Internal Revenue
bulletin

Bulletin No. 2002–3
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

T.D. 8971, page 308.
REG–119436–01, page 377.
Temporary and proposed regulations under section 45D of the Code provide guidance on the new markets tax credit. A taxpayer making a qualified equity investment in a qualified community development entity that has received a new markets tax credit allocation may claim a 5–percent tax credit with respect to the qualified equity investment on each of the first 3 credit allowance dates and a 6–percent credit on each of the remaining 4 credit allowance dates. A public hearing on the proposed regulations is scheduled for March 14, 2002.

T.D. 8974, page 318.
Final regulations under section 6050I of the Code cross reference section 5331 of Title 31 and concern reporting on the same form certain currency transactions that are required to be reported to both IRS and the Financial Crimes Enforcement Network (FinCEN).

EMPLOYEE PLANS

Rev. Rul. 2002–3, page 316.
Health insurance premiums. This ruling provides guidance on the application of sections 106(a) and 105(b) of the Code to reimbursements of employees for salary reduction amounts previously excluded from gross income under section 106(a). Rev. Rul. 61–146 distinguished.

EMPLOYMENT TAX

Rev. Rul. 2002–3, page 316.
Health insurance premiums. This ruling provides guidance on the application of sections 106(a) and 105(b) of the Code to reimbursements of employees for salary reduction amounts previously excluded from gross income under section 106(a). Rev. Rul. 61–146 distinguished.

Notice 2002–5, page 320.
Tax Court review of worker classification and section 530 determinations. This document describes procedures that the Service has implemented to comply with the amendment to section 7436 of the Code by the Community Renewal Tax Relief Act of 2000. Notice 98–43 modified and superseded.

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Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ADMINISTRATIVE

Notice 2002–6, page 326.
This document clarifies that, although tax return preparers may be subject to the privacy provisions of the Gramm-Leach-Bliley Act, those provisions do not supersede, alter, or affect the pre-existing requirements of section 7216 of the Code restricting the disclosure or use of tax return information by a tax return preparer.

Rev. Proc. 2002–9, page 327.
Methods of accounting; automatic consent. Procedures are provided under which a taxpayer may obtain automatic consent of the Commissioner to change certain methods of accounting. Rev. Proc. 99–49 modified and superseded.

Rev. Proc. 2002–12, page 374.
Materials and supplies; restaurant smallwares. A safe harbor method of accounting for "smallwares" is provided for taxpayers engaged in the trade or business of operating a restaurant or tavern. Under this safe harbor method, such taxpayers may account for smallwares in the same manner as materials and supplies that are not incidental under section 1.162–3 of the regulations.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 45.—New Markets Tax Credit

26 CFR 1.45D–1T: New markets tax credit.

T.D. 8971

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

New Markets Tax Credit

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance for taxpayers claiming the new markets tax credit under section 45D. A taxpayer making a qualified equity investment in a qualified community development entity that has received a new markets tax credit allocation may claim a 5–percent tax credit with respect to the qualified equity investment on each of the first 3 credit allowance dates and a 6–percent tax credit with respect to the qualified equity investment on each of the remaining 4 credit allowance dates. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in REG–119436–01 on page 377 of this Bulletin.

DATES: *Effective Date:* These regulations are effective December 26, 2001.

Date of Applicability: For date of applicability of § 1.45D–1T, see § 1.45D–1T(h).

FOR FURTHER INFORMATION CONTACT: Paul Handleman (202) 622–3040.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collections of information contained in these regulations have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1765. Responses to these collections of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

For further information concerning these collections of information, and where to submit comments on the collections of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published elsewhere in this issue of the Bulletin.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains temporary regulations relating to the new markets tax credit under section 45D of the Internal Revenue Code (Code). This provision was added to the Code by section 121(a) of the Community Renewal Tax Relief Act of 2000 (Public Law 106–554). The Secretary has delegated certain administrative, application, allocation, monitoring, and other programmatic functions relating to the new markets tax credit program to the Under Secretary (Domestic Finance), who in turn has delegated those functions to the Community Development Financial Institutions Fund (CDFI Fund).

On May 1, 2001, the IRS published an advance notice of proposed rulemaking (Announcement 2001–49, 2001–20 I.R.B. 1183) in the **Federal Register** (66 FR 21844) inviting comments relating to tax issues arising under section 45D. Numerous comments have been received. The IRS and Treasury Department have reviewed and considered all the comments in the process of preparing this Treasury decision. This preamble to the temporary regulations describes many, but not all, of the comments received by the IRS.

Explanation of Provisions

General Overview

Taxpayers may claim a new markets tax credit on a credit allowance date in an amount equal to the applicable percentage of the taxpayer's qualified equity investment in a qualified community development entity (CDE). The credit allowance date for any qualified equity investment is the date on which the investment is initially made and each of the 6 anniversary dates thereafter. The applicable percentage is 5 percent for the first 3 credit allowance dates and 6 percent for the remaining credit allowance dates.

A CDE is any domestic corporation or partnership if: (1) the primary mission of the entity is serving or providing investment capital for low-income communities or low-income persons; (2) the entity maintains accountability to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity; and (3) the entity is certified by the Secretary for purposes of section 45D as being a CDE.

The new markets tax credit may be claimed only for a qualified equity investment in a CDE. A qualified equity investment is any equity investment in a CDE for which the CDE has received an allocation from the Secretary if, among other things, the CDE uses substantially all of the cash from the investment to make qualified low-income community investments. Under a safe harbor, the substantially-all requirement is treated as met if at least 85 percent of the aggregate gross assets of the CDE are invested in qualified low-income community investments.

Qualified low-income community investments consist of: (1) any capital or equity investment in, or loan to, any qualified active low-income community business; (2) the purchase from another CDE of any loan made by such entity that

is a qualified low-income community investment; (3) financial counseling and other services to businesses located in, and residents of, low-income communities; and (4) certain equity investments in, or loans to, a CDE.

In general, a qualified active low-income community business is a corporation or a partnership if for the taxable year: (1) at least 50 percent of the total gross income of the entity is derived from the active conduct of a qualified business within any low-income community; (2) a substantial portion of the use of the tangible property of the entity is within any low-income community; (3) a substantial portion of the services performed for the entity by its employees is performed in any low-income community; (4) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to certain collectibles; and (5) less than 5 percent of the average of the aggregate unadjusted bases of the property of the entity is attributable to certain nonqualified financial property.

Substantially All

As indicated above, a CDE must use substantially all of the cash from a qualified equity investment to make qualified low-income community investments. Most commentators suggest that the substantially-all test should require that at least 85 percent of the taxpayer's cash be committed to, or invested in, qualified low-income community investments. Some commentators propose that in order to provide CDEs with financial flexibility in managing their investments, the percentage should be reduced for the later years of the 7–year credit period. The temporary regulations adopt the suggestion to define *substantially all* as 85 percent or more and reduce the substantially-all percentage to 75 percent for the seventh year of the 7–year credit period.

Some commentators suggest that a CDE's costs of obtaining equity investments in the CDE (such as underwriters' fees and broker fees) and the CDE's overhead expenses (such as staff salaries) should count toward satisfying the substantially-all requirement. Some commentators suggest that reserves maintained by the CDE of up to 10 percent of the taxpayer's cash investment in the CDE should count toward satisfying the substantially-all requirement. The temporary regulations do not include issuance costs or CDE overhead expenses as counting toward the substantially-all requirement. However, the temporary regulations provide that reserves (but not in excess of 5 percent of the taxpayer's cash investment) for loan losses and for additional investments in existing qualified low-income community investments are treated as invested in a qualified low-income community investment.

Several commentators suggest that, for purposes of the "85 percent of the aggregate gross assets" safe harbor, aggregate gross assets should be determined according to cost basis and not, for example, fair market value. The temporary regulations adopt this suggestion. Cost basis is defined under the temporary regulations as cost basis under section 1012.

Commentators propose that a CDE should have from 12 months to 5 years to invest the cash from a qualified equity investment in a qualified low-income community investment, depending upon the type of investment. The temporary regulations adopt a 12–month period for investing the taxpayer's cash investment.

Commentators propose that repayments to a CDE of equity or principal from qualified low-income community investments should have to be reinvested by the CDE within 12 months, but that no reinvestment should be required in the sixth and seventh years of the 7–year credit period. One commentator proposes that reinvestment should be encouraged, but not required. Another commentator would limit the time period to 45 days for identifying the investment and 180 days for making the investment. The temporary regulations adopt the suggestion that repayment amounts reinvested within 12 months are treated as continuously invested in qualified low-income community investments. In addition, repayments received in the seventh year of the 7–year credit period are not required to be reinvested.

