph (h)(2) of this section, *P* recognizes a loss of $1,895,393 in 1997 and *Q* recognizes $1,895,393 of gain in 1997.

Example 2. Termination by assignment. (a) The facts are the same as in *Example 1*, except that on January 1, 1997, *P* pays unrelated party *R* $1,895,393 to assume all of *P*'s rights and obligations under the swap with *Q*. In return for this payment, *R* agrees to pay 10% of $100 million annually to *Q* and to receive LIBOR payments from *Q* for the remaining five years of the swap.

(b) The payment from *P* to *R* terminates *P*'s interest in the swap contract with *Q* and is a termination payment, as defined in paragraph (h)(1) of this section, for *P*. Under paragraph (h)(2) of this section, *P* recognizes a loss of $1,895,393 in 1997. Whether *Q* also has a termination payment with respect to the payment from *P* to *R* is determined under section 1001.

(c) Under paragraph (h)(3) of this section, the assignment payment that *R* receives from *P* is a nonperiodic payment for an interest rate swap. Because the assignment payment is not a significant nonperiodic payment within the meaning of paragraph (g)(1) of this section, *R* amortizes the $1,895,393 over the five year term of the swap agreement under paragraph (f)(2) of this section.

Example 3. Assignment of swap with yield adjustment fee. (a) The facts are the same as in *Example 2*, except that on January 1, 1995, *Q* paid *P* a yield adjustment fee to enter into the seven year interest rate swap. In accordance with paragraph (f)(2) of this section, *P* and *Q* included the ratable daily portions of that nonperiodic payment in their net income or net deduction from the contract for 1995 and 1996. On January 1, 1997, $300,000 of the nonperiodic payment has not yet been recognized by *P* and *Q*.

(b) Under paragraph (h)(2) of this section, *P* recognizes a loss of $1,595,393 ($1,895,393–$300,000) in 1997. *R* accounts for the termination payment in the same way it did in *Example 2*; the existence of an unamortized payment with respect to the original swap has no effect on *R*.

Example 4. Assignment of one leg of a swap. (a) On January 1, 1995, *S* enters into an interest rate swap agreement with unrelated counterparty *T* under which, for a term of five years, *S* will make annual payments at 10% and *T* will make annual payments at LIBOR on a notional principal amount of $50 million. On January 1, 1996, unrelated party U pays *T* $15,849,327 for the right to receive the four remaining $5,000,000 payments from *S*. Under the terms of the agreement between *S* and *T*, *S* is notified of this assignment, and *S* is contractually bound thereafter to make its payments to *U* on the appropriate payment dates. *S*'s obligation to pay *U* is conditioned on *T* making its LIBOR payment to *S* on the appropriate payment dates.

(b) Because *T* has assigned to *U* its rights to the fixed rate payments, but not its floating rate obligations under the notional principal contract, *U*'s payment to *T* is not a termination payment as defined in paragraph (h)(1) of this section, but is covered by paragraph (h)(4)(i) of this section. The economic substance of the transaction between *T* and *U* is a loan that does not affect the way that *S* and *T* account for the notional principal contract under this section.

(i) *Anti-abuse rule*. If a taxpayer enters into a transaction with a principal purpose of applying the rules of this section to produce a material distortion of income, the Commissioner may depart from the rules of this section as necessary to reflect the appropriate timing of income and deductions from the transaction.

(j) *Effective date*. These regulations are effective for notional principal contracts entered into on or after December 13, 1993.

[T.D. 8491, 58 FR 53128, Oct. 14, 1993; 59 FR 9411, Feb. 28, 1994, as amended by T.D. 8554, 59 FR 36358, July 18, 1994]

§ 1.446–4 Hedging transactions.

(a) *In general*. Except as provided in this paragraph (a), a hedging transaction as defined in § 1.1221–2(b) (whether or not the character of gain or loss from the transaction is determined under § 1.1221–2) must be accounted for under the rules of this section. To the

extent that provisions of any other regulations governing the timing of income, deductions, gain, or loss are inconsistent with the rules of this section, the rules of this section control.

(1) *Trades or businesses excepted.* A taxpayer is not required to account for hedging transactions under the rules of this section for any trade or business in which the cash receipts and disbursements method of accounting is used or in which § 1.471–6 is used for inventory valuations if, for all prior taxable years ending on or after September 30, 1993, the taxpayer met the $5,000,000 gross receipts test of section 448(c) (or would have met that test if the taxpayer were a corporation or partnership). A taxpayer not required to use the rules of this section may nonetheless use a method of accounting that is consistent with these rules.

(2) *Coordination with other sections.* This section does not apply to—

(i) Any position to which section 475(a) applies;

(ii) An integrated transaction subject to § 1.1275–6;

(iii) Any section 988 hedging transaction if the transaction is integrated under § 1.988–5 or if other regulations issued under section 988(d) (or an advance ruling described in 1.988–5(e)) govern when gain or loss from the transaction is taken into account; or

(iv) The determination of the issuer's yield on an issue of tax-exempt bonds for purposes of the arbitrage restrictions to which § 1.148–4(h) applies.

(b) *Clear reflection of income.* The method of accounting used by a taxpayer for a hedging transaction must clearly reflect income. To clearly reflect income, the method used must reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged. Taking gains and losses into account in the period in which they are realized may clearly reflect income in the case of certain hedging transactions. For example, where a hedge and the item being hedged are disposed of in the same taxable year, taking realized gain or loss into account on both items in that taxable year may clearly reflect income. In the case of many hedging transactions, however, taking gains and losses into account as they are realized does not result in the matching required by this section.

(c) *Choice of method and consistency.* For any given type of hedging transaction, there may be more than one method of accounting that satisfies the clear reflection requirement of paragraph (b) of this section. A taxpayer is generally permitted to adopt a method of accounting for a particular type of hedging transaction that clearly reflects the taxpayer's income from that type of transaction. See paragraph (e) of this section for requirements and limitations on the taxpayer's choice of method. Different methods of accounting may be used for different types of hedging transactions and for transactions that hedge different types of items. Once a taxpayer adopts a method of accounting, however, that method must be applied consistently and can only be changed with the consent of the Commissioner, as provided by section 446(e) and the regulations and procedures thereunder.

(d) *Recordkeeping requirements*—(1) *In general.* The books and records maintained by a taxpayer must contain a description of the accounting method used for each type of hedging transaction. The description of the method or methods used must be sufficient to show how the clear reflection requirement of paragraph (b) of this section is satisfied.

(2) *Additional identification.* In addition to the identification required by § 1.1221–2(f), the books and records maintained by a taxpayer must contain whatever more specific identification with respect to a transaction is necessary to verify the application of the method of accounting used by the taxpayer for the transaction. This additional identification may relate to the hedging transaction or to the item, items, or aggregate risk being hedged. The additional identification must be made at the time specified in § 1.1221–2(f)(2) and must be made on, and retained as part of, the taxpayer's books and records.

(3) *Transactions in which character of gain or loss is not determined under § 1.1221–2.* A section 988 transaction, as

defined in section 988(c)(1), or a qualified fund, as defined in section 988(c)(1)(E)(iii), is subject to the identification and recordkeeping requirements of §1.1221–2(f). See §1.1221–2(a)(4).

(e) *Requirements and limitations with respect to hedges of certain assets and liabilities.* In the case of certain hedging transactions, this paragraph (e) provides guidance in determining whether a taxpayer's method of accounting satisfies the clear reflection requirement of paragraph (b) of this section. Even if these rules are satisfied, however, the taxpayer's method, as actually applied to the taxpayer's hedging transactions, must clearly reflect income by meeting the matching requirement of paragraph (b) of this section.

(1) *Hedges of aggregate risk*—(i) *In general.* The method of accounting used for hedges of aggregate risk must comply with the matching requirements of paragraph (b) of this section. Even though a taxpayer may not be able to associate the hedging transaction with any particular item being hedged, the timing of income, deduction, gain, or loss from the hedging transaction must be matched with the timing of the aggregate income, deduction, gain, or loss from the items being hedged. For example, if a notional principal contract hedges a taxpayer's aggregate risk, taking into account income, deduction, gain, or loss under the provisions of §1.446–3 may clearly reflect income. See paragraph (e)(5) of this section.

(ii) *Mark-and-spread method.* The following method may be appropriate for taking into account income, deduction, gain, or loss from hedges of aggregate risk:

(A) The hedging transactions are marked to market at regular intervals for which the taxpayer has the necessary data, but no less frequently than quarterly; and

(B) The income, deduction, gain, or loss attributable to the realization or periodic marking to market of hedging transactions is taken into account over the period for which the hedging transactions are intended to reduce risk. Although the period over which the hedging transactions are intended to reduce risk may change, the period must be reasonable and consistent with the taxpayer's hedging policies and strategies.

(2) *Hedges of items marked to market.* In the case of a transaction that hedges an item that is marked to market under the taxpayer's method of accounting, marking the hedge to market clearly reflects income.

(3) *Hedges of inventory*—(i) *In general.* If a hedging transaction hedges purchases of inventory, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of the cost of inventory. Similarly, if a hedging transaction hedges sales of inventory, gain or loss on the hedging transaction may be taken into account in the same period that it would be taken into account if the gain or loss were treated as an element of sales proceeds. If a hedge is associated with a particular purchase or sales transaction, the gain or loss on the hedge may be taken into account when it would be taken into account if it were an element of cost incurred in, or sales proceeds from, that transaction. As with hedges of aggregate risk, however, a taxpayer may not be able to associate hedges of inventory purchases or sales with particular purchase or sales transactions. In order to match the timing of income, deduction, gain, or loss from the hedge with the timing of aggregate income, deduction, gain, or loss from the hedged purchases or sales, it may be appropriate for a taxpayer to account for its hedging transactions in the manner described in paragraph (e)(1)(ii) of this section, except that the gain or loss that is spread to each period is taken into account when it would be if it were an element of cost incurred (purchase hedges), or an element of proceeds from sales made (sales hedges), during that period.

(ii) *Alternative methods for certain inventory hedges.* In lieu of the method described in paragraph (e)(3)(i) of this section, other simpler, less precise methods may be used in appropriate cases where the clear reflection requirement of paragraph (b) of this section is satisfied. For example:

(A) Taking into account realized gains and losses on both hedges of inventory purchases and hedges of inventory sales when they would be taken into account if the gains and losses were elements of inventory cost in the period realized may clearly reflect income in some situations, but does not clearly reflect income for a taxpayer that uses the last-in, first-out method of accounting for the inventory; and

(B) Marking hedging transactions to market with resulting gain or loss taken into account immediately may clearly reflect income even though the inventory that is being hedged is not marked to market, but only if the inventory is not accounted for under either the last-in, first-out method or the lower-of-cost-or-market method and only if items are held in inventory for short periods of time.

(4) *Hedges of debt instruments.* Gain or loss from a transaction that hedges a debt instrument issued or to be issued by a taxpayer, or a debt instrument held or to be held by a taxpayer, must be accounted for by reference to the terms of the debt instrument and the period or periods to which the hedge relates. A hedge of an instrument that provides for interest to be paid at a fixed rate or a qualified floating rate, for example, generally is accounted for using constant yield principles. Thus, assuming that a fixed rate or qualified floating rate instrument remains outstanding, hedging gain or loss is taken into account in the same periods in which it would be taken into account if it adjusted the yield of the instrument over the term to which the hedge relates. For example, gain or loss realized on a transaction that hedged an anticipated fixed rate borrowing for its entire term is accounted for, solely for purposes of this section, as if it decreased or increased the issue price of the debt instrument. Similarly, gain or loss realized on a transaction that hedges a contingent payment on a debt instrument subject to §1.1275–4(c) (a contingent payment debt instrument issued for nonpublicly traded property) is taken into account when the contingent payment is taken into account under §1.1275–4(c).

(5) *Notional principal contracts.* The rules of §1.446–3 govern the timing of income and deductions with respect to a notional principal contract unless, because the notional principal contract is part of a hedging transaction, the application of those rules would not result in the matching that is needed to satisfy the clear reflection requirement of paragraph (b) and, as applicable, (e)(4) of this section. For example, if a notional principal contract hedges a debt instrument, the method of accounting for periodic payments described in §1.446–3(e) and the methods of accounting for nonperiodic payments described in §1.446–3(f)(2)(iii) and (v) generally clearly reflect the taxpayer's income. The methods described in §1.446–3(f)(2)(ii) and (iv), however, generally do not clearly reflect the taxpayer's income in that situation.

(6) *Disposition of hedged asset or liability.* If a taxpayer hedges an item and disposes of, or terminates its interest in, the item but does not dispose of or terminate the hedging transaction, the taxpayer must appropriately match the built-in gain or loss on the hedging transaction to the gain or loss on the disposed item. To meet this requirement, the taxpayer may mark the hedge to market on the date it disposes of the hedged item. If the taxpayer intends to dispose of the hedging transaction within a reasonable period, however, it may be appropriate to match the realized gain or loss on the hedging transaction with the gain or loss on the disposed item. If the taxpayer intends to dispose of the hedging transaction within a reasonable period and the hedging transaction is not actually disposed of within that period, the taxpayer must match the gain or loss on the hedge at the end of the reasonable period with the gain or loss on the disposed item. For purposes of this paragraph (e)(6), a reasonable period is generally 7 days.

(7) *Recycled hedges.* If a taxpayer enters into a hedging transaction by recycling a hedge of a particular hedged item to serve as a hedge of a different item, as described in §1.1221–2(d)(4), the taxpayer must match the built-in gain or loss at the time of the recycling to the gain or loss on the original hedged item, items, or aggregate risk. Income, deduction, gain, or loss attributable to the period after the recycling must be

matched to the new hedged item, items, or aggregate risk under the principles of paragraph (b) of this section.

(8) *Unfulfilled anticipatory transactions*—(i) *In general*. If a taxpayer enters into a hedging transaction to reduce risk with respect to an anticipated asset acquisition, debt issuance, or obligation, and the anticipated transaction is not consummated, any income, deduction, gain, or loss from the hedging transaction is taken into account when realized.