Qualified Active Low-Income Community Businesses

As indicated above, qualified low-income community investments include any capital or equity investment in, or loan to, any qualified active low-income community business. A business is a qualified active low-income community business only if, among other things: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of a qualified business within any low-income community; (2) a substantial portion of the use of the tangible property of the business is within any low-income community; and (3) a substantial portion of the services performed for the business by its employees is performed in any low-income community.

Commentators propose that, to satisfy the "50 percent of the total gross income derived from the active conduct" requirement (50–percent requirement) in the case of a manufacturing business, 50 percent of production, but not sales, should have to occur within a low-income community. For a services business, commentators recommend a requirement that at least 50 percent of the services be provided by employees of offices in low-income communities even if the services are provided elsewhere. One commentator suggests that the 50–percent requirement should be deemed met if the business is located in the low-income community and most of the employees are residents of the low-income community. Another commentator suggests that the requirement should be satisfied if 50 percent of the total gross income is derived from: (1) the operation of, or production at, a facility located in a low-income community; (2) most of the employees are based at such a facility; and (3) the management is located within the low-income community.

For purposes of the tangible property and services performed requirements, recommendations for the percentage that should constitute a substantial portion range from 20 percent to 50 percent. Alternatively, some commentators propose that the tangible property and services performed requirements should be satisfied if the business satisfies one of the following: (1) the business is located in a qualified area; (2) the business operates a major facility in a qualified area; (3) the business' primary business activity takes place in a qualified area; or (4) the business' primary mission is working with people in qualified areas.

For purposes of the tangible property and services performed requirements, the temporary regulations define a substantial portion as 40 percent. In addition, the temporary regulations provide that the 50–percent requirement is deemed to be satisfied if the entity meets the requirements of either the tangible property test or the services performed test, if 50 percent is substituted for 40 percent. Further, the entity may satisfy the 50-percent requirement based on all the facts and circumstances.

Commentators propose that for purposes of determining when a trade or business constitutes a qualified active low-income community business, an entity should qualify as a qualified active low-income community business if the CDE reasonably expects, at the time the CDE makes the capital or equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a qualified active low-income community business throughout the entire period of the investment or loan. This proposal has been adopted in the temporary regulations, except in the case where the CDE controls the entity.

If the CDE controls the entity at any time during the 7-year credit period, the reasonable expectation test does not apply and the entity must be a qualified active low-income community business during the entire period the CDE controls the entity. Commentators suggest that control for this purpose should be defined as at least 50 percent of voting power. Some commentators suggest that control should be determined based on whether the CDE is related to the entity within the meaning of sections 267(b) or 707(b)(1). The temporary regulations define control with respect to an entity as direct or indirect ownership (based on value) or control (based on voting or management rights) of 33 percent or more of the entity. However, a CDE does not control an entity if an unrelated person possesses greater control over the entity than the CDE.

Financial Counseling and Other Services

Commentators suggest that the definition of financial counseling and other services should include services for identifying CDE investment opportunities; preparing business owners to use financial products; underwriting loans and investments; helping business owners create viable business plans; and, after loans and investments are made, enhancing business planning, marketing, management, and financial skills of business owners and serving on their boards of directors. The temporary regulations define *financial counseling and other services* as advice provided by the CDE relating to the organization or operation of a trade or business that is provided to a qualified active low-income community business or to residents of a low-income community.

Investments in Other CDEs

Commentators propose that, for purposes of the substantially-all requirement, tracing should not be required when a CDE invests in another CDE, but other mechanisms should be required (for example, decertifying the recipient CDE if it does not use funds properly). Alternatively, commentators propose tracing at the recipient CDE level, but minimizing the reporting and recapture burdens for the recipient CDEs. Some commentators suggest that the recipient CDE should have the same restrictions placed on it as the investing CDE. The temporary regulations provide that an equity investment in, or loan to, another CDE is a qualified low-income community investment only to the extent that the recipient CDE uses the proceeds: (1) for either an investment in, or a loan to, a qualified active low-income community business, or financial counseling and other services; and (2) in a manner that would constitute a qualified low-income community investment if it were made directly by the CDE making the equity investment or loan.

Recapture

A recapture event requiring an investor to recapture credits previously taken may occur for an equity investment in a CDE if the CDE: (1) ceases to be a CDE; (2) ceases to use substantially all of the proceeds of the equity investment for qualified low-income community investments; or (3) redeems the investor's equity investment. Commentators suggest that a CDE should be permitted to take remedial actions to avoid recapture. The temporary regulations adopt this suggestion by providing a CDE the opportunity to request a waiver of a requirement or an extension of time to meet a deadline contained in the temporary regulations if such waiver or extension does not materially frustrate the purposes of section 45D and the regulations thereunder. A CDE that believes it has good cause for a waiver or an extension may request relief from the Commissioner in a ruling request. In considering such a ruling request, the Commissioner may consult with the CDFI Fund in a manner consistent with section 6103. The granting of a waiver or an extension may require adjustments of the CDE's requirements under section 45D and the regulations thereunder as may be appropriate.

Other Federal Tax Benefits

The Treasury Department is authorized to prescribe regulations that limit the new markets tax credit for investments that are directly or indirectly subsidized by other Federal tax benefits (including the low-income housing tax credit under section 42 and the exclusion from gross income under section 103). Commentators suggest that a CDE should not be permitted to use the proceeds of a qualified equity investment to purchase tax-exempt bonds. However, the same commentators state that there should be no restriction on the receipt of tax-exempt bond proceeds by a qualified active low-income community business. The temporary regulations do not prohibit a CDE from purchasing tax-exempt bonds because tax-exempt financing provides a subsidy to borrowers and not bondholders. Moreover, a loan by a CDE directly to a qualified active low-income community business cannot be a tax-exempt bond because the loan is not an obligation of a state or local government. Because the rental to others of residential rental property cannot be a qualified active low-income community business, a taxpayer cannot receive the low-income housing tax credit and new markets tax credit on the same investment. Although the temporary regulations do not provide specific rules on double tax benefit issues, the IRS and the Treasury Department request additional comments on what Federal tax benefits should limit the new markets tax credit.

Reporting Requirements

The Treasury Department is authorized to prescribe regulations that impose appropriate reporting requirements for the new markets tax credit. Commentators suggest that the information reporting to the Treasury Department should be undertaken on an annual basis and that CDEs should be required to provide the following information: financial statements, a list of investors and closing and commitment dates, a list of eligible investments, terms of investments and location of investments, information on loan loss or investments reserves, and information on financial counseling and other services.

The reporting requirements in the temporary regulations require a CDE to provide notice: (1) to any taxpayer who acquires a qualified equity investment in the CDE at its original issue that the equity investment is a qualified equity investment entitling the taxpayer to claim the new markets tax credit; and (2) in the case of a recapture event, to each holder of an equity investment, including all prior holders of that investment, that a recapture event has occurred. CDEs must comply with such reporting requirements to the Secretary as the Secretary may prescribe. Taxpayers may claim the new markets tax credit by completing Form 8874, "New Markets Credit," and by filing the form with the taxpayer's Federal income tax return.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that any burden on taxpayers is minimal. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Paul F. Handleman, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.45D–1T also issued under 26 U.S.C. 45D(i); * * *

Par. 2. Section 1.45D–1T is added to read as follows:

§ 1.45D–1T New markets tax credit.

(a) *Table of contents*. This paragraph lists the headings that appear in § 1.45D–1T.

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(b) Allowance of credit
(1) In general.
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(c) Qualified equity investment.
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(ii) Manner for requesting a waiver or extension.
(iii) Terms and conditions.
(5) Example.
(f) Basis reduction.
(1) In general.
(2) Adjustment in basis of interest in partnership or S corporation.
(g) Other rules.

(1) Anti-abuse.

(2) Reporting requirements.

(i) Notification by CDE to taxpayer.

(A) Allowance of new markets tax credit.

(B) Recapture event.

(ii) CDE reporting requirements to Secretary.

(iii) Manner of claiming new markets tax credit.

(iv) Reporting recapture tax.

(h) Effective date.

(b) *Allowance of credit*—(1) *In general*. For purposes of the general business credit under section 38, a taxpayer holding a qualified equity investment on a credit allowance date which occurs during the taxable year may claim the new markets tax credit determined under section 45D and this section for such taxable year in an amount equal to the applicable percentage of the amount paid to a qualified community development entity (CDE) for such investment at its original issue. *Qualified equity investment* is defined in paragraph (c) of this section. *Credit allowance date* is defined in paragraph (b)(2) of this section. *Applicable percentage* is defined in paragraph (b)(3) of this section. A *CDE* is a qualified community development entity as defined in section 45D(c). The amount paid at original issue is determined under paragraph (b)(4) of this section.

(2) *Credit allowance date*. The term *credit allowance date* means, with respect to any qualified equity investment—

(i) The date on which the investment is initially made; and

(ii) Each of the 6 anniversary dates of such date thereafter.

(3) *Applicable percentage*. The *applicable percentage* is 5 percent for the first 3 credit allowance dates and 6 percent for the other 4 credit allowance dates.

(4) *Amount paid at original issue*. The amount paid to the CDE for a qualified equity investment at its original issue consists of all amounts paid by the taxpayer to, or on behalf of, the CDE (including any underwriter's fees) to purchase the investment at its original issue.

(c) *Qualified equity investment*—(1) *In general*. The term *qualified equity investment* means any equity investment (as defined in paragraph (c)(2) of this section) in a CDE if—

(i) The investment is acquired by the taxpayer at its original issue (directly or through an underwriter) solely in exchange for cash;

(ii) Substantially all (as defined in paragraph (c)(5) of this section) of such cash is used by the CDE to make qualified low-income community investments (as defined in paragraph (d)(1) of this section); and

(iii) The investment is designated for purposes of section 45D and this section by the CDE on its books and records using any reasonable method.

(2) *Equity investment*. The term *equity investment means* any stock (other than nonqualified preferred stock as defined in section 351(g)(2)) in an entity that is a corporation for Federal tax purposes and any capital interest in an entity that is a partnership for Federal tax purposes. See §§ 301.7701–1 through 301.7701–3 of this chapter for rules governing when a business entity, such as a business trust or limited liability company, is classified as a corporation or a partnership for Federal tax purposes.

(3) *Equity investments made prior to allocation*—(i) *In general*. Except as provided in paragraph (c)(3)(ii) of this section, an equity investment in an entity is not eligible to be designated as a qualified equity investment if it is made before the entity enters into an allocation agreement with the Secretary. An *allocation agreement* is an agreement between the Secretary and a CDE relating to a new markets tax credit allocation under section 45D(f)(2).

(ii) *Exception*. Notwithstanding paragraph (c)(3)(i) of this section, an equity investment in an entity is eligible to be designated as a qualified equity investment under paragraph (c)(1)(iii) of this section if—

(A) The equity investment is made on or after April 20, 2001;

(B) The entity in which the equity investment is made is certified by the Secretary as a CDE under section 45D(c) before January 1, 2003;

(C) The entity in which the equity investment is made receives notification of the credit allocation (with the actual receipt of such credit allocation contingent upon subsequently entering into an allocation agreement) from the Secretary before January 1, 2003; and

(D) The equity investment otherwise satisfies the requirements of section 45D and this section.

(iii) *Initial investment date*. If an equity investment is designated as a qualified equity investment in accordance with paragraph (c)(3)(ii) of this section, the investment is treated as initially made on the effective date of the allocation agreement between the CDE and the Secretary.

(4) *Limitations*—(i) *In general*. The term *qualified equity investment* does not include—

(A) Any equity investment issued by a CDE more than 5 years after the date the CDE enters into an allocation agreement (as defined in paragraph (c)(3)(i) of this section) with the Secretary; and

(B) Any equity investment by a CDE in another CDE, if the CDE making the investment has received an allocation under section 45D(f)(2).

(ii) *Allocation limitation*. The maximum amount of equity investments issued by a CDE that may be designated under paragraph (c)(1)(iii) of this section by the CDE may not exceed the portion of the limitation amount allocated to the CDE by the Secretary under section 45D(f)(2).

(5) *Substantially all*—(i) *In general*. Except as provided in paragraph (c)(5)(v) of this section, the term *substantially all* means at least 85 percent. The substantially-all requirement must be satisfied for each annual period in the 7-year credit period using either the direct-tracing calculation under paragraph (c)(5)(ii) of this section, or the safe harbor calculation under paragraph (c)(5)(iii) of this section. The substantially-all requirement is treated as satisfied for an annual period if either the direct-tracing calculation under paragraph (c)(5)(ii) of this section, or the safe harbor calculation under paragraph (c)(5)(iii) of this section, is performed every six months and the average of the two calculations for the annual period is at least 85 percent. For purposes of this paragraph (c)(5)(i), the *7-year credit period* means the period of 7 years beginning on the date the qualified equity investment is initially made. See paragraph (c)(6) of this section for circumstances in which a CDE may treat more than one equity investment as a single qualified equity investment.

(ii) *Direct-tracing calculation*. The substantially-all requirement is satisfied if at least 85 percent of the taxpayer's investment is directly traceable to qualified low-income community investments as defined in paragraph (d)(1) of this section. The direct-tracing calculation is a fraction the numerator of which is the CDE's aggregate cost basis determined under section 1012 in all of the qualified low-income community investments that are directly traceable to the taxpayer's cash investment, and the denominator of which is the amount of the taxpayer's cash investment under paragraph (b)(4) of this section. For purposes of this paragraph (c)(5)(ii), cost basis includes the cost basis of any qualified low-income community investment that becomes worthless. See paragraph (d)(2) of this section for the treatment of amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment.

(iii) *Safe harbor calculation*. The substantially-all requirement is satisfied if at least 85 percent of the aggregate gross assets of the CDE are invested in qualified low-income community investments as defined in paragraph (d)(1) of this section. The safe harbor calculation is a fraction the numerator of which is the CDE's aggregate cost basis determined under section 1012 in all of its qualified low-income community investments, and the denominator of which is the CDE's aggregate cost basis determined under section 1012 in all of its assets. For purposes of this paragraph (c)(5)(iii), cost basis includes the cost basis of any qualified low-income community investment that becomes worthless. See paragraph (d)(2) of this section for the treatment of amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment.

(iv) *Time limit for making investments.* The taxpayer's cash investment received by a CDE is treated as invested in a qualified low-income community investment as defined in paragraph (d)(1) of this section only to the extent that the cash is so invested no later than 12 months after the date the cash is paid by the taxpayer (directly or through an underwriter) to the CDE.

(v) *Reduced substantially-all percentage.* For purposes of the substantially-all requirement (including the direct-tracing calculation under paragraph (c)(5)(ii) of this section and the safe harbor calculation under paragraph (c)(5)(iii) of this section), 85 percent is reduced to 75 percent for the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section).

(6) *Aggregation of equity investments.* A CDE may treat any qualified equity investments issued on the same day as one qualified equity investment. If a CDE aggregates equity investments under this paragraph (c)(6), the rules in this section shall be construed in a manner consistent with that treatment.

(7) *Subsequent purchasers.* A qualified equity investment includes any equity investment that would (but for paragraph (c)(1)(i) of this section) be a qualified equity investment in the hands of the taxpayer if the investment was a qualified equity investment in the hands of a prior holder.

(d) *Qualified low-income community investments*—(1) *In general*. The term *qualified low-income community investment* means any of the following—

(i) *Investment in a qualified active low-income community business*. Any capital or equity investment in, or loan to, any qualified active low-income community business (as defined in paragraph (d)(4) of this section).

(ii) *Purchase of certain loans from CDEs*. The purchase from another CDE (whether or not that CDE has received an allocation from the Secretary under section 45D(f)(2)) of any loan made by such entity that is a qualified low-income community investment. A loan purchased from another CDE is a qualified low-income community investment if it qualifies as such either—

(A) At the time the selling CDE made the loan; or

(B) At the time the loan is purchased from the selling CDE.

(iii) *Financial counseling and other services.* Financial counseling and other services (as defined in paragraph (d)(7) of this section) provided to any qualified active low-income community business, or to any residents of a low-income community (as defined in section 45D(e)).

(iv) *Investments in other CDEs.* Any equity investment in, or loan to, any CDE, but only to the extent that the CDE in which the equity investment or loan is made uses the proceeds of the investment or loan in a manner—

(A) That is described in paragraphs (d)(1)(i) or (iii) of this section; and

(B) That would constitute a qualified low-income community investment if it were made directly by the CDE making such equity investment or loan.

(2) *Payments of, or for, capital, equity or principal*—(i) *In general*. Except as otherwise provided in this paragraph (d)(2), amounts received by a CDE in payment of, or for, capital, equity or principal with respect to a qualified low-income community investment must be reinvested by the CDE in a qualified low-income community investment no later than 12 months from the date of receipt to be treated as continuously invested in a qualified low-income community investment. If the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount at least equal to such original cost basis, then an amount equal to such original cost basis will be treated as continuously invested in a qualified low-income community investment. In addition, if the amounts received by the CDE are equal to or greater than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests, in accordance with this paragraph (d)(2)(i), an amount less than such original cost basis, then only the amount so reinvested will be treated as continuously invested in a qualified low-income community investment. If the amounts received by the CDE are less than the cost basis of the original qualified low-income community investment (or applicable portion thereof), and the CDE reinvests an amount in accordance with this paragraph (d)(2)(i), then the amount treated as continuously invested in a qualified low-income community investment will equal the excess (if any) of such original cost basis over the amounts received by the CDE that are not so reinvested. Amounts received by a CDE in payment of, or for,

capital, equity or principal with respect to a qualified low-income community investment during the seventh year of the 7-year credit period (as defined in paragraph (c)(5)(i) of this section) do not have to be reinvested by the CDE in a qualified low-income community investment in order to be treated as continuously invested in a qualified low-income community investment.