(ii) *Consummation of anticipated transaction*. A taxpayer consummates a transaction for purposes of paragraph (e)(8)(i) of this section upon the occurrence (within a reasonable interval around the expected time of the anticipated transaction) of either the anticipated transaction or a different but similar transaction for which the hedge serves to reasonably reduce risk.

(9) *Hedging by members of a consolidated group*—(i) *General rule: single-entity approach*. In general, a member of a consolidated group must account for its hedging transactions as if all of the members were separate divisions of a single corporation. Thus, the timing of the income, deduction, gain, or loss on a hedging transaction must match the timing of income, deduction, gain, or loss from the item or items being hedged. Because all of the members are treated as if they were divisions of a single corporation, intercompany transactions are neither hedging transactions nor hedged items for these purposes.

(ii) *Separate-entity election*. If a consolidated group makes an election under §1.1221–2(e)(2), then paragraph (e)(9)(i) of this section does not apply. Thus, in that case, each member of the consolidated group must account for its hedging transactions in a manner that meets the requirements of paragraph (b) of this section. For example, the income, deduction, gain, or loss from intercompany hedging transactions (as defined in §1.1221–2(e)(2)(ii)) is taken into account under the timing rules of §1.446–4 rather than under the timing rules of §1.1502–13.

(iii) *Definitions*. For definitions of consolidated group, divisions of a single corporation, intercompany transaction, and member, see section 1502 and the regulations thereunder.

(iv) *Effective date*. This paragraph (e)(9) applies to transactions entered into on or after March 8, 1996.

(f) *Type or character of income and deduction*. The rules of this section govern the timing of income, deduction, gain, or loss on hedging transactions but do not affect the type or character of income, deduction, gain, or loss produced by the transaction. Thus, for example, the rules of paragraph (e)(3) of this section do not affect the computation of cost of goods sold or sales proceeds for a taxpayer that hedges inventory purchases or sales. Similarly, the rules of paragraph (e)(4) of this section do not increase or decrease the interest income or expense of a taxpayer that hedges a debt instrument or a liability.

(g) *Effective date*. This section applies to hedging transactions entered into on or after October 1, 1994.

(h) *Consent to change methods of accounting*. The Commissioner grants consent for a taxpayer to change its methods of accounting for transactions that are entered into on or after October 1, 1994, and that are described in paragraph (a) of this section. This consent is granted only for changes for the taxable year containing October 1, 1994. The taxpayer must describe its new methods of accounting in a statement that is included in its Federal income tax return for that taxable year.

[T.D. 8554, 59 FR 36358, July 18, 1994, as amended by T.D. 8653, 61 FR 519, Jan. 8, 1996; T.D. 8674, 61 FR 30138, June 14, 1996; T.D. 8985, 67 FR 12865, Mar. 20, 2002; 67 FR 31955, May 13, 2002]

§ 1.446–5 Debt issuance costs.

(a) *In general*. This section provides rules for allocating debt issuance costs over the term of the debt. For purposes of this section, the term *debt issuance costs* means those transaction costs incurred by an issuer of debt (that is, a borrower) that are required to be capitalized under §1.263(a)–5. If these costs are otherwise deductible, they are deductible by the issuer over the term of the debt as determined under paragraph (b) of this section.

(b) *Method of allocating debt issuance costs*—(1) *In general*. Solely for purposes of determining the amount of debt

issuance costs that may be deducted in any period, these costs are treated as if they adjusted the yield on the debt. To effect this, the issuer treats the costs as if they decreased the issue price of the debt. See §1.1273–2 to determine issue price. Thus, debt issuance costs increase or create original issue discount and decrease or eliminate bond issuance premium.

(2) *Original issue discount*. Any resulting original issue discount is taken into account by the issuer under the rules in §1.163–7, which generally require the use of a constant yield method (as described in §1.1272–1) to compute how much original issue discount is deductible for a period. However, see §1.163–7(b) for special rules that apply if the total original issue discount on the debt is *de minimis*.

(3) *Bond issuance premium*. Any remaining bond issuance premium is taken into account by the issuer under the rules of §1.163–13, which generally require the use of a constant yield method for purposes of allocating bond issuance premium to accrual periods.

(c) *Examples*. The following examples illustrate the rules of this section:

Example 1. (i) On January 1, 2004, X borrows $10,000,000. The principal amount of the loan ($10,000,000) is repayable on December 31, 2008, and payments of interest in the amount of $500,000 are due on December 31 of each year the loan is outstanding. X incurs debt issuance costs of $130,000 to facilitate the borrowing.

(ii) Under §1.1273–2, the issue price of the loan is $10,000,000. However, under paragraph (b) of this section, X reduces the issue price of the loan by the debt issuance costs of $130,000, resulting in an issue price of $9,870,000. As a result, X treats the loan as having original issue discount in the amount of $130,000 (stated redemption price at maturity of $10,000,000 minus the issue price of $9,870,000). Because this amount of original issue discount is more than the *de minimis* amount of original issue discount for the loan determined under §1.1273–1(d) ($125,000 ($10,000,000 × .0025 × 5)), X must allocate the original issue discount to each year based on the constant yield method described in §1.1272–1(b). See §1.163–7(a). Based on this method and a yield of 5.30%, compounded annually, the original issue discount is allocable to each year as follows: $23,385 for 2004, $24,625 for 2005, $25,931 for 2006, $27,306 for 2007, and $28,753 for 2008.

Example 2. (i) Assume the same facts as in *Example 1*, except that X incurs debt issuance costs of $120,000 rather than $130,000.

(ii) Under §1.1273–2, the issue price of the loan is $10,000,000. However, under paragraph (b) of this section, X reduces the issue price of the loan by the debt issuance costs of $120,000, resulting in an issue price of $9,880,000. As a result, X treats the loan as having original issue discount in the amount of $120,000 (stated redemption price at maturity of $10,000,000 minus the issue price of $9,880,000). Because this amount of original issue discount is less than the *de minimis* amount of original issue discount for the loan determined under §1.1273–1(d) ($125,000), X does not have to use the constant yield method described in §1.1272–1(b) to allocate the original issue discount to each year. Instead, under §1.163–7(b)(2), X can choose to allocate the original issue discount to each year on a straight-line basis over the term of the loan or in proportion to the stated interest payments ($24,000 each year). X also could choose to deduct the original issue discount at maturity of the loan. X makes its choice by reporting the original issue discount in a manner consistent with the method chosen on X's timely filed federal income tax return for 2004. If X wanted to use the constant yield method, based on a yield of 5.279%, compounded annually, the original issue discount is allocable to each year as follows: $21,596 for 2004, $22,736 for 2005, $23,937 for 2006, $25,200 for 2007, and $26,531 for 2008.

(d) *Effective date*. This section applies to debt issuance costs paid or incurred for debt instruments issued on or after December 31, 2003.

(e) *Accounting method changes*—(1) *Consent to change*. An issuer required to change its method of accounting for debt issuance costs to comply with this section must secure the consent of the Commissioner in accordance with the requirements of §1.446–1(e). Paragraph (e)(2) of this section provides the Commissioner's automatic consent for certain changes.

(2) *Automatic consent*. The Commissioner grants consent for an issuer to change its method of accounting for debt issuance costs incurred for debt instruments issued on or after December 31, 2003. Because this change is made on a cut-off basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (e)(2) applies provided—

(i) The change is made to comply with this section;

(ii) The change is made for the first taxable year for which the issuer must account for debt issuance costs under this section; and

(iii) The issuer attaches to its federal income tax return for the taxable year containing the change a statement that it has changed its method of accounting under this section.

[T.D. 9107, 69 FR 464, Jan. 5, 2004]

§ 1.446–6 REMIC inducement fees.

(a) *Purpose*. This section provides specific timing rules for the clear reflection of income from an inducement fee received in connection with becoming the holder of a noneconomic REMIC residual interest. An inducement fee must be included in income over a period reasonably related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest.

(b) *Definitions*. For purposes of this section:

(1) *Applicable REMIC*. The applicable REMIC is the REMIC that issued the noneconomic residual interest with respect to which the inducement fee is paid.

(2) *Inducement fee*. An inducement fee is the amount paid to induce a person to become the holder of a noneconomic residual interest in an applicable REMIC.

(3) *Noneconomic residual interest*. A REMIC residual interest is a noneconomic residual interest if it is a noneconomic residual interest within the meaning of § 1.860E–1(c)(2).

(4) *Remaining anticipated weighted average life*. The remaining anticipated weighted average life is the anticipated weighted average life determined using the methodology set forth in § 1.860E–1(a)(3)(iv) applied as of the date of acquisition of the noneconomic residual interest.

(5) *REMIC*. The term REMIC has the same meaning in this section as given in § 1.860D–1.

(c) *General rule*. All taxpayers, regardless of their overall method of accounting, must recognize an inducement fee over the remaining expected life of the applicable REMIC in a manner that reasonably reflects, without regard to this paragraph, the after-tax costs and benefits of holding that noneconomic residual interest.

(d) *Special rule on disposition of a residual interest*. If any portion of an inducement fee received with respect to becoming the holder of a noneconomic residual interest in an applicable REMIC has not been recognized in full by the holder as of the time the holder transfers, or otherwise ceases to be the holder for Federal tax purposes of, that residual interest in the applicable REMIC, then the holder must include the unrecognized portion of the inducement fee in income at that time. This rule does not apply to a transaction to which section 381(c)(4) applies.

(e) *Safe harbors*. If inducement fees are recognized in accordance with a method described in this paragraph (e), that method complies with the requirements of paragraph (c) of this section.

(1) *The book method*. Under the book method, an inducement fee is recognized in accordance with the method of accounting, and over the same period, used by the taxpayer for financial reporting purposes (including consolidated financial statements to shareholders, partners, beneficiaries, and other proprietors and for credit purposes), provided that the inducement fee is included in income for financial reporting purposes over a period that is not shorter than the period during which the applicable REMIC is expected to generate taxable income.

(2) *The modified REMIC regulatory method*. Under the modified REMIC regulatory method, the inducement fee is recognized ratably over the remaining anticipated weighted average life of the applicable REMIC as if the inducement fee were unrecognized gain being included in gross income under § 1.860F–2(b)(4)(iii).

(3) *Additional safe harbor methods*. The Commissioner, by revenue ruling or revenue procedure (*see* § 1.601(d)(2) of this chapter), may provide additional safe harbor methods for recognizing inducement fees relating to noneconomic REMIC residual interests.

(f) *Method of accounting*. The treatment of inducement fees is a method of accounting to which the provisions of sections 446 and 481 and the regulations

thereunder apply. A taxpayer is generally permitted to adopt a method of accounting for inducement fees that satisfies the requirements of paragraph (c) of this section. Once a taxpayer adopts a method of accounting for inducement fees, that method must be applied consistently to all inducement fees received in connection with noneconomic REMIC residual interests and may be changed only with the consent of the Commissioner, as provided by section 446(e) and the regulations and procedures thereunder.

(g) *Effective date.* This section is applicable for taxable years ending on or after May 11, 2004.

[T.D. 9128, 69 FR 26041, May 11, 2004]

§ 1.448–1 Limitation on the use of the cash receipts and disbursements method of accounting.

(a)–(f) [Reserved]

(g) *Treatment of accounting method change and timing rules for section 481(a) adjustment*—(1) *Treatment of change in accounting method.* Notwithstanding any other procedure published prior to January 7, 1991, concerning changes from the cash method, any taxpayer to whom section 448 applies must change its method of accounting in accordance with the provisions of this paragraph (g) and paragraph (h) of this section. In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. The adjustments required under section 481(a) with respect to the change in method of accounting of such a taxpayer shall not be reduced by amounts attributable to taxable years preceding the Internal Revenue Code of 1954. Paragraph (h)(2) of this section provides procedures under which a taxpayer may change to an overall accrual method of accounting for the first taxable year the taxpayer is subject to this section (''first section 448 year''). If the taxpayer complies with the provisions of paragraph (h)(2) of this section for its first section 448 year, the change shall be treated as made with the consent of the Commissioner. Paragraph (h)(3) of this section provides procedures under which a taxpayer may change to other than an overall accrual method of accounting for its first section 448 year. Unless the taxpayer complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year, the taxpayer must comply with the provisions of paragraph (h)(4) of this section. See paragraph (h) of this section for rules to effect a change in method of accounting.

(2) *Timing rules for section 481(a) adjustment*—(i) *In general.* Except as otherwise provided in paragraphs (g)(2)(ii) and (g)(3) of this section, a taxpayer required by this section to change from the cash method must take the net section 481(a) adjustment into account over the section 481(a) adjustment period as determined under the applicable administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method (for example, see Rev. Proc. 2002–9 (2002–1 C.B. 327) and Rev. Proc. 97–27 (1997–1 C.B. 680) (also see § 601.601(d)(2) of this chapter)), provided the taxpayer complies with the provisions of paragraph (h)(2) or (3) of this section for its first section 448 year.

(ii) *Hospital timing rules*—(A) *In general.* In the case of a hospital that is required by this section to change from the cash method, the section 481(a) adjustment shall be taken into account ratably (beginning with the year of change) over 10 years, provided the taxpayer complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year.

(B) *Definition of hospital.* For purposes of paragraph (g) of this section, a hospital is an institution—

(*1*) Accredited by the Joint Commission on Accreditation of Healthcare Organizations or its predecessor (the JCAHO) (or accredited or approved by a program of the qualified governmental unit in which such institution is located if the Secretary of Health and Human Services has found that the accreditation or comparable approval standards of such qualified governmental unit are essentially equivalent to those of the JCAHO);

(*2*) Used primarily to provide, by or under the supervision of physicians, to inpatients diagnostic services and

therapeutic services for medical diagnosis, treatment, and care of injured, disabled, or sick persons;

(*3*) Requiring every patient to be under the care and supervision of a physician; and

(*4*) Providing 24-hour nursing services rendered or supervised by a registered professional nurse and having a licensed practical nurse or registered nurse on duty at all times.