(ii) *Subsequent reinvestments*. In applying paragraph (d)(2)(i) of this section to subsequent reinvestments, the original cost basis is reduced by the amount (if any) by which the original cost basis exceeds the amount determined to be continuously invested in a qualified low-income community investment.

(iii) *Special rule for loans*. Periodic amounts received during a calendar year as repayment of principal on a loan that is a qualified low-income community investment are treated as continuously invested in a qualified low-income community investment if the amounts are reinvested in another qualified low-income community investment by the end of the following calendar year.

(iv) *Example*. The application of paragraphs (d)(2)(i) and (ii) of this section is illustrated by the following example:

Example. On April 1, 2003, A, B, and C each pay $100,000 to acquire a capital interest in X, a partnership. X is a CDE that has received a new markets tax credit allocation from the Secretary. X treats the 3 partnership interests as one qualified equity investment under paragraph (c)(6) of this section. In August 2003, X uses the $300,000 to make a qualified low-income community investment under paragraph (d)(1) of this section. In August 2005, the qualified low-income community investment is redeemed for $250,000. In February 2006, X reinvests $230,000 of the $250,000 in a second qualified low-income community investment and uses the remaining $20,000 for operating expenses. Under paragraph (d)(2)(i) of this section, $280,000 of the proceeds of the qualified equity investment is treated as continuously invested in a qualified low-income community investment. In December 2008, X sells the second qualified low-income community investment and receives $400,000. In March 2009, X reinvests $320,000 of the $400,000 in a third qualified low-income community investment. Under paragraphs (d)(2)(i) and (ii) of this section, $280,000 of the proceeds of the qualified equity investment is treated as continuously invested in a qualified low-income community investment ($40,000 is treated as invested in another qualified low-income community investment in March 2009).

(3) *Special rule for reserves*. Reserves (not in excess of 5 percent of the taxpayer's cash investment under paragraph (b)(4) of this section) maintained by the CDE for loan losses or for additional investments in existing qualified low-income community investments are treated as invested in a qualified low-income community investment under paragraph (d)(1) of this section.

(4) *Qualified active low-income community business*—(i) *In general*. The term *qualified active low-income community business* means, with respect to any taxable year, a corporation (including a nonprofit corporation) or a partnership, if the requirements in paragraphs (d)(4)(i)(A), (B), (C), (D), and (E) are met.

(A) *Gross-income requirement*. At least 50 percent of the total gross income of such entity is derived from the active conduct of a qualified business (as defined in paragraph (d)(5) of this section) within any low-income community (as defined in section 45D(e)). An entity is deemed to satisfy this paragraph (d)(4)(i)(A) if the entity meets the requirements of either paragraph (d)(4)(i)(B) or (C) of this section, if "50 percent" is applied instead of *40 percent*. In addition, an entity may satisfy this paragraph (d)(4)(i)(A) based on all the facts and circumstances.

(B) *Use of tangible property*. At least 40 percent of the use of the tangible property of such entity (whether owned or leased) is within any low-income community. This percentage is determined based on a fraction the numerator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year in a low-income community and the denominator of which is the average value of the tangible property owned or leased by the entity and used by the entity during the taxable year. Property owned by the entity is valued at its cost basis as determined under section 1012. Property leased by the entity is valued at a reasonable amount established by the entity.

(C) *Services performed*. At least 40 percent of the services performed for such entity by its employees are performed in a low-income community. This percentage is determined based on a fraction the numerator of which is the total amount paid by the entity for employee services performed in a low-income community during the taxable year and the denominator of which is the total amount paid by the entity for employee services during the taxable year.

(D) *Collectibles*. Less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles (as defined in section 408(m)(2)) other than collectibles that are held primarily for sale to customers in the ordinary course of business.

(E) *Nonqualified financial property*. Less than 5 percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to *nonqualified financial property* (as defined in section 1397C(e)). Because the definition of *nonqualified financial property* in section 1397C(e) includes debt instruments with a term in excess of 18 months, banks, credit unions, and other financial institutions are generally excluded from the definition of a *qualified active low-income community business*.

(ii) *Proprietorships*. Any business carried on by an individual as a proprietor is a qualified active low-income community business if the business would meet the requirements of paragraph (d)(4)(i) of this section if the business were incorporated.

(iii) *Portions of business*. A CDE may treat any trade or business as a qualified active low-income community business if the trade or business would meet the requirements of paragraph (d)(4)(i) of this section if the trade or business were separately incorporated.

(5) *Qualified business*—(i) *In general*. Except as otherwise provided in this paragraph (d)(5), the term *qualified business* means any trade or business. There is no requirement that employees of a qualified business be residents of a low-income community.

(ii) *Rental of real property*. The rental to others of real property located in any low-income community (as defined in section 45D(e)) is a *qualified business* if and only if the property is not residential rental property (as defined in section 168(e)(2)(A)) and there are substantial improvements located on the real property.

(iii) *Exclusions*—(A) *Trades or businesses involving intangibles*. The term *qualified business* does not include any trade or business consisting predominantly of the development or holding of intangibles for sale or license.

(B) *Certain other trades or businesses*. The term *qualified business* does not include any trade or business consisting of the operation of any private or commercial golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for consumption off premises.

(C) *Farming*. The term *qualified business* does not include any trade or business the principal activity of which is farming (within the meaning of section 2032A(e)(5)(A) or (B)) if, as of the close of the taxable year of the taxpayer conducting such trade or business, the sum of the aggregate unadjusted bases (or, if greater, the fair market value) of the assets owned by the taxpayer that are used in such a trade or business, and the aggregate value of the assets leased by the taxpayer that are used in such a trade or business, exceeds $500,000. For purposes of this paragraph (d)(5)(iii)(C), two or more trades or businesses will be treated as a single trade or business under rules similar to the rules of section 52(a) and (b).

(6) *Qualifications*—(i) *In general*. Except as provided in paragraph (d)(6)(ii) of this section, an entity is treated as a qualified active low-income community business for the duration of the CDE's investment in the entity if the CDE reasonably expects, at the time the CDE makes the capital or equity investment in, or loan to, the entity, that the entity will satisfy the requirements to be a qualified active low-income community business under paragraph (d)(4)(i) of this section throughout the entire period of the investment or loan.

(ii) *Control*—(A) *In general*. If a CDE controls or obtains control of an entity at any time during the 7-year credit period (as defined in paragraph (c)(5)(i) of this section), the entity will be treated as a qualified active low-income community business only if the entity satisfies the requirements of paragraph (d)(4)(i) of this section throughout the entire period the CDE controls the entity.

(B) *Definition of control*. Generally, control means, with respect to an entity, direct or indirect ownership (based on value) or control (based on voting or management rights) of 33 percent or more of the entity. However, a CDE does not control an entity if an unrelated person possesses greater control over the entity than the CDE.

(7) *Financial counseling and other services*. The term *financial counseling and other services* means advice provided by the CDE relating to the organization or operation of a trade or business.

(e) *Recapture*—(1) *In general*. If, at any time during the 7-year period beginning on the date of the original issue of a qualified equity investment in a CDE, there is a recapture event under paragraph (e)(2) of this section with respect to such investment, then the tax imposed by Chapter 1 of the Internal Revenue Code for the taxable year in which the recapture event occurs is increased by the credit recapture amount under section 45D(g)(2). A recapture event under paragraph (e)(2) of this section requires recapture of credits allowed to the taxpayer who purchased the equity investment from the CDE at its original issue and to all subsequent holders of that investment.

(2) *Recapture event*. There is a recapture event with respect to an equity investment in a CDE if—

(i) The entity ceases to be a CDE;

(ii) The proceeds of the investment cease to be used in a manner that satisfies the substantially-all requirement of paragraph (c)(1)(ii) of this section; or

(iii) The investment is redeemed by the CDE.

(3) *Bankruptcy*. Bankruptcy of a CDE is not a recapture event.

(4) *Waiver of requirement or extension of time*—(i) *In general*. The Commissioner may waive a requirement or extend a deadline if such waiver or extension does not materially frustrate the purposes of section 45D and this section.

(ii) *Manner for requesting a waiver or extension*. A CDE that believes it has good cause for a waiver or an extension may request relief from the Commissioner in a ruling request. The request should set forth all the relevant facts and include a detailed explanation describing the event or events relating to the request for a waiver or an extension. For further information on the application procedure for a ruling, see Rev. Proc. 2001–1 (2001–1 I.R.B. 1) (see §601.601(d)(2) of this chapter).