For purposes of this section, an entity need not be owned by or on behalf of a governmental unit or by a section 501(c)(3) organization, or operated by a section 501(c)(3) organization, in order to be considered a hospital. In addition, for purposes of this section, a hospital does not include a rest or nursing home, continuing care facility, daycare center, medical school facility, research laboratory, or ambulatory care facility.

(C) *Dual function facilities*. With respect to any taxpayer whose operations consist both of a hospital, and other facilities not qualifying as a hospital, the portion of the adjustment required by section 481(a) that is attributable to the hospital shall be taken into account in accordance with the rules of paragraph (g)(2) of this section relating to hospitals. The portion of the adjustment required by section 481(a) that is not attributable to the hospital shall be taken into account in accordance with the rules of paragraph (g)(2) of this section not relating to hospitals.

(iii) *Untimely change in method of accounting to comply with this section*. Unless a taxpayer (including a hospital and a cooperative) required by this section to change from the cash method complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year within the time prescribed by those paragraphs, the taxpayer must take the section 481 (a) adjustment into account under the provisions of any applicable administrative procedure that is prescribed by the Commissioner after January 7, 1991, specifically for purposes of complying with this section. Absent such an administrative procedure, a taxpayer must request a change under §1.446–1(e)(3) and shall be subject to any terms and conditions (including the year of change) as may be imposed by the Commissioner.

(3) *Special timing rules for section 481(a) adjustment*—(i)*Cessation of trade or business*. If the taxpayer ceases to engage in the trade or business to which the section 481(a) adjustment relates, or if the taxpayer operating the trade or business terminates existence, and such cessation or termination occurs prior to the expiration of the adjustment period described in paragraph (g)(2)(i) or (ii) of this section, the taxpayer must take into account, in the taxable year of such cessation or termination, the balance of the adjustment not previously taken into account in computing taxable income. For purposes of this paragraph (g)(3)(i), the determination as to whether a taxpayer has ceased to engage in the trade or business to which the section 481(a) adjustment relates, or has terminated its existence, is to be made under the principles of §1.446–1(e)(3)(ii) and its underlying administrative procedures.

(ii) *De minimis rule for a taxpayer other than a cooperative*. Notwithstanding paragraph (g)(2)(i) and (ii) of this section, a taxpayer other than a cooperative (within the meaning of section 1381(a)) that is required to change from the cash method by this section may elect to use, in lieu of the adjustment period described in paragraph (g)(2)(i) and (ii) of this section, the adjustment period for *de minimis* section 481(a) adjustments provided in the applicable administrative procedure issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method. A taxpayer may make an election under this paragraph (g)(3)(ii) only if—

(A) The taxpayer's entire net section 481(a) adjustment (whether positive or negative) is a de minimis amount as determined under the applicable administrative procedure issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in accounting method,

(B) The taxpayer complies with the provisions of paragraph (h)(2) or (3) of this section for its first section 448 year,

(C) The return for such year is due (determined with regard to extensions) after December 27, 1993, and

(D) The taxpayer complies with any applicable instructions to Form 3115 that specify the manner of electing the adjustment period for de minimis section 481(a) adjustments.

(4) *Additional rules relating to section 481(a) adjustment*. In addition to the rules set forth in paragraph (g) (2) and (3) of this section, the following rules shall apply in taking the section 481(a) adjustment into account—

(i) Any net operating loss and tax credit carryforwards will be allowed to offset any positive section 481(a) adjustment,

(ii) Any net operating loss arising in the year of change or in any subsequent year that is attributable to a negative section 481(a) adjustment may be carried back to earlier taxable years in accordance with section 172, and

(iii) For purposes of determining estimated income tax payments under sections 6654 and 6655, the section 481(a) adjustment will be recognized in taxable income ratably throughout a taxable year.

(5) *Outstanding section 481(a) adjustment from previous change in method of accounting*. If a taxpayer changed its method of accounting to the cash method for a taxable year prior to the year the taxpayer was required by this section to change from the cash method (the section 448 year), any section 481(a) adjustment from such prior change in method of accounting that is outstanding as of the section 448 year shall be taken into account in accordance with the provisions of this paragraph (g)(5). A taxpayer shall account for any remaining portion of the prior section 481(a) adjustment outstanding as of the section 448 year by continuing to take such remaining portion into account under the provisions and conditions of the prior change in method of accounting, or, at the taxpayer's option, combining or netting the remaining portion of the prior section 481(a) adjustment with the section 481(a) adjustment required under this section, and taking into account under the provisions of this section the resulting net amount of the adjustment. Any taxpayer choosing to combine or net the section 481(a) adjustments as described in the preceding sentence shall indicate such choice on the Form 3115 required to be filed by such taxpayer under the provisions of paragraph (h) of this section.

(h) *Procedures for change in method of accounting*—(1) *Applicability*. Paragraph (h) of this section applies to taxpayers who change from the cash method as required by this section. Paragraph (h) of this section does not apply to a change in accounting method required by any Code section (or regulations thereunder) other than this section.

(2) *Automatic rule for changes to an overall accrual method*—(i) *Timely changes in method of accounting*. Notwithstanding any other available procedures to change to the accrual method of accounting, a taxpayer to whom paragraph (h) of this section applies who desires to make a change to an overall accrual method for its first section 448 year must make that change under the provisions of this paragraph (h)(2). A taxpayer changing to an overall accrual method under this paragraph (h)(2) must file a current Form 3115 by the time prescribed in paragraph (h)(2)(ii). In addition, the taxpayer must set forth on a statement accompanying the Form 3115 the period over which the section 481(a) adjustment will be taken into account and the basis for such conclusion. Moreover, the taxpayer must type or legibly print the following statement at the top of page 1 of the Form 3115: ''Automatic Change to Accrual Method—Section 448.'' The consent of the Commissioner to the change in method of accounting is granted to taxpayers who change to an overall accrual method under this paragraph (h)(2). See paragraph (g)(2)(i), (g)(2)(ii), or (g)(3) of this section, whichever is applicable, for rules to account for the section 481(a) adjustment.

(ii) *Time and manner for filing Form 3115*—(A) *In general*. Except as provided in paragraph (h)(2)(ii)(B) of this section, the Form 3115 required by paragraph (h)(2)(i) must be filed no later than the due date (determined with regard to extensions) of the taxpayer's federal income tax return for the first section 448 year and must be attached to that return.

(B) *Extension of filing deadline*. Notwithstanding paragraph (h)(2)(ii)(A) of this section, the filing of the Form 3115

required by paragraph (h)(2)(i) shall not be considered late if such Form 3115 is attached to a timely filed amended income tax return for the first section 448 year, provided that—

(*1*) The taxpayer's first section 448 year is a taxable year that begins (or, pursuant to §1.441–2(c), is deemed to begin) in 1987, 1988, 1989, or 1990,

(*2*) The taxpayer has not been contacted for examination, is not before appeals, and is not before a federal court with respect to an income tax issue (each as defined in applicable administrative pronouncements), unless the taxpayer also complies with any requirements for approval in those applicable administrative pronouncements, and

(*3*) Any amended return required by this paragraph (h)(2)(ii)(B) is filed on or before July 8, 1991.

Filing an amended return under this paragraph (h)(2)(ii)(B) does not extend the time for making any other election. Thus, for example, taxpayers that comply with this section by filing an amended return pursuant to this paragraph (h)(2)(ii)(B) may not elect out of section 448 pursuant to paragraph (i)(2) of this section.

(3) *Changes to a method other than overall accrual method*—(i) *In general.* A taxpayer to whom paragraph (h) of this section applies who desires to change to a special method of accounting must make that change under the provisions of this paragraph (h)(3), except to the extent other special procedures have been promulgated regarding the special method of accounting. Such a taxpayer includes taxpayers who change to both an accrual method of accounting and a special method of accounting such as a long-term contract method. In order to change an accounting method under this paragraph (h)(3), a taxpayer must submit an application for change in accounting method under the applicable administrative procedures in effect at the time of change, including the applicable procedures regarding the time and place of filing the application for change in method. Moreover, a taxpayer who changes an accounting method under this paragraph (h)(3) must type or legibly print the following statement on the top of page 1 of Form 3115: ''Change to a Special Method of Accounting—Section 448.'' The filing of a Form 3115 by any taxpayer requesting a change of method of accounting under this paragraph (h)(3) for its taxable year beginning in 1987 will not be considered late if the form is filed with the appropriate office of the Internal Revenue Service on or before the later of: the date that is the 180th day of the taxable year of change; or September 14, 1987. If the Commissioner approves the taxpayer's application for change in method of accounting, the timing of the adjustment required under section 481 (a), if applicable, will be determined under the provisions of paragraph (g)(2)(i), (g)(2)(ii), or (g)(3) of this section, whichever is applicable. If the Commissioner denies the taxpayer's application for change in accounting method, or if the taxpayer's application is untimely, the taxpayer must change to an overall accrual method of accounting under the provisions of either paragraph (h)(2) or (h)(4) of this section, whichever is applicable.

(ii) *Extension of filing deadline.* Notwithstanding paragraph (h)(3)(i) of this section, if the events or circumstances which under section 448 disqualify a taxpayer from using the cash method occur after the time prescribed under applicable procedures for filing the Form 3115, the filing of such form shall not be considered late if such form is filed on or before 30 days after the close of the taxable year.

(4) *Untimely change in method of accounting to comply with this section.* Unless a taxpayer to whom paragraph (h) of this section applies complies with the provisions of paragraph (h)(2) or (h)(3) of this section for its first section 448 year, the taxpayer must comply with the requirements of §1.446–1 (e)(3) (including any applicable administrative procedure that is prescribed thereunder after January 7, 1991 specifically for purposes of complying with this section) in order to secure the consent of the Commissioner to change to a method of accounting that is in compliance with the provisions of this section. The taxpayer shall be subject to any terms and conditions (including the year of change) as may be imposed by the Commissioner.

(i) *Effective date*—(1) *In general.* Except as provided in paragraph (i)(2), (3), (4), and (5) of this section, this section applies to any taxable year beginning after December 31, 1986.

(2) *Election out of section 448*—(i) *In general.* A taxpayer may elect not to have this section apply to any (A) transaction with a related party (within the meaning of section 267(b) of the Internal Revenue Code of 1954, as in effect on October 21, 1986), (B) loan, or (C) lease, if such transaction, loan, or lease was entered into on or before September 25, 1985. Any such election described in the preceding sentence may be made separately with respect to each transaction, loan, or lease. For rules relating to the making of such election, see § 301.9100–7T (temporary regulations relating to elections under the Tax Reform Act of 1986). Notwithstanding the provisions of this paragraph (i)(2), the gross receipts attributable to a transaction, loan, or lease described in this paragraph (i)(2) shall be taken into account for purposes of the $5,000,000 gross receipts test described in paragraph (f) of this section.

(ii) *Special rules for loans.* If the taxpayer makes an election under paragraph (i)(2)(i) of this section with respect to a loan entered into on or before September 25, 1985, the election shall apply only with respect to amounts that are attributable to the loan balance outstanding on September 25, 1985. The election shall not apply to any amounts advanced or lent after September 25, 1985, regardless of whether the loan agreement was entered into on or before such date. Moreover, any payments made on outstanding loan balances after September 25, 1985, shall be deemed to first extinguish loan balances outstanding on September 25, 1985, regardless of any contrary treatment of such loan payments by the borrower and lender.

(3) *Certain contracts entered into before September 25, 1985.* This section does not apply to a contract for the acquisition or transfer of real property or a contract for services related to the acquisition or development of real property if—

(i) The contract was entered into before September 25, 1985; and

(ii) The sole element of the contract which was not performed as of September 25, 1985, was payment for such property or services.

(4) *Transitional rule for paragraphs (g) and (h) of this section.* To the extent the provisions of paragraphs (g) and (h) of this section were not reflected in paragraphs (g) and (h) of § 1.448–1T (as set forth in 26 CFR part 1 as revised on April 1, 1993), paragraphs (g) and (h) of this section will not be adversely applied to a taxpayer with respect to transactions entered into before December 27, 1993.

(5) *Effective date of paragraph (g)(2)(i).* Paragraph (g)(2)(i) of this section applies to taxable years ending on or after June 16, 2004.

[T.D. 8514, 58 FR 68299, Dec. 27, 1993, as amended by T.D. 8996, 67 FR 35012, May 17, 2002; T.D. 9131, 69 FR 33572, June 16, 2004]

§ 1.448–1T Limitation on the use of the cash receipts and disbursements method of accounting (temporary).

(a) *Limitation on accounting method*—(1) *In general.* This section prescribes regulations under section 448 relating to the limitation on the use of the cash receipts and disbursements method of accounting (the cash method) by certain taxpayers.

(2) *Limitation rule.* Except as otherwise provided in this section, the computation of taxable income using the cash method is prohibited in the case of a—

(i) C corporation,

(ii) Partnership with a C corporation as a partner, or

(iii) Tax shelter.

A partnership is described in paragraph (a)(2)(ii) of this section, if the partnership has a C corporation as a partner at any time during the partnership's taxable year beginning after December 31, 1986.

(3) *Meaning of C corporation.* For purposes of this section, the term ''C corporation'' includes any corporation that is not an S corporation. For example, a regulated investment company (as defined in section 851) or a real estate investment trust (as defined in section 856) is a C corporation for purposes of this section. In addition, a trust subject to tax under section 511 (b) shall be treated, for purposes of this

section, as a C corporation, but only with respect to the portion of its activities that constitute an unrelated trade or business. Similarly, for purposes of this section, a corporation that is exempt from federal income taxes under section 501 (a) shall be treated as a C corporation only with respect to the portion of its activities that constitute an unrelated trade or business. Moreover, for purposes of determining whether a partnership has a C corporation as a partner, any partnership described in paragraph (a)(2)(ii) of this section is treated as a C corporation. Thus, if partnership ABC has a partner that is a partnership with a C corporation, then, for purposes of this section, partnership ABC is treated as a partnership with a C corporation partner.

(4) *Treatment of a combination of methods.* For purposes of this section, the use of a method of accounting that records some, but not all, items on the cash method shall be considered the use of the cash method. Thus, a C corporation that uses a combination of accounting methods including the use of the cash method is subject to this section.