(iii) *Terms and conditions*. The granting of a waiver or an extension to a CDE under this section may require adjustments of the CDE's requirements under section 45D and this section as may be appropriate.

(5) *Example*. The application of this paragraph (e) is illustrated by the following example:

Example. In 2003, A and B acquire separate qualified equity investments in X, a partnership. X is a CDE that has received a new markets tax credit allocation from the Secretary. X uses the proceeds of A's qualified equity investment to make a qualified low-income community investment in Y, and X uses the proceeds of B's qualified equity investment to make a qualified low-income community investment in Z. Y and Z are not CDEs. X controls both Y and Z within the meaning of paragraph (d)(6)(ii)(B) of this section. In 2003, Y and Z are qualified active low-income community businesses. In 2007, Y, but not Z, is a qualified active low-income community business and X does not satisfy the substantially-all requirement using the safe harbor calculation under paragraph (c)(5)(iii) of this section. A's equity investment satisfies the substantially-all requirement of paragraph (c)(1)(ii) of this section using the direct-tracing calculation of paragraph (c)(5)(ii) of this section because A's equity investment is traceable to Y. However, B's equity investment fails the substantially-all requirement using the direct-tracing calculation because B's equity investment is traceable to Z. Therefore, under paragraph (e)(2)(ii) of this section, there is a recapture event for B's equity investment (but not A's equity investment).

(f) *Basis reduction*—(1) *In general*. A taxpayer's basis in a qualified equity investment is reduced by the amount of any new markets tax credit determined under paragraph (b)(1) of this section with respect to the investment. A basis reduction occurs on each credit allowance date under paragraph (b)(2) of this section. This paragraph (f) does not apply for purposes of sections 1202, 1400B, and 1400F.

(2) *Adjustment in basis of interest in partnership or S corporation*. The adjusted basis of either a partner's interest in a partnership, or stock in an S corporation, must be appropriately adjusted to take into account adjustments made under paragraph (f)(1) of this section in the basis of a qualified equity investment held by the partnership or S corporation (as the case may be).

(g) *Other rules*—(1) *Anti-abuse*. If a principal purpose of a transaction or a series of transactions is to achieve a result that is inconsistent with the purposes of section 45D and this section, the Commissioner may treat the transaction or

series of transactions as causing a recapture event under paragraph (e)(2) of this section.

(2) *Reporting requirements*—(i) *Notification by CDE to taxpayer*—(A) *Allowance of new markets tax credit*. A CDE must provide notice to any taxpayer who acquires a qualified equity investment in the CDE at its original issue that the equity investment is a qualified equity investment entitling the taxpayer to claim the new markets tax credit. The notice must be provided by the CDE to the taxpayer no later than 60 days after the date the taxpayer makes the investment in the CDE. The notice must contain the amount paid to the CDE for the qualified equity investment at its original issue and the taxpayer identification number of the CDE.

(B) *Recapture event*. If, at any time during the 7–year period beginning on the date of the original issue of a qualified equity investment in a CDE, there is a recapture event under paragraph (e)(2) of this section with respect to such investment, the CDE must provide notice to each holder, including all prior holders, of the investment that a recapture event has occurred. The notice must be provided by the CDE no later than 60 days after the date the CDE becomes aware of the recapture event.

(ii) *CDE reporting requirements to Secretary*. Each CDE must comply with such reporting requirements to the Secretary as the Secretary may prescribe.

(iii) *Manner of claiming new markets tax credit*. A taxpayer may claim the new markets tax credit for each applicable taxable year by completing Form 8874, "*New Markets Credit*," and by filing Form 8874 with the taxpayer's Federal income tax return.

(iv) *Reporting recapture tax*. If there is a recapture event with respect to a taxpayer's equity investment in a CDE, the taxpayer must include the credit recapture amount under section 45D(g)(2) on the line for recapture taxes on the taxpayer's Federal income tax return for the taxable year in which the recapture event under paragraph (e)(2) of this section occurs (or on the line for total tax, if there is no such line for recapture taxes) and write *NMCR* (new markets credit recapture) next to the entry space.

(h) *Effective date*. This section applies on or after December 26, 2001.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In § 602.101, paragraph (b) is amended by adding an entry to the table in numerical order to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.45D–1T	1545–1765
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 17, 2001.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 21, 2001, 8:45 a.m., and published in the issue of the Federal Register for December 26, 2001, 66 F.R. 66307)

Section 106.—Contributions by Employer to Accident and Health Plans

(Also Section 125 — Cafeteria Plans and Section 105 — Amounts Received Under Accident and Health Plans).

Application of sections 106(a) and 105(b) to reimbursements of employees for salary reduction amounts previously excluded from gross income under section 106(a).

Rev. Rul. 2002–3

ISSUE

Whether, under the facts described, the exclusions from gross income under §§106(a) or 105(b) of the Internal Revenue Code apply to reimbursements by an employer to employees for salary reduction amounts used to pay for health insurance premiums.

FACTS

Employer M provides health coverage for its employees through a group health insurance policy. The coverage constitutes accident or health coverage for purposes of the exclusion for employer-provided accident or health coverage under §106(a).

M has a payroll arrangement under which employees' salaries are reduced, and M applies the salary reduction amounts to the payment of the health insurance premiums for the employees. Thus, employees receive lower salaries in exchange for employer-provided health coverage. In addition, M makes "reimbursement" payments to employees with respect to the health insurance premiums in amounts that cause employees' after-tax pay from M to be the same as what it would have been if there were no salary reduction and no "reimbursement" payments. M takes the position that both the salary reduction and the "reimbursement" payments are excluded from gross income of employees and are not subject to Federal Insurance Contributions Act (FICA) or Federal Unemployment Tax Act (FUTA) taxes.

The salary reduction used to pay for health insurance premiums under M's payroll arrangement could be done with or without employee elections. For example, M could make a unilateral decision to reduce employees' salaries and use those amounts to provide health insurance to the employees. Alternatively, M could offer employees the choice under a §125 cafeteria plan to reduce their salaries in order to receive employer-provided health insurance.

LAW AND ANALYSIS

In general, §106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Under §106(a), an employee may exclude premiums for accident or health insurance coverage that are paid by an employer. Also, under §105(b), an employee may exclude amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents) for personal injuries or sickness. To the extent amounts are excluded from gross income under §105(b) or 106(a), they are also excluded from income tax withholding under §3401. In addition, amounts paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents) for personal injuries or sickness are also excluded from FICA and FUTA taxes under §§3121(a) and 3306(b).

Under §125, an employer may establish a cafeteria plan that permits an employee to choose among two or more benefits, consisting of cash (generally, salary) and qualified benefits, including accident or health coverage. Pursuant to §125, the amount of an employee's salary reduction applied to purchase such coverage is not included in gross income, even though it is available to the employee and the employee could have chosen to receive cash instead. If an employee elects salary reduction pursuant to §125, the coverage is excludable from gross income under §106 as employer-provided accident or health coverage.

Rev. Rul. 61–146 (1961–2 C.B. 25) provides that the §106 exclusion applies to an employer's reimbursement of an employee for individual accident and health insurance premiums paid by the employee to an insurer if (1) the employer has an accident and health plan under which it permits such reimbursements and (2) any reimbursement is of premiums actually paid by the employee.

Under the rationale of Rev. Rul. 61–146, §106 allows an employee to exclude employer reimbursements for health insurance premiums, but only if those premiums are actually paid by the employee. Under both alternative arrangements described above, when M applies the amount of employees' salary reduction to pay health insurance premiums, the premium payments are paid by M, not the employees, and are excludable from the employees' gross income under §106 because they are paid by M. Although the §106 exclusion applies to the health insurance premiums paid by M, there is no employee-paid premium for M to "reimburse", and therefore the reimbursement payments that M makes to employees are not excluded from gross income under §106. Similarly, the reimbursement payments are not excluded from gross income under §105 because they do not reimburse employees for expenses incurred for medical care. Accordingly, the reimbursement payments are not excluded from income tax withholding under §3401. In addition, because the reimbursement payments are not reimbursements of expenses incurred for medical care, they are not excluded from FICA taxes under §3121(a) or FUTA taxes under §3306(b).

If the premium payments were instead actually paid by the employees out of the employees' salaries, the salary amounts from which the payments were made would not be excludable from the employees' gross income, but any payments by M to reimburse the employees for the premium payments would be excludable under section 106.