(b) *Tax shelter defined*—(1) *In general.* For purposes of this section, the term ''tax shelter'' means any—

(i) Enterprise (other than a C corporation) if at any time (including taxable years beginning before January 1, 1987) interests in such enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale,

(ii) Syndicate (within the meaning of paragraph (b)(3) of this section), or

(iii) Tax shelter within the meaning of section 6662(d)(2)(C).

(2) *Requirement of registration.* For purposes of paragraph (b)(1)(i) of this section, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to register the offering would result in a violation of the applicable federal or state law (regardless of whether the offering is in fact registered). In addition, an offering is required to be registered with a federal or state agency if, under the applicable federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable federal or state law (regardless of whether the notice is in fact filed).

(3) *Meaning of syndicate.* For purposes of paragraph (b)(1)(ii) of this section, the term ''syndicate'' means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs. For purposes of this paragraph (b)(3), the term ''limited entrepreneur'' has the same meaning given such term in section 464 (e)(2). In addition, in determining whether an interest in a partnership is held by a limited partner, or an interest in an entity or enterprise is held by a limited entrepreneur, section 464 (c)(2) shall apply in the case of the trade or business of farming (as defined in paragraph (d)(2) of this section), and section 1256 (e)(3)(C) shall apply in any other case. Moreover, for purposes of this paragraph (b)(3), the losses of a partnership, entity, or enterprise (the enterprise) means the excess of the deductions allowable to the enterprise over the amount of income recognized by such enterprise under the enterprise's method of accounting used for federal income tax purposes (determined without regard to this section). For this purpose, gains or losses from the sale of capital assets or section 1221 (2) assets are not taken into account.

(4) *Presumed tax avoidance.* For purposes of paragraph (b)(1)(iii) of this section, marketed arrangements in which persons carrying on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons use borrowed funds to prepay a substantial portion of their farming expenses (*e.g.*, payment for farm supplies that will not be used or consumed until a taxable year subsequent to the taxable year of payment).

(5) *Taxable year tax shelter must change accounting method.* A partnership, entity, or enterprise that is a tax shelter must change from the cash

method for the later of (i) the first taxable year beginning after December 31, 1986, or (ii) the taxable year that such partnership, entity, or enterprise becomes a tax shelter.

(c) *Effect of section 448 on other provisions.* Nothing in section 448 shall have any effect on the application of any other provision of law that would otherwise limit the use of the cash method, and no inference shall be drawn from section 448 with respect to the application of any such provision. For example, nothing in section 448 affects the requirement of section 447 that certain corporations must use an accrual method of accounting in computing taxable income from farming, or the requirement of §1.446–1(c)(2) that an accrual method be used with regard to purchases and sales of inventory. Similarly, nothing in section 448 affects the authority of the Commissioner under section 446(b) to require the use of an accounting method that clearly reflects income, or the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. For example, a taxpayer using the cash method may be required to change to an accrual method of accounting under section 446(b) because such method clearly reflects that taxpayer's income, even though the taxpayer is not prohibited by section 448 from using the cash method. Similarly, a taxpayer using an accrual method of accounting that is not prohibited by section 448 from using the cash method may not change to the cash method unless the taxpayer secures the consent of the Commissioner under section 446(e), and, in the opinion of the Commissioner, the use of the cash method clearly reflects that taxpayer's income under section 446(b).

(d) *Exception for farming business*—(1) *In general.* Except in the case of a tax shelter, this section shall not apply to any farming business. A taxpayer engaged in a farming business and a separate nonfarming business is not prohibited by this section from using the cash method with respect to the farming business, even though the taxpayer may be prohibited by this section from using the cash method with respect to the nonfarming business.

(2) *Meaning of farming business.* For purposes of paragraph (d) of this section, the term ''farming business'' means—

(i) The trade or business of farming as defined in section 263A(e)(4) (including the operation of a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees), or

(ii) The raising, harvesting , or growing of trees described in section 263A(c)(5) (relating to trees raised, harvested, or grown by the taxpayer other than trees described in paragraph (d)(2)(i) of this section).

Thus, for purposes of this section, the term ''farming business'' includes the raising of timber. For purposes of this section, the term ''farming business'' does not include the processing of commodities or products beyond those activities normally incident to the growing, raising or harvesting of such products. For example, assume that a C corporation taxpayer is in the business of growing and harvesting wheat and other grains. The taxpayer processes the harvested grains to produce breads, cereals, and similar food products which it sells to customers in the course of its business. Although the taxpayer is in the farming business with respect to the growing and harvesting of grain, the taxpayer is not in the farming business with respect to the processing of such grains to produce food products which the taxpayer sells to customers. Similarly, assume that a taxpayer is in the business of raising poultry or other livestock. The taxpayer uses the livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged or canned for sale to customers. Although the taxpayer is in the farming business with respect to the raising of livestock, the taxpayer is not in the farming business with respect to the meat processing operation. However, under this section the term ''farming business'' does include processing activities which are normally incident to the growing, raising or harvesting of agricultural products. For example, assume a taxpayer is in the business of growing fruits and vegetables. When the fruits and vegetables are ready to be harvested, the taxpayer

picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the business of farming with respect to the growing of fruits and vegetables, and the processing activities incident to the harvest.

(e) *Exception for qualified personal service corporation*—(1) *In general.* Except in the case of a tax shelter, this section does not apply to a qualified personal service corporation.

(2) *Certain treatment for qualified personal service corporation.* For purposes of paragraph (a)(2)(ii) of this section (relating to whether a partnership has a C corporation as a partner), a qualified personal service corporation shall be treated as an individual.

(3) *Meaning of qualified personal service corporation.* For purposes of this section, the term ''qualified personal service corporation'' means any corporation that meets—

(i) The function test paragraph (e)(4) of this section, and

(ii) The ownership test of paragraph (e)(5) of this section.

(4) *Function test*—(i) *In general.* A corporation meets the function test if substantially all the corporation's activities for a taxable year involve the performance of services in one or more of the following fields—

(A) Health,

(B) Law,

(C) Engineering (including surveying and mapping),

(D) Architecture,

(E) Accounting,

(F) Actuarial science,

(G) Performing arts, or

(H) Consulting.

Substantially all of the activities of a corporation are involved in the performance of services in any field described in the preceding sentence (a qualifying field), only if 95 percent or more of the time spent by employees of the corporation, serving in their capacity as such, is devoted to the performance of services in a qualifying field. For purposes of determining whether this 95 percent test is satisfied, the performance of any activity incident to the actual performance of services in a qualifying field is considered the performance of services in that field. Activities incident to the performance of services in a qualifying field include the supervision of employees engaged in directly providing services to clients, and the performance of administrative and support services incident to such activities.

(ii) *Meaning of services performed in the field of health.* For purposes of paragraph (e)(4)(i)(A) of this section, the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers.

(iii) *Meaning of services performed in the field of performing arts.* For purposes of paragraph (e)(4)(i)(G) of this section, the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (*e.g.*, persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performances of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers). Finally, the performance of services in the field of the performing arts does not include the provision of services by athletes.

(iv) *Meaning of services performed in the field of consulting*—(A) *In general.* For purposes of paragraph (e)(4)(i)(H) of this section, the performance of services in the field of consulting means

the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.*, whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect).

(B) *Examples*. The following examples illustrate the provisions of paragraph (e)(4)(iv)(A) of this section. The examples do not address all types of services that may or may not qualify as consulting. The determination of whether activities not specifically addressed in the examples qualify as consulting shall be made by comparing the service activities in question to the types of service activities discussed in the examples. With respect to a corporation which performs services which qualify as consulting under this section, and other services which do not qualify as consulting, see paragraph (e)(4)(i) of this section which requires that substantially all of the corporation's activities involve the performance of services in a qualifying field.

Example 1. A taxpayer is in the business of providing economic analyses and forecasts of business prospects for its clients. Based on these analyses and forecasts, the taxpayer advises its clients on their business activities. For example, the taxpayer may analyze the economic conditions and outlook for a particular industry which a client is considering entering. The taxpayer will then make recommendations and advise the client on the prospects of entering the industry, as well as on other matters regarding the client's activities in such industry. The taxpayer provides similar services to other clients, involving, for example, economic analyses and evaluations of business prospects in different areas of the United States or in other countries, or economic analyses of overall economic trends and the provision of advice based on these analyses and evaluations. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example 2. A taxpayer is in the business of providing services that consist of determining a client's electronic data processing needs. The taxpayer will study and examine the client's business, focusing on the types of data and information relevant to the client and the needs of the client's employees for access to this information. The taxpayer will then make recommendations regarding the design and implementation of data processing systems intended to meet the needs of the client. The taxpayer does not, however, provide the client with additional computer programming services distinct from the recommendations made by the taxpayer with respect to the design and implementation of the client's data processing systems. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example 3. A taxpayer is in the business of providing services that consist of determining a client's management and business structure needs. The taxpayer will study the client's organization, including, for example, the departments assigned to perform specific functions, lines of authority in the managerial hierarchy, personnel hiring, job responsibility, and personnel evaluations and compensation. Based on the study, the taxpayer will then advise the client on changes in the client's management and business structure, including, for example, the restructuring of the client's departmental systems or its lines of managerial authority. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example 4. A taxpayer is in the business of providing financial planning services. The taxpayer will study a particular client's financial situation, including, for example, the client's present income, savings and investments, and anticipated future economic and financial needs. Based on this study, the taxpayer will then assist the client in making decisions and plans regarding the client's financial activities. Such financial planning includes the design of a personal budget to assist the client in monitoring the client's financial situation, the adoption of investment strategies tailored to the client's needs, and other similar services. The taxpayer is considered to be engaged in the performance of services in the field of consulting.

Example 5. A taxpayer is in the business of executing transactions for customers involving various types of securities or commodities generally traded through organized exchanges or other similar networks. The taxpayer provides its clients with economic analyses and forecasts of conditions in various industries and businesses. Based on

these analyses, the taxpayer makes recommendations regarding transactions in securities and commodities. Clients place orders with the taxpayer to trade securities or commodities based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the trade orders. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the execution of trade orders for its clients).

Example 6. A taxpayer is in the business of studying a client's needs regarding its data processing facilities and making recommendations to the client regarding the design and implementation of data processing systems. The client will then order computers and other data processing equipment through the taxpayer based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the equipment orders made by the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of sales services. Relevant to this determination is the fact that the compensation of the taxpayer for its services it contingent upon the consummation of the transaction the services were intended to effect (i.e., the execution of equipment orders for its clients).

Example 7. A taxpayer is in the business of assisting businesses in meeting their personnel requirements by referring job applicants to employers with hiring needs in a particular area. The taxpayer may be informed by potential employers of their need for job applicants, or, alternatively, the taxpayer may become aware of the client's personnel requirements after the taxpayer studies and examines the client's management and business structure. The taxpayer's compensation for its services is typically based on the job applicants, referred by the taxpayer to the clients, who accept employment positions with the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is involved in the performance of services economically similar to brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the hiring of a job applicant by the client).

Example 8. The facts are the same as in Example 7, except that the taxpayer's clients are individuals who use the services of the taxpayer to obtain employment positions. The taxpayer is typically compensated by its clients who obtain employment as a result of the taxpayer's services. For the reasons set forth in Example 7, the taxpayer is not considered to be engaged in the performance of services in the field of consulting.

Example 9. A taxpayer is in the business of assisting clients in placing advertisements for their goods and services. The taxpayer analyzes the conditions and trends in the client's particular industry, and then makes recommendations to the client regarding the types of advertisements which should be placed by the client and the various types of advertising media (e.g., radio, television, magazines, etc.) which should be used by the client. The client will then purchase, through the taxpayer, advertisements in various media based on the taxpayer's recommendations. The taxpayer's compensation for its services is typically based on the particular orders for advertisements which the client makes. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of services economically similar to brokerage services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the placing of advertisements by clients).

Example 10. A taxpayer is in the business of selling insurance (including life and casualty insurance), annuities, and other similar insurance products to various individual and business clients. The taxpayer will study the particular client's financial situation, including, for example, the client's present income, savings and investments, business and personal insurance risks, and anticipated future economic and financial needs. Based on this study, the taxpayer will then make recommendations to the client regarding the desirability of various insurance products. The client will then purchase these various insurance products through the taxpayer. The taxpayer's compensation for its services is typically based on the purchases made by the clients. The taxpayer is not considered to be engaged in the performance of services in the field of consulting. The taxpayer is engaged in the performance of brokerage or sales services. Relevant to this determination is the fact that the compensation of the taxpayer for its services is contingent upon the consummation of the transaction the services were intended to effect (i.e., the purchase of insurance products by its clients).

(5) *Ownership test*—(i) *In general.* A corporation meets the ownership test, if at all times during the taxable year, substantially all the corporation's

stock, by value, is held, directly or indirectly, by—

(A) Employees performing services for such corporation in connection with activities involving a field referred to in paragraph (e)(4) of this section,

(B) Retired employees who had performed such services for such corporation,

(C) The estate of any individual described in paragraph (e)(5)(i) (A) or (B) of this section, or

(D) Any other person who acquired such stock by reason of the death of an individual described in paragraph (e)(5)(i) (A) or (B) of this section, but only for the 2-year period beginning on the date of the death of such individual.

For purposes of this paragraph (e)(5) of this section, the term ''substantially all'' means an amount equal to or greater than 95 percent.

(ii) *Definition of employee.* For purposes of the ownership test of this paragraph (e)(5) of this section, a person shall not be considered an employee of a corporation unless the services performed by that person for such corporation, based on the facts and circumstances, are more than de minimis. In addition, a person who is an employee of a corporation shall not be treated as an employee of another corporation merely by reason of the employer corporation and the other corporation being members of the same affiliated group or otherwise related.

(iii) *Attribution rules.* For purposes of this paragraph (e)(5) of this section, a corporation's stock is considered held indirectly by a person if, and to the extent, such person owns a proportionate interest in a partnership, S corporation, or qualified personal service corporation that owns such stock. No other arrangement or type of ownership shall constitute indirect ownership of a corporation's stock for purposes of this paragraph (e)(5) of this section. Moreover, stock of a corporation held by a trust is considered held by a person if, and to the extent, such person is treated under subpart E, part I, subchapter J, chapter 1 of the Code as the owner of the portion of the trust that consists of such stock.