HOLDING

The exclusions from gross income under §§106(a) and 105(b) do not apply to amounts that an employer pays to employees to reimburse the employees for amounts paid by an employer for health insurance coverage that are excluded from gross income under §106(a) (including salary reduction amounts pursuant to a cafeteria plan under §125 that are applied to pay for such coverage). Accordingly, the reimbursement amounts that the employer pays to the employees are included in the employees' gross income under §61 and are subject to employment taxes under §§3401, 3121(a), and 3306(b).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 61–146 is distinguished.

DRAFTING INFORMATION

The principal author of this Revenue Ruling is Janet A. Laufer of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this Revenue Ruling, contact her at (202) 622–6080 (not a toll-free call).

Section 6050I.—Returns Relating to Cash Received in Trade or Business, etc.

26 CFR 1.6050I–1: Returns relating to cash in excess of $10,000 received in a trade or business.

T.D. 8974

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Amendment to Section 6050I Cross-Referencing Section 5331 of Title 31 Relating to Reporting of Certain Currency Transactions by Nonfinancial Trades or Businesses Under the Bank Secrecy Act

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final amendments to the Income Tax Regulations under section 6050I of the Internal Revenue Code which requires persons to report information about financial transactions to the IRS, and section 5331 of title 31 which requires persons to report similar information about certain transactions to the Financial Crimes Enforcement Network. These regulations provide that this information shall be reported on the same form as prescribed by the Secretary.

DATES: *Effective Date*: These regulations are effective December 31, 2001.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, contact Tiffany P. Smith at (202) 622–4910 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document amends the Income Tax Regulations (26 CFR part 1) under section 6050I of the Internal Revenue Code (Code). These final regulations address the related reporting requirements of section 6050I of the Code and section 5331 of title 31.

The Bank Secrecy Act, Titles I and II of Public Law 91–508 (84 Stat. 1116) as amended, codified at 12 U.S.C. 1829b, 12 U.S.C. 1951–1959, and 31 U.S.C. 5311, et seq., authorizes the Secretary of the Treasury, inter alia, to issue regulations requiring financial institutions to keep records and file reports that are determined to have a high degree of usefulness in criminal, tax, and regulatory matters, and to implement counter-money laundering programs and compliance procedures. Regulations implementing Title II of the Bank Secrecy Act (codified at 31 U.S.C. 5311, et seq.), appear at 31 CFR Part 103.

Section 365 of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the USA Patriot Act), Public Law 107–56 (115 Stat. 272) amended the Bank Secrecy Act by adding section 5331. Under 31 U.S.C. 5331, any person who is engaged in a trade or business and who, in the course of such trade or business, receives more than $10,000 in coins or currency in one transaction (or two or more related transactions), is required to file a report with respect to such transaction (or related transactions) with the Treasury Department. Reporting under section 5331 does not apply to amounts received in a transaction reported under 31 U.S.C. 5313 and the accompanying regulations.

The reporting requirement under section 5331 of title 31 is analogous to the reporting requirement administered by the IRS, under section 6050I of title 26, United States Code, and 26 CFR 1.6050I–1. Inasmuch as section 6050I of title 26 requires persons to report information about financial transactions to the IRS, and section 5331 of title 31 requires persons to report similar information about certain transactions to the Financial Crimes Enforcement Network, these final regulations provide that this information shall be reported on the same form as prescribed by the Secretary.

Effective Date of Regulations

These regulations are effective as of the date of publication in the **Federal Register**.

Special Analyses

Because this regulation merely advises taxpayers that information reported under section 6050I is, with one exception, also reported under 31 U.S.C. 5331, and imposes no requirement on any person, notice and public procedure are unnecessary pursuant to 5 U.S.C. 553(b)(B). For this reason, a delayed effective date is not required pursuant to 5 U.S.C. 553(d)(3).

It has been determined that this final regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Because no notice of proposed rulemaking is required, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Code, this final regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these final regulations is Tiffany P. Smith, Office of the Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division.

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Final Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.6050I–0 is amended by revising the entry for § 1.6050I(a)(1) and adding entries to the table for § 1.6050I–1(a)(1)(i) and (a)(1)(ii) to read as follows:

§ 1.6050I–0 Table of contents.

* * * * *

§ 1.6050I–1 Returns relating to cash in excess of $10,000 received in a trade or business.

(a) * * *

(1) Reportable transaction.

(i) In general.

(ii) Certain financial transactions.

* * * * *

Par. 3. Section 1.6050I–1 is amended by:

1. Redesignating paragraph (a)(1) as paragraph (a)(1)(i).

2. Adding a new paragraph heading for (a)(1).

3. Adding paragraph (a)(1)(ii).

The additions read as follows:

§ 1.6050I–1 Returns relating to cash in excess of $10,000 received in a trade or business.

(a) *Reporting requirement*—(1) *Reportable transaction*—(i) *In general.* * * *

(ii) *Certain financial transactions.* Section 6050I of title 26 requires persons to report information about financial transactions to the Internal Revenue Service, and section 5331 of title 31 requires persons to report similar information about certain transactions to the Financial Crimes Enforcement Network.

This information shall be reported on the same form as prescribed by the Secretary.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 20, 2001.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 28, 2001, 8:45 a.m., and published in the issue of the Federal Register for December 31, 2001, 66 F.R. 67687)

Part III. Administrative, Procedural, and Miscellaneous

Updated Procedures for Processing Employment Tax Cases Involving Worker Classification and Section 530 of the Revenue Act of 1978 Under Section 7436 of the Internal Revenue Code

Notice 2002–5

PURPOSE

Section 314(f) of the Community Renewal Tax Relief Act of 2000 ("CRTRA '00") (H.R. 5662, incorporated in H.R. 4577, the Consolidated Appropriations Act 2001), Pub. L. No. 106–554, 112 Stat. 2763, 2762A–643 (2000), amended § 7436 of the Internal Revenue Code (Code) to expand, retroactively to August 5, 1997, the subject matter jurisdiction of the Tax Court in employment status proceedings. This notice provides information about when and how the Internal Revenue Service (Service) will issue a Notice of Determination of Worker Classification (Notice of Determination) and how taxpayers petition for Tax Court review of the determinations under Code § 7436. This notice modifies and supercedes Notice 98–43 (1998–2 C.B. 207).

BACKGROUND

The Taxpayer Relief Act of 1997 ("TRA '97"), Pub. L. No. 105–34, 111 Stat. 788, created § 7436 of the Code, which provides Tax Court review rights concerning certain employment tax determinations. As originally enacted, § 7436 authorized the Tax Court only to review determinations by the Service that a taxpayer's workers should be classified as employees for purposes of subtitle C (which governs employment taxes) of the Code, or that the taxpayer for whom the services were performed is not entitled to treatment under section 530(a) of the Revenue Act of 1978 (which relieves a taxpayer of employment tax liability in certain circumstances)[1]. Section 7436(a) requires that the determination(s) involve an actual controversy and that the determination(s) be made as part of an examination.

By § 314(f) of CRTRA '00, Code § 7436(a) was amended retroactively to August 5, 1997. The jurisdiction given to the Tax Court by the original legislation was retained, but CRTRA '00 also authorized the Tax Court to determine the proper amount of employment tax under the determinations of worker status and section 530 treatment.

ISSUES TO WHICH § 7436 APPLIES

Section 7436(a) provides that for purposes of subtitle C of the Code, the Tax Court has jurisdiction to:

(1) review the Service's determination that one or more individuals performing services for the taxpayer are employees;

(2) review the Service's determination that the taxpayer is not entitled to treatment under § 530(a) of the Revenue Act of 1978 with respect to those individuals; and

(3) determine the proper amount of employment tax under the above determinations.

The employment taxes imposed by subtitle C of the Code are Federal Insurance Contributions Act (FICA) taxes (under Code §§ 3101–3128), the Railroad Retirement Tax Act (RRTA) taxes (under Code §§ 3201–3232), the Federal Unemployment Tax Act (FUTA) taxes (under Code §§ 3301–3311), the Railroad Unemployment Repayment Tax (RURT) taxes (under Code §§ 3321–3322), and the collection of income tax at source on wages (under Code §§ 3401–3406). "Employment tax" under the statutory language includes the additions to tax, additional amounts, and penalties provided by chapter 68A of the Code (§§ 6651–6665). Thus, the Tax Court has jurisdiction to determine the proper amount of the additions to tax, additional amounts, and penalties that relate to the employment tax imposed by subtitle C with respect to determinations of worker classification and § 530 treatment.

Section 7436(a) does not provide the Tax Court with jurisdiction to review any employment tax determinations other than the three listed in the statute. The procedures set forth in § 7436 do not apply to employment status issues not arising under Subtitle C, such as the classification of individuals for purposes of pension plan coverage or the proper treatment of individual income tax deductions. Nor is Tax Court review available when there is no controversy with respect to the classification of workers, such as where the taxpayer itself treated the workers as employees by issuing them Forms W–2 (*Wage and Tax Statements*). Additionally, since § 7436(a) only confers jurisdiction upon the Tax Court to review determinations that are made by the Service as part of an examination, other Service determinations of employment status (including those that are made in the context of private letter rulings, technical advice memoranda or Forms SS–8 [*Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding*]) that are not made as part of an examination are not subject to review by the Tax Court under § 7436(a).