(iv) *Disregard of community property laws.* For purposes of this paragraph (e)(5) of this section, community property laws shall be disregarded. Thus, in determining the stock ownership of a corporation, stock owned by a spouse solely by reason of community property laws shall be treated as owned by the other spouse.

(v) *Treatment of certain stock plans.* For purposes of this paragraph (e)(5) of this section, stock held by a plan described in section 401 (a) that is exempt from tax under section 501 (a) shall be treated as held by an employee described in paragraph (e)(5)(i)(A) of this section.

(vi) *Special election for certain affiliated groups.* For purposes of determining whether the stock ownership test of this paragraph (e)(5) of this section has been met, at the election of the common parent of an affiliated group (within the meaning of section 1504 (a)), all members of such group shall be treated as one taxpayer if substantially all (within the meaning of paragraph (e)(4)(i) of this section) the activities of all such members (in the aggregate) are in the same field described in paragraph (e)(4)(i)(A)–(H) of this section. For rules relating to the making of the election, see 26 CFR 5h.5 (temporary regulations relating to elections under the Tax Reform Act of 1986).

(vii) *Examples.* The following examples illustrate the provisions of paragraph (e) of this section:

Example 1. (i) X, a Corporation, is engaged in the business of providing accounting services to its clients. These services consist of the preparation of audit and financial statements and the preparation of tax returns. For purposes of section 448, such services consist of the performance of services in the field of accounting. In addition, for purposes of section 448, the supervision of employees directly preparing the statements and returns, and the performance of all administrative and support services incident to such activities (including secretarial, janitorial, purchasing, personnel, security, and payroll services) are the performance of services in the field of accounting.

(ii) In addition, X owns and leases a portion of an office building. For purposes of this section, the following types of activities undertaken by the employees of X shall be considered as the performance of services in a field other than the field of accounting: (A)

services directly relating to the leasing activities, e.g., time spent in leasing and maintaining the leased portion of the building; (B) supervision of employees engaged in directly providing services in the leasing activity; and (C) all administrative and support services incurred incident to services described in (A) and (B). The leasing activities of X are considered the performance of services in a field other than the field of accounting, regardless of whether such leasing activities constitute a trade or business under the Code. If the employees of X spend 95% or more of their time in the performance of services in the field of accounting, X satisfies the function test of paragraph (e)(4) of this section.

Example 2. Assume that Y, a C corporation, meets the function test of paragraph (e)(4) of this section. Assume further that all the employees of Y are performing services for Y in a qualifying field as defined in paragraph (e)(4) of this section. P, a partnership, owns 40%, by value, of the stock of Y. The remaining 60% of the stock of Y is owned directly by employees of Y. Employees of Y have an aggregate interest of 90% in the capital and profits of P. This, 96% of the stock of Y is held directly, or indirectly, by employees of Y performing services in a qualifying field. Accordingly, Y meets the ownership test of paragraph (e)(5) of this section and is a qualified personal service corporation.

Example 3. The facts are the same as in Example 2, except that 40% of the stock of Y is owned by Z, a C corporation. The remaining 60% of the stock is owned directly by the employees of Y. Employees of Y own 90% of the stock, by value, of Z. Assume that Z independently qualifies as a personal service corporation. The result is the same as in Example 2, i.e., 96% of the stock of Y is held, directly or indirectly, by employees of Y performing services in a qualifying field. Thus, Y is a qualified personal service corporation.

Example 4. The facts are the same as in Example 3, except that Z does not independently qualify as a personal service corporation. Because Z is not a qualified personal service corporation, the Y stock owned by Z is not treated as being held indirectly by the Z shareholders. Consequently, only 60% of the stock of Y is held, directly or indirectly, by employees of Y. Thus, Y does not meet the ownership test of paragraph (e)(5) of this section, and is not a qualified personal service corporation.

Example 5. Assume that W, a C corporation, meets the function test of paragraph (e)(4) of this section. In addition, assume that all the employees of W are performing services for W in a qualifying field. Nominal legal title to 100% of the stock of W is held by employees of W. However, due solely to the operation of community property laws, 20% of the stock of W is held by spouses of such employees who themselves are not employees of W. In determining the ownership of the stock, community property laws are disregarded. Thus, Y meets the ownership test of paragraph (e)(5) of this section, and is a qualified personal service corporation.

Example 6. Assume that 90% of the stock of T, a C corporation, is directly owned by the employees of T. Spouses of T's employees directly own 5% of the stock of T. The spouses are not employees of T, and their ownership does not occur solely by operation of community property laws. In addition, 5% of the stock of T is held by trusts (other than a trust described in section 401(a) that is exempt from tax under section 501(a)), the sole beneficiaries of which are employees of T. The employees are not treated as owners of the trusts under subpart E, part I, subchapter J, chapter 1 of the Code. Since a person is not treated as owning the stock of a corporation owned by that person's spouse, or by any portion of a trust that is not treated as owned by such person under subpart E, only 90% of the stock of T is treated as held, directly or indirectly, by employees of T. Thus, T does not meet the ownership test of paragraph (e)(5) of this section, and is not a qualified personal service corporation.

Example 7. Assume that Y, a C corporation, directly owns all the stock of three subsidiaries, F, G, and H. Y is a common parent of an affiliated group within the meaning of section 1504(a) consisting of Y, F, G, and H. Y is not engaged in the performance of services in a qualifying field. Instead, Y is a holding company whose activities consist of its ownership and investment in its operating subsidiaries. Substantially all the activities of F involve the performance of services in the field of engineering. In addition, a majority of (but not substantially all) the activities of G involve the performance of services in the field of engineering; the remainder of G's services involve the performance of services in a nonqualifying field. Moreover, a majority of (but not substantially all) the activities of H involve the performance of services in the field of engineering; the remainder of H's activities involve the performance of services in the field of architecture. Nevertheless, substantially all the activities of the group consisting of Y, F, G, and H, in the aggregate, involve the performance of services in the field of engineering. Accordingly, Y elects under paragraph (e)(5)(vi) of this section to be treated as one taxpayer for determining the ownership test of paragraph (e)(5) of this section. Assume that substantially all the stock of Y (by value) is held by employees of F, G, or H who perform services in connection with a qualifying field (engineering or architecture). Thus, for purposes of determining whether any member corporation is a qualified personal service corporation, the ownership test of paragraph (e)(5) of this section has been satisfied. Since F and H satisfy the function

test of paragraph (e)(4) of this section, F and H are qualified personal service corporations. However, since Y and G each fail the function test of paragraph (e)(4) of this section, neither corporation is a qualified personal service corporation.

Example 8. The facts are the same as in Example 7, except that less than substantially all the activities of the group consisting of Y, F, G, and H, in the aggregate, are performed in the field of engineering. Substantially all the activities of the group consisting of Y, F, G, and H, are, in the aggregate, performed in two fields, the fields of engineering and architecture. Y may not elect to have the affiliated group treated as one taxpayer for purposes of determining whether group members meet the ownership test of paragraph (e)(5) of this section. The election is available only if substantially all the activities of the group, in the aggregate, involve the performance of services in only one qualifying field. Moreover, none of the group members are qualified personal service corporations. Y fails the function test of paragraph (e)(4) of this section because less than substantially all the activities of Y are performed in a qualifying field. In addition, F, G, and H fail the ownershp test of paragraph (e)(5) of this section because substantially all their stock is owned by Y and not by their employees. The owners of Y are not deemed to indirectly own the stock owned by Y because Y is not a qualified personal service corporation.

Example 9. (i) The facts are the same as in Example 8, except Y itself satisfies the function tests of paragraph (e)(4) of this section because substantially all the activities of Y involve the performance of services in the field of engineering. In addition, assume that all employees of Y are involved in the performance of services in the field of engineering, and that all such employees own 100% of Y's stock. Moreover, assume that one-third of all the employees of Y are separately employed by F. Similarly, another one-third of the employees of Y are separately employed by G and H, respectively. None of the employees of Y are employed by more than one of Y's subsidiaries. Also, no other persons except the employees of Y are employed by any of the subsidiaries.

(ii) Y is a personal service corporation under section 448 because Y satisfies both the function and the ownership test of paragraphs (e) (4) and (5) of this section. As in Example 8, Y is unable to make the election to have the affiliated group treated as one taxpayer for purposes of determining whether group members meet the ownership test of paragraph (e)(5) of this section because less than substantially all the activities, in the aggregate, of the group members are performed in one of the qualifying fields. However, because Y is a personal service corporation, the stock owned by Y is treated as indirectly owned, proportionately, by the owners of Y. Thus, the employees of F are collectively treated as owning one-third of the stock of F, G, and H. The employees of G and H are similarly treated as owning one-third of each subsidiary's stock.

(iii) F, G, and H each fail the ownership test of paragraph (e)(5) of this section because less than substantially all of each corporation's stock is owned by the employees of the respective corporation. Only one-third of each corporation's stock is owned by employees of that corporation. Thus, F, G, and H are not qualified personal service corporations.

Example 10. (i) Assume that Y, a C corporation, directly owns all the stock of three subsidiaries, F, G, and Z. Y is a common parent of an affiliated group within the meaning of section 1504(a) consisting of Y, F, and G. Z is a foreign corporation and is excluded from the affiliated group under section 1504. Assume that Y is a holding company whose activities consist of its ownership and investment in its operating subsidiaries. Substantially all the activities of F, G, and Z involve the performance of services in the field of engineering. Assume that employees of Z own one-third of the stock of Y and that none of these employees are also employees of Y, F, or G. In addition, assume that Y elects to be treated as one taxpayer for determining whether group members meet the ownership tests of paragraph (e)(5) of this section. Thus, Y, F, and G are treated as one taxpayer for purposes of the ownership test.

(ii) None of the members of the group are qualified personal service corporations. Y, F, and G fail the ownership test of paragraph (e)(5) of this section because less than substantially all the stock of Y is owned by employees of either Y, F, or G. Moreover, Z fails the ownership test of paragraph (e)(5) of this section because substantially all its stock is owned by Y and not by its employees.

(6) *Application of function and ownership tests.* A corporation that fails the function test of paragraph (e)(4) of this section for any taxable year, or that fails the ownership test of paragraph (e)(5) of this section at any time during any taxable year, shall change from the cash method effective for the year in which the corporation fails to meet the function test or the ownership test. For example, if a personal service corporation fails the function test for taxable year 1987, such corporation must change from the cash method effective for taxable year 1987. A corporation that fails the function or ownership test for a taxable year shall not be treated as a qualified personal service

corporation for any part of that taxable year.

(f) *Exception for entities with gross receipts of not more than $5 million*—(1) *In general.* Except in the case of a tax shelter, this section shall not apply to any C corporation or partnership with a C corporation as a partner for any taxable year if, for all prior taxable years beginning after December 31, 1985, such corporation or partnership (or any predecessor thereof) meets the $5,000,000 gross receipts test of paragraph (f)(2) of this section.

(2) *The $5,000,000 gross receipts test*—(i) *In general.* A corporation meets the $5,000,000 gross receipts test of this paragraph (f)(2) for any prior taxable year if the average annual gross receipts of such corporation for the 3 taxable years (or, if shorter, the taxable years during which such corporation was in existence) ending with such prior taxable year does not exceed $5,000,000. In the case of a C corporation exempt from federal income taxes under section 501(a), or a trust subject to tax under section 511(b) that is treated as a C corporation under paragraph (a)(3) of this section, only gross receipts from the activities of such corporation or trust that constitute unrelated trades or businesses are taken into account in determining whether the $5,000,000 gross receipts test is satisfied. A partnership with a C corporation as a partner meets the $5,000,000 gross receipts test of this paragraph (f)(2) for any prior taxable year if the average annual gross receipts of such partnership for the 3 taxable years (or, if shorter, the taxable years during which such partnership was in existence) ending with such prior year does not exceed $5,000,000. The gross receipts of the corporate partner are not taken into account in determining whether the partnership meets the $5,000,000 gross receipts test.

(ii) *Aggregation of gross receipts.* For purposes of determining whether the $5,000,000 gross receipts test has been satisfied, all persons treated as a single employer under section 52 (a) or (b), or section 414 (m) or (o) (or who would be treated as a single employer under such sections if they had employees) shall be treated as one person. Gross receipts attributable to transactions between persons who are treated as a common employer under this paragraph shall not be taken into account in determining whether the $5,000,000 gross receipts test is satisified.

(iii) *Treatment of short taxable year.* In the case of any taxable year of less than 12 months (a short taxable year), the gross receipts shall be annualized by (A) multiplying the gross receipts for the short period by 12 and (B) dividing the result by the number of months in the short period.

(iv) *Determination of gross receipts*—(A) *In general.* The term ''gross receipts'' means gross receipts of the taxable year in which such receipts are properly recognized under the taxpayer's accounting method used in that taxable year (determined without regard to this section) for federal income tax purposes. For this purpose, gross receipts include total sales (net of returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments, and from incidental or outside sources. For example, gross receipts include interest (including original issue discount and tax-exempt interest within the meaning of section 103), dividends, rents, royalties, and annuities, regardless of whether such amounts are derived in the ordinary course of the taxpayer's trade of business. Gross receipts are not reduced by cost of goods sold or by the cost of property sold if such property is described in section 1221 (1), (3), (4) or (5). With respect to sales of capital assets as defined in section 1221, or sales of property described in 1221 (2) (relating to property used in a trade or business), gross receipts shall be reduced by the taxpayer's adjusted basis in such property. Gross receipts do not include the repayment of a loan or similar instrument (*e.g.*, a repayment of the principal amount of a loan held by a commercial lender). Finally, gross receipts do not include amounts received by the taxpayer with respect to sales tax or other similar state and local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service, and the taxpayer merely collects and remits the tax to the taxing authority. If, in

contrast, the tax is imposed on the taxpayer under the applicable law, then gross receipts shall include the amounts received that are allocable to the payment of such tax.

(3) *Examples*. The following examples illustrate the provisions of paragraph (f) of this section:

Example 1. X, a calendar year C corporation, was formed on January 1, 1986. Assume that in 1986 X has gross receipts of $15 million. For taxable year 1987, this section applies to X because in 1986, the period during which X was in existence, X has average annual gross receipts of more than $5 million.

Example 2. Y, a calendar year C corporation that is not a qualified personal service corporation, has gross receipts of $10 million, $9 million, and $4 million for taxable years 1984, 1985, and 1986, respectively. In taxable year 1986, X has average annual gross receipts for the 3-taxable-year period ending with 1986 of $7.67 million ($10 million + 9 million + 4 million ÷3). Thus, for taxable year 1987, this section applies and Y must change from the cash method for such year.

Example 3. Z, a C corporation which is not a qualified personal service corporation, has a 5% partnership interest in ZAB partnership, a calendar year cash method taxpayer. All other partners of ZAB partnership are individuals. Z corporation has average annual gross receipts of $100,000 for the 3-taxable-year period ending with 1986 (*i.e.*, 1984, 1985 and 1986). The ZAB partnership has average annual gross receipts of $6 million for the same 3-taxable-year period. Since ZAB fails to meet the $5,000,000 gross receipts test for 1986, this section applies to ZAB for its taxable year beginning January 1, 1987. Accordingly, ZAB must change from the cash method for its 1987 taxable year. The gross receipts of Z corporation are not relevant in determining whether ZAB is subject to this section.

Example 4. The facts are the same as in Example 3, except that during the 1987 taxable year of ZAB, the Z corporation transfers its partnership interest in ZAB to an individual. Under paragraph (a)(1) of this section, ZAB is treated as a partnership with a C corporation as a partner. Thus, this section requires ZAB to change from the cash method effective for its taxable year 1987. If ZAB later desires to change its method of accounting to the cash method for its taxable year beginning January 1, 1988 (or later), ZAB must comply with all requirements of law, including sections 446(b), 446(e), and 481, to effect the change.

Example 5. X, a C corporation that is not a qualified personal service corporation, was formed on January 1, 1986, in a transaction described in section 351. In the transaction, A, an individual, contributed all of the assets and liabilities of B, a trade or business, to X, in return for the receipt of all the outstanding stock of X. Assume that in 1986 X has gross receipts of $4 million. In 1984 and 1985, the gross receipts of B, the trade or business, were $10 million and $7 million respectively. The gross receipts test is applied for the period during which X and its predecessor trade or business were in existence. X has average annual gross receipts for the 3-taxable-year period ending with 1986 of $7 million ($10 million + $7 million + $4 million÷3). Thus, for taxable year 1987, this section applies and X must change from the cash method for such year.

[T.D. 8143, 52 FR 22766, June 16, 1987, as amended by T.D. 8329, 56 FR 485, Jan. 7, 1991; T.D. 8514, 58 FR 68299, Dec. 27, 1993; T.D. 9174, 70 FR 704, Jan. 5, 2005]

§ 1.448–2 Nonaccrual of certain amounts by service providers.

(a) *In general*. This section applies to taxpayers qualified to use a nonaccrual-experience method of accounting provided for in section 448(d)(5) with respect to amounts to be received for the performance of services. A taxpayer that satisfies the requirements of this section is not required to accrue any portion of amounts to be received from the performance of services that, on the basis of the taxpayer's experience, and to the extent determined under the computation or formula used by the taxpayer and allowed under this section, will not be collected. Except as otherwise provided in this section, a taxpayer is qualified to use a nonaccrual-experience method of accounting if the taxpayer uses an accrual method of accounting with respect to amounts to be received for the performance of services by the taxpayer and either—

(1) The services are in fields referred to in section 448(d)(2)(A) and described in § 1.448–1T(e)(4) (health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting); or

(2) The taxpayer meets the $5 million annual gross receipts test of section 448(c) and § 1.448–1T(f)(2) for all prior taxable years.

(b) *Application of method and treatment as method of accounting*. The rules of section 448(d)(5) and the regulations are applied separately to each taxpayer. For purposes of section 448(d)(5), the term *taxpayer* has the same meaning as the term *person* defined in section

7701(a)(1) (rather than the meaning of the term defined in section 7701(a)(14)). The nonaccrual of amounts to be received for the performance of services is a method of accounting (a nonaccrual-experience method). A change to a nonaccrual-experience method, from one nonaccrual-experience method to another nonaccrual-experience method, or to a periodic system (for example, *see* Notice 88–51 (1988–1 C.B. 535) and § 601.601(d)(2)(ii)(*b*) of this chapter), is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations apply. *See* also paragraphs (c)(2)(i), (c)(5), (d)(4), and (e)(3)(i) of this section. Except as provided in other published guidance, a taxpayer who wishes to adopt or change to any nonaccrual-experience method other than one of the safe harbor methods described in paragraph (f) of this section must request and receive advance consent from the Commissioner in accordance with the applicable administrative procedures issued under § 1.446–1(e)(3)(ii) for obtaining the Commissioner's consent.

(c) *Definitions and special rules*—(1) *Accounts receivable*—(i) *In general*. Accounts receivable include only amounts that are earned by a taxpayer and otherwise recognized in income through the performance of services by the taxpayer. For purposes of determining a taxpayer's nonaccrual-experience under any method provided in this section, amounts described in paragraph (c)(1)(ii) of this section are not taken into account. Except as otherwise provided, for purposes of this section, accounts receivable do not include amounts that are not billed (such as for charitable or pro bono services) or amounts contractually not collectible (such as amounts in excess of a fee schedule agreed to by contract). *See* paragraph (g) *Examples 1* and *2* of this section for examples of this rule.

(ii) *Method not available for certain receivables*—(A) *Amounts not earned and recognized through the performance of services*. A nonaccrual-experience method of accounting may not be used with respect to amounts that are not earned by a taxpayer and otherwise recognized in income through the performance of services by the taxpayer. For example, a nonaccrual-experience method may not be used with respect to amounts owed to the taxpayer by reason of the taxpayer's activities with respect to lending money, selling goods, or acquiring accounts receivable or other rights to receive payment from other persons (including persons related to the taxpayer) regardless of whether those persons earned the amounts through the provision of services. However, *see* paragraph (d)(3) of this section for special rules regarding acquisitions of a trade or business or a unit of a trade or business.

(B) *If interest or penalty charged on amounts due*. A nonaccrual-experience method of accounting may not be used with respect to amounts due for which interest is required to be paid or for which there is any penalty for failure to timely pay any amounts due. For this purpose, a taxpayer will be treated as charging interest or penalties for late payment if the contract or agreement expressly provides for the charging of interest or penalties for late payment, regardless of the practice of the parties. If the contract or agreement does not expressly provide for the charging of interest or penalties for late payment, the determination of whether the taxpayer charges interest or penalties for late payment will be made based on all of the facts and circumstances of the transaction, and not merely on the characterization by the parties or the treatment of the transaction under state or local law. However, the offering of a discount for early payment of an amount due will not be regarded as the charging of interest or penalties for late payment under this section, if—

(*1*) The full amount due is otherwise accrued as gross income by the taxpayer at the time the services are provided; and

(*2*) The discount for early payment is treated as an adjustment to gross income in the year of payment, if payment is received within the time required for allowance of the discount. *See* paragraph (g) *Example 3* of this section for an example of this rule.

(2) *Applicable period*—(i) *In general*. The applicable period is the number of taxable years on which the taxpayer bases its nonaccrual-experience method. A change in the number of taxable

years included in the applicable period is a change in method of accounting to which the procedures of section 446 apply. A change in the inclusion or exclusion of the current taxable year in the applicable period is a change in method of accounting to which the procedures of section 446 apply. A change in the number of taxable years included in the applicable period or the inclusion or exclusion of the current taxable year in the applicable period is made on a cut-off basis.

(ii) *Applicable period for safe harbors.* For purposes of the safe harbors under paragraph (f) of this section the applicable period may consist of at least three but not more than six of the immediately preceding consecutive taxable years. Alternatively, the applicable period may consist of the current taxable year and at least two but not more than five of the immediately preceding consecutive taxable years. A period shorter than six taxable years is permissible only if the period contains the most recent preceding taxable years and all of the taxable years in the applicable period are consecutive.

(3) *Bad debts.* Bad debts are accounts receivable determined to be uncollectible and charged off.

(4) *Charge-offs.* Amounts charged off include only those amounts that would otherwise be allowable under section 166(a).

(5) *Determination date.* The determination date in safe harbor 2 provided in paragraph (f)(2) of this section is used as a cut-off date for determining all known data to be taken into account in the computation of the taxable year's uncollectible amount. The determination date may not be later than the earlier of the due date, including extensions, for filing the taxpayer's Federal income tax return for that taxable year or the date on which the taxpayer timely files the return for that taxable year. The determination date may be different in each taxable year. However, once a determination date is selected and used for a particular taxable year, it may not be changed for that taxable year. The choice of a determination date is not a method of accounting.

(6) *Recoveries.* Recoveries are amounts previously excluded from income under a nonaccrual-experience method or charged off that the taxpayer recovers.

(7) *Uncollectible amount.* The uncollectible amount is the portion of any account receivable amount due that, under the taxpayer's nonaccrual-experience method, will be not collected.

(d) *Use of experience to estimate uncollectible amounts*—(1) *In general.* In determining the portion of any amount due that, on the basis of experience, will not be collected, a taxpayer may use any nonaccrual-experience method that clearly reflects the taxpayer's nonaccrual-experience. The determination of whether a nonaccrual-experience method clearly reflects the taxpayer's nonaccrual-experience is made in accordance with the rules under paragraph (e) of this section. Alternatively, the taxpayer may use any one of the five safe harbor nonaccrual-experience methods of accounting provided in paragraphs (f)(1) through (f)(5) of this section, which are presumed to clearly reflect a taxpayer's nonaccrual-experience.

(2) *Application to specific accounts receivable.* The nonaccrual-experience method is applied with respect to each account receivable of the taxpayer that is eligible for this method. With respect to a particular account receivable, the taxpayer determines, in the manner prescribed in paragraphs (d)(1) or (f)(1) through (f)(5) of this section (whichever applies), the uncollectible amount. The determination is required to be made only once with respect to each account receivable, regardless of the term of the receivable. The uncollectible amount is not recognized as gross income. Thus, the amount recognized as gross income is the amount that would otherwise be recognized as gross income with respect to the account receivable, less the uncollectible amount. A taxpayer that excludes an amount from income during a taxable year as a result of the taxpayer's use of a nonaccrual-experience method may not deduct in any subsequent taxable year the amount excluded from income. Thus, the taxpayer may not deduct the excluded amount in a subsequent taxable year in which the taxpayer actually determines that the

amount is uncollectible and charges it off. If a taxpayer using a nonaccrual-experience method determines that an amount that was not excluded from income is uncollectible and should be charged off (for example, a calendar-year taxpayer determines on November 1st that an account receivable that was originated on May 1st of the same taxable year is uncollectible and should be charged off), the taxpayer may deduct the amount charged off when it is charged off, but must include any subsequent recoveries in income. The reasonableness of a taxpayer's determination that amounts are uncollectible and should be charged off may be considered on examination. *See* paragraph (g) *Example 12* of this section for an example of this rule.

(3) *Acquisitions and dispositions*—(i) *Acquisitions*. If a taxpayer acquires the major portion of a trade or business of another person (predecessor) or the major portion of a separate unit of a trade or business of a predecessor, then, for purposes of applying this section for any taxable year ending on or after the acquisition, the experience from preceding taxable years of the predecessor attributable to the portion of the trade or business acquired, if available, must be used in determining the taxpayer's experience.

(ii) *Dispositions*. If a taxpayer disposes of a major portion of a trade or business or the major portion of a separate unit of a trade or business, and the taxpayer furnished the acquiring person the information necessary for the computations required by this section, then, for purposes of applying this section for any taxable year ending on or after the disposition, the experience from preceding taxable years attributable to the portion of the trade or business disposed may not be used in determining the taxpayer's experience.

(iii) *Meaning of terms*. For the meaning of the terms *acquisition*, *separate unit*, and *major portion*, *see* paragraph (b) of §1.52–2. The term *acquisition* includes an incorporation or a liquidation.

(4) *New taxpayers*. The rules of this paragraph (d)(4) apply to any newly formed taxpayer to which the rules of paragraph (d)(3)(i) of this section do not apply. Any newly formed taxpayer that wants to use a safe harbor nonaccrual-experience method of accounting described in paragraph (f)(1), (f)(2), (f)(3), (f)(4), or (f)(5) of this section applies the methods by using the experience of the actual number of taxable years available in the applicable period. A newly formed taxpayer that wants to use one of the safe harbor nonaccrual-experience methods of accounting described in paragraph (f)(2), (f)(4), or (f)(5) of this section in its first taxable year and does not have any accounts receivable upon formation may not exclude any portion of its year-end accounts receivable from income for its first taxable year. The taxpayer must begin creating its moving average in its second taxable year by tracking the accounts receivable as of the first day of its second taxable year. The use of one of the safe harbor nonaccrual-experience methods of accounting described in paragraph (f)(2), (f)(4), or (f)(5) of this section in a taxpayer's second taxable year in this situation is not a change in method of accounting. Although the taxpayer must maintain the books and records necessary to perform the computations under the adopted safe harbor nonaccrual-experience method, the taxpayer is not required to affirmatively elect the method on its Federal income tax return for its first taxable year.

(5) *Recoveries*. Regardless of the nonaccrual-experience method of accounting used by a taxpayer under this section, the taxpayer must take recoveries into account. If, in a subsequent taxable year, a taxpayer recovers an amount previously excluded from income under a nonaccrual-experience method or charged off, the taxpayer must include the recovered amount in income in that subsequent taxable year. *See* paragraph (g) *Example 13* of this section for an example of this rule.