The Service will issue a Notice of Determination only after the Service has determined *both* that the taxpayer is not entitled to § 530 treatment and that one or more individuals performing services for the taxpayer are employees for purposes of subtitle C. The amount of employment tax under those determinations will also be determined and set forth in the Notice of Determination.

TAXPAYERS ELIGIBLE TO SEEK TAX COURT REVIEW

Section 7436(b) of the Code provides that a pleading seeking Tax Court review of the Service's determinations may be filed only by "the person for whom the services are performed." Thus, workers

[1] That statutory language of section 530 of the Revenue Act of 1978, as amended, although not codified in the Internal Revenue Code of 1986, can usually be found in the publisher's notes following Code § 3401(a).

may not seek review of the Service's determinations under § 7436. In addition, because the statute specifies that there be an actual controversy that the workers performing services "for such person" are employees "of such person," review may not be sought by a third party that has not been determined by the Service to be the employer of the workers.

NOTICE OF DETERMINATION OF WORKER CLASSIFICATION

The Service will provide taxpayers with notice of a determination described in § 7436(b) of the Code by sending the taxpayer, by certified or registered mail, a "Notice of Determination of Worker Classification.[2]" A copy of the new Notice of Determination is attached hereto as Exhibit 1.

The Notice of Determination advises taxpayers of the opportunity to seek Tax Court review and provides information on how to do so. The Notice of Determination will include a schedule describing which workers the Service has determined should be classified as employees. The Notice of Determination will also show each kind of tax with its proposed employment tax adjustment by taxable period.

In most cases, a taxpayer who receives a Notice of Determination will have previously received a "thirty-day letter," which the Service sends to taxpayers in unagreed examination cases. The thirty-day letter lists the proposed employment tax adjustments to be made, and describes the taxpayer's right either to agree to the proposed employment tax adjustments or, alternatively, to protest the proposed adjustments to the Appeals function ("Appeals") of the Service within thirty days of the date of the letter. If the taxpayer does not respond to the thirty-day letter by agreeing to the proposed adjustments or, alternatively, by filing a protest to Appeals, the taxpayer will receive, by certified or registered mail, a Notice of Determination. Under normal procedures, if the taxpayer does not respond to the thirty-day letter, the taxpayer should generally expect to receive the Notice of Determination within sixty days after expiration of the thirty-day period beginning with the date on the thirty-day letter. If no Notice of Determination is received during this period, the taxpayer may wish to contact the Internal Revenue Service office that issued the thirty-day letter to check on the status of the case.

If the taxpayer responds to the thirty-day letter by filing a protest to Appeals (or if the case proceeds to Appeals by way of the employment tax early referral procedures, *see* Announcement 97–52, 1997–21 I.R.B. 22, Announcement 96–13, 1996–12 I.R.B. 33, Rev. Proc. 96–9, 1996–1 C.B. 575) and the worker classification and § 530 treatment issues are not settled on an agreed basis in Appeals, the taxpayer will thereafter receive a Notice of Determination. Taxpayers are encouraged to resolve cases in nondocketed status by requesting use of the early referral procedures in appropriate cases.

PREREQUISITE FOR SEEKING TAX COURT REVIEW

Because the Notice of Determination constitutes the Service's determination described in § 7436(a), the Notice of Determination is a jurisdictional prerequisite for seeking Tax Court review of the Service's determinations regarding worker classification, § 530 treatment, and the proper amount of employment tax under those determinations. Tax Court proceedings seeking review of these determinations may not be commenced prior to the time the Service sends the Notice of Determination by certified or registered mail.

TIME BY WHICH PETITION MUST BE FILED

Section 7436(b)(2) provides that a taxpayer's petition for review must be filed with the Tax Court before the 91st day after the Service mails its Notice of Determination by certified or registered mail. On the first page of the Notice of Determination, the Service will specify the last date by which the taxpayer may timely file a petition in the Tax Court. If the taxpayer discusses the case with the Service during the period before the 91st day following the mailing of the Notice of Determination, the discussion will not extend the period during which the taxpayer may timely file a petition with the Tax Court.

A taxpayer who does not file a Tax Court petition within the allotted time retains the right to seek judicial review of the Service's determinations by paying the tax and filing a claim for refund, as required by § 7422 of the Code. If the claim for refund is denied, or if after six months the Service has not responded to the claim for refund, the taxpayer may file a refund suit in district court or the Court of Federal Claims.

APPEALS CONSIDERATION

Cases docketed in the United States Tax Court will be referred by Area Counsel to the Appeals function for consideration of settlement unless the Notice of Determination was issued by Appeals. Cases in which Appeals issued such a Notice of Determination may be referred to Appeals unless Area Counsel determines that there is little likelihood that a settlement of all or a part of the case can be achieved in a reasonable period of time.

SMALL TAX CASE PROCEEDINGS

At the option of the taxpayer, and with the concurrence of the Tax Court, employment status proceedings under § 7436 may be conducted pursuant to the Tax Court's simplified procedures for small tax cases, if the amount of employment taxes placed in dispute is $50,000 or less for each calendar quarter involved. The simplified procedures for small tax cases are set forth in § 7463 of the Code and Rule 295 of the Tax Court's Rules of Practice and Procedure.

SUSPENSION OF STATUTE OF LIMITATIONS

Section 7436(d)(1) provides that the suspension of the limitations period for assessment in Code § 6503(a) applies in

[2] The original notice was called "Notice of Determination Concerning Worker Classification Under § 7436." The title has now been simplified to "Notice of Determination of Worker Classification."

the same manner as if a notice of deficiency had been issued. Thus, the mailing of the Notice of Determination by certified or registered mail will suspend the statute of limitations for assessment of taxes attributable to the worker classification and § 530 treatment issues. The statute of limitations for assessment is suspended for the 90-day period during which the taxpayer can begin a suit in Tax Court, plus an additional 60 days thereafter. Moreover, if the taxpayer does file a timely petition in the Tax Court, the statute of limitations for assessment will be suspended until the decision of the Tax Court becomes final and for 60 days thereafter.

RESTRICTIONS ON ASSESSMENT

Section 7436(d)(1) provides that various restrictions on assessment in Code § 6213 apply in the same manner as if a notice of deficiency had been issued.[3] Thus, after the Notice of Determination is mailed, the Service is precluded from assessing the taxes identified in the Notice of Determination prior to expiration of the 90-day period during which the taxpayer may file a timely Tax Court petition.[4] If the taxpayer does not file a timely Tax Court petition before the 91st day after the Notice of Determination was mailed, the employment taxes identified in the Notice of Determination shall thereafter be assessed.

AGREED SETTLEMENTS

If the taxpayer wishes to settle the worker classification, § 530 treatment, and amount of employment tax issues on an agreed basis, either before issuance of the Notice of Determination, or after issuance of the Notice of Determination but before expiration of the 90–day period for filing a Tax Court petition, the taxpayer must formally waive the restrictions on assessment contained in Code §§ 7436 (d)(1) and 6213(a). This will generally be accomplished by execution of an agreed settlement that contains the following language:

I understand that by signing this agreement, I am waiving the restrictions on assessment provided in section 7436(d) and 6213(a) of the Internal Revenue Code of 1986.

The Service will not assess employment taxes attributable to worker classification or § 530 treatment issues unless either the Service has issued a Notice of Determination to the taxpayer and the 90-day period for filing a Tax Court petition has expired, or, alternatively, the taxpayer has waived the restrictions on assessment. If the Service erroneously makes an assessment of taxes attributable to worker classification and § 530 issues without first either issuing a Notice of Determination or obtaining a waiver of restrictions on assessment from the taxpayer, the taxpayer is entitled to an automatic abatement of the assessment. However, once any such procedural defects are corrected, the Service may reassess the employment taxes to the same extent as if the abated assessment had not occurred.

EFFECTIVE DATE

Section 1454 of TRA '97 and § 314(f) of CRTRA '00 are effective as of August 5, 1997. Assessments that were made prior to the August 5, 1997, effective date are not subject to the procedures discussed above. All employment tax examinations involving worker classification and/or § 530 treatment issues that were pending as of August 5, 1997, are subject to Code § 7436, as amended.

COMMENTS

The Service invites comments with respect to the attached Notice of Determination, as well as with respect to any procedural issues contained in this notice. Written comments should be submitted to

Linda E. Mosakowski
Office of Chief Counsel,
Internal Revenue Service
1111 Constitution Avenue, N.W.
(CC:TEGE:EOEG:ET2)
Washington, D.C. 20224.