(6) *Request to exclude taxable years from applicable period*. A period shorter than the applicable period generally is permissible only if the period consists of consecutive taxable years and there is a change in the type of a substantial portion of the outstanding accounts receivable such that the risk of loss is substantially increased. A decline in the general economic conditions in the area, which substantially increases the

risk of loss, is a relevant factor in determining whether a shorter period is appropriate. However, approval to use a shorter period will not be granted unless the taxpayer supplies evidence that the accounts receivable outstanding at the close of the taxable years for the shorter period requested are more comparable in nature and risk to accounts receivable outstanding at the close of the current taxable year. A substantial increase in a taxpayer's bad debt experience is not, by itself, sufficient to justify the use of a shorter period. If approval is granted to use a shorter period, the experience for the excluded taxable years may not be used for any subsequent taxable year. A request for approval to exclude the experience of a prior taxable year must be made in accordance with the applicable procedures for requesting a letter ruling and must include a statement of the reasons the experience should be excluded. A request will not be considered unless it is sent to the Commissioner at least 30 days before the close of the first taxable year for which the approval is requested.

(7) *Short taxable years.* A taxpayer with a short taxable year that uses a nonaccrual-experience method that compares accounts receivable balance to total bad debts during the taxable year should make appropriate adjustments.

(8) *Recordkeeping requirements*—(i) A taxpayer using a nonaccrual-experience method of accounting must keep sufficient books and records to establish the amount of any exclusion from gross income under section 448(d)(5) for the taxable year, including books and records demonstrating—

(A) The nature of the taxpayer's nonaccrual-experience method;

(B) Whether, for any particular taxable year, the taxpayer qualifies to use its nonaccrual-experience method (including the self-testing requirements of paragraph (e) of this section (if applicable));

(C) The taxpayer's determination that amounts are uncollectible;

(D) The proper amount that is excludable under the taxpayer's nonaccrual-experience method; and

(E) The taxpayer's determination date under paragraph (c)(5) of this section (if applicable).

(ii) If a taxpayer does not maintain records of the data that are sufficient to establish the amount of any exclusion from gross income under section 448(d)(5) for the taxable year, the Internal Revenue Service may change the taxpayer's method of accounting on examination. *See* §1.6001–1 for rules regarding records.

(e) *Requirements for nonaccrual method to clearly reflect experience*—(1) *In general.* A nonaccrual-experience method clearly reflects the taxpayer's experience if the taxpayer's nonaccrual-experience method meets the self-test requirements described in this paragraph (e). If a taxpayer is using one of the safe harbor nonaccrual-experience methods described in paragraphs (f)(1) through (f)(4) of this section, its method is deemed to clearly reflect its experience and is not subject to the self-testing requirements in paragraphs (e)(2) and (e)(3) of this section.

(2) *Requirement to self-test*—(i) *In general.* A taxpayer using, or desiring to use, a nonaccrual-experience method must self-test its nonaccrual-experience method for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method (first-year self-test) and every three taxable years thereafter (three-year self-test). Each self-test must be performed by comparing the uncollectible amount (under the taxpayer's nonaccrual-experience method) with the taxpayer's actual experience. A taxpayer using the safe harbor under paragraph (f)(5) of this section must self-test using the safe harbor comparison method in paragraph (e)(3) of this section.

(ii) *First-year self-test.* The first-year self-test must be performed by comparing the uncollectible amount with the taxpayer's actual experience for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method. If the uncollectible amount for the first-year self-test is less than or equal to the taxpayer's actual experience for its

first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method, the taxpayer's nonaccrual-experience method is treated as clearly reflecting its experience for the first taxable year. If, as a result of the first-year self-test, the uncollectible amount for the test period is greater than the taxpayer's actual experience, then—

(A) The taxpayer's nonaccrual-experience method is treated as not clearly reflecting its experience;

(B) The taxpayer is not permitted to use that nonaccrual-experience method in that taxable year; and

(C) The taxpayer must change to (or adopt) for that taxable year either—

(*1*) Another nonaccrual-experience method that clearly reflects experience, that is, a nonaccrual-experience method that meets the first-year self-test requirement; or

(*2*) A safe harbor nonaccrual-experience method described in paragraphs (f)(1) through (f)(5) of this section.

(iii) *Three-year self-test*—(A) *In general*. The three-year self-test must be performed by comparing the sum of the uncollectible amounts for the current taxable year and prior two taxable years (cumulative uncollectible amount) with the sum of the taxpayer's actual experience for the current taxable year and prior two taxable years (cumulative actual experience amount).

(B) *Recapture*. If the cumulative uncollectible amount for the test period is greater than the cumulative actual experience amount for the test period, the taxpayer's uncollectible amount is limited to the cumulative actual experience amount for the test period. Any excess of the taxpayer's cumulative uncollectible amount over the taxpayer's cumulative actual nonaccrual-experience amount excluded from income during the test period must be recaptured into income in the third taxable year of the three-year self-test period.

(C) *Determination of whether method is permissible or impermissible*. If the cumulative uncollectible amount is less than 110 percent of the cumulative actual experience amount, the taxpayer's nonaccrual-experience method is treated as a permissible method and the taxpayer may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement of this paragraph (e)(2)(iii). If the cumulative uncollectible amount is greater than or equal to 110 percent of the cumulative actual experience amount, the taxpayer's nonaccrual-experience method is treated as impermissible in the taxable year subsequent to the three-year self-test year and does not clearly reflect its experience. The taxpayer must change to another nonaccrual-experience method that clearly reflects experience, including, for example, one of the safe harbor nonaccrual-experience methods described in paragraphs (f)(1) through (f)(5) of this section, for the subsequent taxable year. A change in method of accounting from an impermissible method under this paragraph (e)(2)(iii)(C) to a permissible method in the taxable year subsequent to the three-year self-test year is made on a cut-off basis.

(iv) *Determination of taxpayer's actual experience*. [Reserved]

(3) *Safe harbor comparison method*—(i) *In general*. A taxpayer using, or desiring to use, a nonaccrual-experience method under the safe harbor in paragraph (f)(5) of this section must self-test its nonaccrual-experience method for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method (first-year self-test) and every three taxable years thereafter (three-year self-test). A nonaccrual-experience method under the safe harbor in paragraph (f)(5) of this section is deemed to clearly reflect experience provided all the requirements of the safe harbor comparison method of this paragraph (e)(3) are met. Each self-test must be performed by comparing the uncollectible amount (under the taxpayer's nonaccrual-experience method) with the uncollectible amount that would have resulted from use of one of the safe harbor methods described in paragraph (f)(1), (f)(2), (f)(3), or (f)(4) of this section. A change from a nonaccrual-experience method that uses the safe harbor comparison method for self-testing to a nonaccrual-experience method that does not use the safe harbor comparison method for self-testing, and vice versa,

is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations apply. A change solely to use or discontinue use of the safe harbor comparison method for purposes of determining whether the nonaccrual-experience method clearly reflects experience must be made on a cut-off basis and without audit protection.

(ii) *Requirements to use safe harbor comparison method*—(A) *First-year self-test*. The first-year self-test must be performed by comparing the uncollectible amount with the uncollectible amount determined under any of the safe harbor methods described in paragraph (f)(1), (f)(2), (f)(3), or (f)(4) of this section (safe harbor uncollectible amount) for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method. If the uncollectible amount for the first-year self-test is less than or equal to the safe harbor uncollectible amount, then the taxpayer's nonaccrual-experience method is treated as clearly reflecting its experience for the first taxable year. If, as a result of the first-year self-test, the uncollectible amount for the test period is greater than the safe harbor uncollectible amount, then—

(*1*) The taxpayer's nonaccrual-experience method is treated as not clearly reflecting its experience;

(*2*) The taxpayer is not permitted to use that nonaccrual-experience method in that taxable year; and

(*3*) The taxpayer must change to (or adopt) for that taxable year either—

(*i*) Another nonaccrual-experience method that clearly reflects experience, that is, a nonaccrual-experience method that meets the first-year self-test requirement; or

(*ii*) A safe harbor nonaccrual-experience method described in paragraphs (f)(1) through (f)(5) of this section.

(B) *Three-year self-test*. The three-year self-test must be performed by comparing the sum of the uncollectible amounts for the current taxable year and prior two taxable years (cumulative uncollectible amount) with the sum of the uncollectible amount determined under any of the safe harbor methods described in paragraph (f)(1), (f)(2), (f)(3), or (f)(4) of this section for the current taxable year and prior two taxable years (cumulative safe harbor uncollectible amounts). If the cumulative uncollectible amount for the three-year self-test is less than or equal to the cumulative safe harbor uncollectible amount for the test period, then the taxpayer's nonaccrual-experience method is treated as clearly reflecting its experience for the test period and the taxpayer may continue to use that nonaccrual-experience method, subject to a requirement to self-test again after three taxable years. If the cumulative uncollectible amount for the test period is greater than the cumulative safe harbor uncollectible amount for the test period, the taxpayer's uncollectible amount is limited to the cumulative safe harbor uncollectible amount for the test period. Any excess of the taxpayer's cumulative uncollectible amount over the taxpayer's cumulative safe harbor uncollectible amount excluded from income during the test period must be recaptured into income in the third taxable year of the three-year self-test period. If the cumulative uncollectible amount is less than 110 percent of the cumulative safe harbor uncollectible amount, the taxpayer's nonaccrual-experience method is treated as a permissible method and the taxpayer may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement of this paragraph (e)(3)(ii)(B). If the cumulative uncollectible amount is greater than or equal to 110 percent of the cumulative safe harbor uncollectible amount, the taxpayer's nonaccrual-experience method is treated as impermissible in the taxable year subsequent to the three-year self-test year and does not clearly reflect its experience. The taxpayer must change to another nonaccrual-experience method that clearly reflects experience, including, for example, one of the safe harbor nonaccrual-experience methods described in paragraphs (f)(1) through (f)(5) of this section, for the subsequent taxable year. A change in method of accounting from an impermissible method under this paragraph (e)(3)(ii)(B) to a permissible method in the taxable year

subsequent to the three-year self-test year is made on a cut-off basis.

(4) *Methods that do not clearly reflect experience.* [Reserved]

(5) *Contemporaneous documentation.* For purposes of this paragraph (e), including the safe harbor comparison method of paragraph (e)(3) of this section, a taxpayer must document in its books and records, in the taxable year any first-year or three-year self-test is performed, the method used to conduct the self-test, including appropriate documentation and computations that resulted in the determination that the taxpayer's nonaccrual-experience method clearly reflected the taxpayer's nonaccrual-experience for the applicable test period.

(f) *Safe harbors*—(1) *Safe harbor 1: revenue-based moving average method.* A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (revenue-based moving average percentage). The revenue-based moving average percentage is computed by dividing the total bad debts sustained, adjusted by recoveries received, throughout the applicable period by the total revenue resulting in accounts receivable earned throughout the applicable period. *See* paragraph (g) *Example 4* of this section for an example of this method. Thus, the uncollectible amount under the revenue-based moving average method is computed:

$$\frac{\text{Bad debts sustained, adjusted by recoveries received, during the applicable period}}{\text{Total revenue resulting in accounts receivable during the applicable period}} \times \text{Accounts receivable at end of current taxable year}$$

(2) *Safe harbor 2: actual experience method—(i) Option A: single determination date.* A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (moving average nonaccrual-experience percentage) and then increasing the resulting amount by 5 percent. *See* paragraph (g) *Example 5* of this section for an example of safe harbor 2 in general, and paragraph (g) *Example 6* of this section for an example of the single determination date option of safe harbor 2. The taxpayer's moving average nonaccrual-experience percentage is computed by dividing the total bad debts sustained, adjusted by recoveries that are allocable to the bad debts, by the determination date of the current taxable year related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period by the sum of the accounts receivable at the beginning of each taxable year during the applicable period. Thus, the uncollectible amount under Option A of the actual experience method is computed:

$$\frac{\text{Bad debts sustained, adjusted by recoveries received that are allocable to the bad debts, by the determination date of the current taxable year related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period}}{\text{Sum of accounts receivable at the beginning of each taxable year during the applicable period}} \times \text{Accounts receivable at end of current taxable year} \times 1.05$$

(ii) *Option B: multiple determination dates.* Alternatively, in computing its bad debts related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period, a taxpayer may use

the original determination date for each taxable year during the applicable period. That is, the taxpayer may use bad debts sustained, adjusted by recoveries received that are allocable to the bad debts, by the determination date of each taxable year during the applicable period rather than the determination date of the current taxable year. *See* paragraph (g) *Example 7* of this section for an example of the multiple determination date option of safe harbor 2. Thus, the uncollectible amount under Option B of the actual experience method is computed:

$$\frac{\text{Sum of, for each taxable year during the applicable period, bad debts sustained, adjusted by recoveries received that are allocable to the bad debts, by that taxable year's determination date and related to the taxpayer's accounts receivable balance at the beginning of the taxable year}}{\text{Sum of accounts receivable at the beginning of each taxable year during the applicable period}} \times \text{Accounts receivable at end of current taxable year} \times 1.05$$

(iii) *Tracing of recoveries*—(A) *In general*. Bad debts related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period must be adjusted by the portion, if any, of recoveries received that are properly allocable to the bad debts.

(B) *Specific tracing*. If a taxpayer, without undue burden, can trace all recoveries to their corresponding charge-offs, the taxpayer must specifically trace all recoveries.

(C) *Recoveries cannot be traced without undue burden*. If a taxpayer has any recoveries that cannot, without undue burden, be traced to corresponding charge-offs, the taxpayer may allocate those or all recoveries between charge-offs of amounts in the relevant beginning accounts receivable balances and other charge-offs using an allocation method that is reasonable under all of the facts and circumstances.

(*1*) *Reasonable allocations*. An allocation method is reasonable if there is a cause and effect relationship between the allocation base or ratio and the recoveries. A taxpayer may elect to trace recoveries that are traceable and allocate all untraceable recoveries to charge-offs of amounts in the relevant beginning accounts receivable balances. Such an allocation method will be deemed to be reasonable under all the facts and circumstances.

(*2*) *Allocations that are not reasonable*. Allocation methods that generally will not be considered reasonable include, for example, methods in which there is not a cause and effect relationship between the allocation base or ratio and methods in which receivables for which the nonaccrual-experience method is not allowed to be used are included in the allocation. *See* paragraph (c)(1)(ii) of this section for examples of receivables for which the nonaccrual-experience method is not allowed.

(3) *Safe harbor 3: modified Black Motor method*. A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (modified Black Motor moving average percentage) and then reducing the resulting amount by the bad debts written off during the current taxable year relating to accounts receivable generated during the current taxable year. The modified Black Motor moving average percentage is computed by dividing the total bad debts sustained, adjusted by recoveries received, during the applicable period by the sum of accounts receivable at the end of each taxable year during the applicable period. *See* paragraph (g) *Example 8* of this section for an example of this method. Thus, the uncollectible amount under the modified Black Motor method is computed:

$$\frac{\text{Bad debts sustained, adjusted by recoveries received, during the applicable period}}{\text{Sum of accounts receivable at the end of each taxable year during the applicable period}} \times \text{Accounts receivable at end of current taxable year} - \text{Bad debts written off during the current taxable year relating to accounts receivable generated during the current taxable year}$$

(4) *Safe harbor 4: modified moving average method.* A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (modified moving average percentage). The modified moving average percentage is computed by dividing the total bad debts sustained, adjusted by recoveries received, during the applicable period other than bad debts that were written off in the same taxable year the related accounts receivable were generated by the sum of accounts receivable at the beginning of each taxable year during the applicable period. *See* paragraph (g) *Example 9* of this section for an example of this method. Thus, the uncollectible amount under the modified moving average method is computed:

$$\frac{\text{(Bad debts sustained, adjusted by recoveries received, during the applicable period} - \text{Bad debts written off in same taxable year accounts receivable generated)}}{\text{Sum of accounts receivable at the beginning of each taxable year during the applicable period}} \times \text{Accounts receivable at end of current taxable year}$$

(5) *Safe harbor 5: alternative nonaccrual-experience method.* A taxpayer may use an alternative nonaccrual-experience method that clearly reflects the taxpayer's actual nonaccrual-experience, provided the taxpayer's alternative nonaccrual-experience method meets the self-test requirements described in paragraph (e)(3) of this section.

(g) *Examples.* The following examples illustrate the provisions of this section. In each example, the taxpayer uses a calendar year for Federal income tax purposes and an accrual method of accounting, does not require the payment of interest or penalties with respect to past due accounts receivable (except in the case of *Example 3*) and, in the case of *Examples 5* through *7*, selects an appropriate determination date for each taxable year. The examples are as follows:

Example 1. Contractual allowance or adjustment. B, a healthcare provider, performs a medical procedure on individual C, who has health insurance coverage with IC, an insurance company. B bills IC and C for $5,000, B's standard charge for this medical procedure. However, B has a contract with IC that obligates B to accept $3,500 as full payment for the medical procedure if the procedure is provided to a patient insured by IC. Under the contract, only $3,500 of the $5,000 billed by B is legally collectible from IC and C. The remaining $1,500 represents a contractual allowance or contractual adjustment. Under paragraph (c)(1)(i) of this section, the remaining $1,500 is not a contractually collectible amount for purposes of this section and B may not use a nonaccrual-experience method with respect to this portion of the receivable.

Example 2. Charitable or pro bono services. D, a law firm, agrees to represent individual E in a legal matter and to provide services to E on a pro bono basis. D normally charges $500 for these services. Because D provides its services to E pro bono, D's services are never billed or intended to result in revenue.

Thus, under paragraph (c)(1)(i) of this section, the $500 is not a collectible amount for purposes of this section and D may not use a nonaccrual-experience method with respect to this portion of the receivable.

Example 3. Charging interest and/or penalties. Z has two billing methods for the amounts to be received from Z's provision of services described in paragraph (a)(1) of this section. Under one method, for amounts that are more than 90 days past due, Z charges interest at a market rate until the amounts (together with interest) are paid. Under the other billing method, Z charges no interest for amounts past due. Under paragraph (c)(1)(ii) of this section, A may not use a nonaccrual-experience method of accounting with respect to any of the amounts billed under the method that charges interest on amounts that are more than 90 days past due. Z may, however, use the nonaccrual-experience method with respect to the amounts billed under the method that does not charge interest for amounts past due.

Example 4. Safe harbor 1: Revenue-based moving average method. (i) F uses the revenue-based moving average method described in paragraph (f)(1) of this section with an applicable period of six taxable years. F's total accounts receivable and bad debt experience for the 2006 taxable year and the five immediately preceding consecutive taxable years are as follows:

Taxable year	Total accounts receivable earned during the taxable year	Bad debts adjusted for recoveries
2001	$40,000	$5,700
2002	40,000	7,200
2003	40,000	11,000
2004	60,000	10,200
2005	70,000	14,000
2006	80,000	16,800
Total	330,000	64,900

(ii) F's revenue-based moving average percentage is 19.67% ($64,900/$330,000). If $49,300 of accounts receivable remains outstanding as of the close of that taxable year (2006), F's uncollectible amount using the revenue-based moving average safe harbor method is computed by multiplying $49,300 by the revenue-based moving average percentage of 19.67%, or $9,697. Thus, F may exclude $9,697 from gross income for 2006.

Example 5. Safe harbor 2: Actual experience method . (i) G is eligible to use a nonaccrual-experience method and wishes to adopt the actual experience method of paragraph (f)(2) of this section. G elects to use a three-year applicable period consisting of the current and two immediately preceding consecutive taxable years. G determines that its actual accounts receivable collection experience is as follows:

Taxable year	Total A/R balance at beginning of taxable year	Bad debts, adjusted for recoveries, related to A/R balance at beginning of taxable year
2006	$1,000,000	$35,000
2007	760,000	75,000
2008	1,975,000	65,000
Total	3,735,000	175,000

(ii) G's ending A/R Balance on December 31, 2008, is $880,000. In 2008, G computes its uncollectible amount by using a three-year moving average under paragraph (f)(2) of this section. G's moving average nonaccrual-experience percentage is 4.7%, determined by dividing the sum of the amount of G's accounts receivable outstanding on January 1 of 2006, 2007, and 2008, that were determined to be bad debts (adjusted for recoveries allocable to the bad debts) on or before the corresponding determination date(s), by the sum of the amount of G's accounts receivable outstanding on January 1 of 2006, 2007, and 2008 ($175,000/$3,735,000 or 4.7%). G's uncollectible amount for 2008 is determined by multiplying this percentage by the balance of G's accounts receivable on December 31, 2008 ($880,000×4.7%=$41,360), and increasing this amount by 105% ($41,360×105%=$43,428). G may exclude $43,428 from gross income for 2008.

Example 6. Safe harbor 2: Single determination date (Option A). H is eligible to use a nonaccrual-experience method and wishes to adopt the actual experience method of paragraph (f)(2) of this section. H elects to use a six-year applicable period consisting of the current and five immediately preceding taxable years. H also elects to use a single determination date in accordance with paragraph (f)(2)(i) of this section. H selects December 31, its taxable year-end, as its determination date. Since H is using a single determination date from the current taxable year, its determination date for the 2001–2006 applicable period is December 31, 2006. H has a $800 charge-off in 2003 of an account receivable in the 2003 beginning accounts receivable balance. In 2005, H has a recovery of $100 which is traceable, without undue burden, to the $800 charge-off in 2003. Since the $100 recovery occurred prior to H's December 31, 2006, determination date, it reduces the amount of H's bad debts in the numerator of the formula for purposes of determining H's moving average nonaccrual-experience percentage. In addition, H must include the $100 recovery in income in 2005 (*see* paragraph (d)(5) of this section regarding recoveries).

Example 7. Safe harbor 2: Multiple determination dates (Option B). The facts are the same as in *Example 6*, except H elects to use multiple determination dates in accordance with

paragraph (f)(2)(ii) of this section. Consequently, H's determination date is December 31, 2001, for its calculations of the portion of the numerator relating to the 2001 taxable year, December 31, 2002, for its calculations of the portion of the numerator relating to the 2002 taxable year, and so on through the final taxable year (2006), which has a determination date of December 31, 2006. Since the $100 recovery did not occur until after December 31, 2003 (the determination date for the 2003 taxable year), it does not reduce the amount of H's bad debts in the numerator of the formula for purposes of determining H's moving average nonaccrual-experience percentage. However, H still must include the $100 recovery in income in 2005 (*see* paragraph (d)(5) of this section regarding recoveries).

Example 8. Safe harbor 3: Modified Black Motor method. (i) J uses the modified Black Motor method described in paragraph (f)(3) of this section and a six-year applicable period. J's total accounts receivable and bad debt experience for the 2006 taxable year and the five immediately preceding consecutive taxable years are as follows:

Taxable year	Accounts receivable at end of taxable year	Bad debts (adjusted for recoveries)
2001	$130,000	$9,100
2002	140,000	7,000
2003	140,000	14,000
2004	160,000	14,400
2005	170,000	20,400
2006	180,000	10,800
Total	920,000	75,700

(ii) J's modified Black Motor moving average percentage is 8.228% ($75,700/$920,000). If the accounts receivable generated and written off during the current taxable year are $3,600, J's uncollectible amount is $11,210, computed by multiplying J's accounts receivable on December 31, 2006 ($180,000) by the modified Black Motor moving average percentage of 8.228% and reducing the resulting amount by $3,600 (J's accounts receivable generated and written off during the 2006 taxable year). J may exclude $11,210 from gross income for 2006.

Example 9. Safe harbor 4: Modified moving average method. (i) The facts are the same as in *Example 8*, except that the balances represent accounts receivable at the beginning of the taxable year, and J uses the modified moving average method described in paragraph (f)(4) of this section and a six-year applicable period. Furthermore, the accounts receivable that were written off in the same taxable year they were generated, adjusted for recoveries of bad debts during the period are as follows:

Taxable year	Accounts receivable written off in same taxable year as generated (adjusted for recoveries)
2001	$3,033
2002	2,333
2003	4,667
2004	4,800
2005	6,800
2006	3,600
Total	25,233

(ii) J's modified moving average percentage is 5.486% (($75,700 − $25,233)/$920,000). J's uncollectible amount is $9,875, computed by multiplying J's accounts receivable on December 31, 2006 ($180,000) by the modified moving average percentage of 5.486%. J may exclude $9,875 from gross income for 2006.

Example 10. First-year self-test. Beginning in 2006, K is eligible to use a nonaccrual-experience method and wants to adopt an alternative nonaccrual-experience method under paragraph (f)(5) of this section, and consequently is subject to the safe harbor comparison method of self-testing under paragraph (e)(3) of this section. K elects to self-test against safe harbor 1 for purposes of conducting its first-year self-test. K's uncollectible amount for 2006 is $22,000. K's safe harbor uncollectible amount under safe harbor 1 is $21,000. Because K's uncollectible amount for 2006 ($22,000) is greater than the safe harbor uncollectible amount ($21,000), K's alternative nonaccrual-experience method is treated as not clearly reflecting its nonaccrual experience for 2006. Accordingly, K must adopt either another nonaccrual-experience method that clearly reflects experience (subject to the self-testing requirements of paragraph (e)(2)(ii) of this section, or a safe harbor nonaccrual-experience method described in paragraph (f)(1) (revenue-based moving average), (f)(2) (actual experience method), (f)(3) (modified Black Motor method), (f)(4) (modified moving average method) of this section, or another alternative nonaccrual-experience method under paragraph (f)(5) of this section that meets the self-testing requirements of paragraph (e)(3) of this section.

Example 11. Three-year self-test. The facts are the same as in Example 10, except that K's safe harbor uncollectible amount under safe harbor 1 for 2006 is also $22,000. Consequently, K meets the first-year self-test requirement and may use its alternative nonaccrual-experience method. Subsequently, K's cumulative uncollectible amount for 2007 through 2009 is $300,000. K's safe harbor uncollectible amount for 2007 through 2009 under its chosen safe harbor method for self-testing (safe harbor 1) is $295,000. Because K's cumulative uncollectible amount for the

three-year test period (taxable years 2007 through 2009) is greater than its safe harbor uncollectible amount for the three-year test period ($295,000), under paragraph (e)(3)(ii)(B) of this section, the $5,000 excess of K's cumulative uncollectible amount over K's safe harbor uncollectible amount for the three-year test period must be recaptured into income in 2009 in accordance with paragraph (e)(3)(ii)(B) of this section. Since K's cumulative uncollectible amount for the three-year test period ($300,000) is less than 110% of its safe harbor uncollectible amount ($295,000×110%=$324,500), under paragraph (e)(3)(ii)(B) of this section, K may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement.

Example 12. Subsequent worthlessness of year-end receivable. The facts are the same as in *Example 4,* except that one of the accounts receivable outstanding at the end of 2002 was for $8,000, and in 2003, under section 166, the entire amount of this receivable becomes wholly worthless. Because F does not accrue as income $1,573 of this account receivable ($8,000×.1967) under the nonaccrual-experience method in 2002, under paragraph (d)(2) of this section F may not deduct this portion of the account receivable as a bad debt deduction under section 166 in 2003. F may deduct the remaining balance of the receivable in 2003 as a bad debt deduction under section 166 ($8,000 − $1,574=$6,426).

Example 13. Subsequent collection of year-end receivable. The facts are the same as in *Example 4.* In 2007, F collects in full an account receivable of $1,700 that was outstanding at the end of 2006. Under paragraph (d)(5) of this section, F must recognize additional gross income in 2007 equal to the portion of this receivable that F excluded from gross income in the prior taxable year ($1,700×.1967=$334). That amount ($334) is a recovery under paragraph (d)(5) of this section.

(h) *Effective date.* This section is applicable for taxable years ending on or after August 31, 2006.

[T.D. 9285, 71 FR 52437, Sept. 6, 2006]

TAXABLE YEAR FOR WHICH ITEMS OF GROSS INCOME INCLUDED

§ 1.451–1 General rule for taxable year of inclusion.

(a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and paragraph (a) of § 1.706–1. If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

(b) *Special rule in case of death.* (1) A taxpayer's taxable year ends on the date of his death. See section 443(a)(2) and paragraph (a)(2) of § 1.443–1. In computing taxable income for such year, there shall be included only amounts