For further information regarding this notice contact Linda E. Mosakowski at (202) 622–6040 (not a toll-free call).

[3] Only the prinicples of subsections (a), (b), (c), (d), and (f) of § 6213 apply to the employment status proceedings under § 7436.

[4] The Service may immediately assess proposed employment tax amounts that do not arise as a result of a determination by the Service that an individual is an employee of the taxpayer. To the extent the employment taxes relate to individuals the taxpayer was already treating as employees, those tax amounts would not be included in the Notice of Determination and thus, assessment of those taxes would not be restricted by section 6213 (a).

EXHIBIT 1

Internal Revenue Service

IRS Contact Person
Name:
Telephone Number:
Identification Number:
Location Symbols:

Last Day to File a Petition With the United States Tax Court:

Taxpayer Identification Number:

NOTICE OF DETERMINATION OF WORKER CLASSIFICATION

Dear

This letter is your Notice of Determination of Worker Classification ("Notice"), as required by law, to notify you (before assessment) that we have determined that you owe additional employment tax, additions to tax, and/or penalties for the tax periods identified below.

We have made three determinations:

- we have determined that for purposes of federal employment taxes, the individual(s) described or listed in Table 1 below are to be legally classified as employees for the tax periods indicated;
- we have determined that with respect to such individual(s) you are not entitled to relief from employment tax under the treatment described in section 530(a) of the Revenue Act of 1978; and
- we have determined that for the tax periods indicated, you owe additional employment tax, additions to tax, and/or penalties in the amounts set forth in Table 2 following the list of re-classified individuals. (Please be aware that the figures on Table 2 do not include the interest that is required by law to be imposed on underpayments of tax.)

EXHIBIT 1

For the tax periods indicated, we determined that the following individual(s) are to be legally classified as your employees:

TABLE 1

Individuals *Tax Periods*

	Year	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Calendar Year

EXHIBIT 1

Table 2 indicates the proper amount of employment tax, additions to tax, and/or penalties that arises from the classification of the above-listed individuals as employees. Please note that these figures do not include the interest that accrues on the underpayment of tax.

TABLE 2

		Tax Period Ending				
Year	**Type of Tax**	**March 31**	**June 30**	**Sept 30**	**Dec. 31**	**TOTAL**
	Old Age, Survivor, Disability Insurance	$	$	$	$	$
	Hospital Insurance					
	Income Tax Withholding					
	Federal Unemployment Tax Act					
	Addition to Tax I.R.C. §					
	Addition to Tax I.R.C. §					
	Penalty I.R.C. §					
	TOTAL					
	Old Age, Survivor, Disability Insurance					
	Hospital Insurance					
	Income Tax Withholding					
	Federal Unemployment Tax Act					
	Addition to Tax I.R.C. §					
	Addition to Tax I.R.C. §					
	Penalty I.R.C. §					
	TOTAL					
	Old Age, Survivor, Disability Insurance					
	Hospital Insurance					
	Income Tax Withholding					
	Federal Unemployment Tax Act					
	Addition to Tax I.R.C. §					
	Addition to Tax I.R.C. §					
	Penalty I.R.C. §					
	TOTAL					

If you want to contest any or all of our three determinations in the United States Tax Court, you must file a petition with the United States Tax Court by the date indicated on the first page of this letter as the "Last Day to File a Petition With the United States Tax Court." You may mail the petition to the Tax Court (and/or write to the court with questions about the Tax Court proceedings) at the following address:

United States Tax Court
400 Second Street, N.W.
Washington, DC 20217

The time you have to file a petition with the Tax Court (that is, before the 91st day after the letter is mailed) is set by law and cannot be extended or suspended. Therefore, contacting the Internal Revenue Service (IRS) or contacting the Tax Court for more information, or receiving other correspondence from the IRS, will not change the period for filing a petition with the Tax Court.

We have enclosed several documents with this Notice of Determination of Worker Classification. Forms 4666, 4667, and/or 4668 provide details on how we calculated the amount of your additional employment tax liability. Form 2504–WC is a waiver form that you may use if you decide not to file a petition in the Tax Court. Sending us a signed Form 2504–WC gives us permission to assess the proposed amounts quickly and can help limit the accumulation of interest. Publication 3953, "*Questions & Answers About Tax Court Proceedings for Determination of Employment Status Under I.R.C. § 7436*" provides details about this Notice and the Tax Court proceedings.

If you have any questions about this letter, you may write to the person whose name and IRS address are shown on the front of this letter. If you write, please include your telephone number, the best time for us to call you if we need more information, and a copy of this letter to help us identify your account. Keep the original letter for your records.

If you prefer, you may call the IRS contact person at the telephone number on the front page of this letter. If this number is outside your local calling area, there will be a long distance charge to you. You may call the IRS telephone number listed in your local directory. An IRS employee there may be able to help you, but the contact person at our address shown on this letter is most familiar with your case.

You also have the right to contact a Taxpayer Advocate. If you believe that your tax matter is not being resolved through established IRS procedures or you are suffering or about to suffer a significant hardship, a Taxpayer Advocate may assist you in getting your tax matter addressed in a prompt and proper manner. A Taxpayer Advocate, however, does not have the ability to reverse legally correct tax determinations, extend the time fixed by law for filing a petition in the United States Tax Court, or act as a substitute for established IRS procedures, such as the formal appeals process. If you would like to contact a Taxpayer Advocate for assistance, please refer to section 12 of the enclosed Publication 3953 for the address and telephone number of your local Taxpayer Advocate.

Thank you for your cooperation.

Sincerely,

Commissioner
By

Restrictions on Disclosure and Use of Tax Return Information by Tax Return Preparers

Notice 2002–6

The Internal Revenue Service (IRS) has received inquiries from practitioners and tax return preparers regarding the effect of the Gramm-Leach-Bliley Act on Section 7216 of the Internal Revenue Code. The Gramm-Leach-Bliley Act, Pub. L. No. 106–102, 113 Stat. 1338, imposed new requirements on financial institutions to protect the privacy of non-public personal information. I.R.C. § 7216 prohibits the unauthorized use or disclosure of tax return information by tax return preparers.

Tax return preparers, as defined in Treas. Reg. § 301.7216–1(b)(2), are advised that, although tax return preparers may be subject to the privacy provisions of the Gramm-Leach-Bliley Act, those provisions do not supersede, alter, or affect the preexisting requirements of I.R.C. § 7216 restricting the disclosure or use of tax return information by a tax return preparer. Specifically, the Gramm-Leach-Bliley Act does not permit use or disclosure of tax return information prohibited by I.R.C. § 7216 and regulations promulgated thereunder.

For guidance on the use or disclosure of tax return information, tax return preparers may refer to Treas. Reg. § 301.7216 and Notice 2000–64 (2000–51 I.R.B. 589).

The principal author of this notice is Brinton T. Warren of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division. For further information regarding this announcement, contact Brinton Warren at (202) 622–4940 (not a toll-free call).

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 56, 61, 77, 111, 162, 165, 166, 167, 168, 171, 174, 197, 263, 263A, 267, 404, 446, 448, 451, 454, 455, 460, 461, 471, 472, 475, 481, 585, 985, 1272, 1273, 1278, 1281, 1363; 1.61–8, 1.77–1, 1.77–2, 1.162–1, 1.162–3, 1.162–4, 1.162–11, 1.165–2, 1.165–3, 1.167(a)–2, 1.167(a)–14, 1.167(a)–8, 1.167(a)–11, 1.167(e)–1, 1.171–4, 1.174–1, 1.174–3, 1.174–4, 1.197–1T, 1.197–2, 1.263(a)–1, 1.263(a)–2, 1.263A–1, 1.263A–2, 1.263A–3, 1.263A–4, 1.446–1, 1.446–2, 1.448–2T, 1.451–1, 1.454–1, 1.455–6, 1.460–1. 1.460–4, 1.461–4, 1.461–5, 1.471–1, 1.471–2, 1.471–3, 1.472–1, 1.472–2, 1.472–6, 1.472–8, 1.481–1, 1.481–4, 1.861–18, 1.985–5, 1.985–8, 1.1272–1, 1.1273–1, 1.1273–2.)

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SECTION 1. PURPOSE

This revenue procedure provides the procedures by which a taxpayer may obtain automatic consent to change the methods of accounting described in the APPENDIX of this revenue procedure. This revenue procedure clarifies, modifies, amplifies, and supersedes Rev. Proc. 99–49 (1999–2 C.B. 725). It also consolidates automatic consent procedures for changes in several methods of accounting that were published subsequent to the

publication of Rev. Proc. 99–49, and provides new automatic consent procedures for changes in several other methods of accounting. A taxpayer complying with all the applicable provisions of this revenue procedure has obtained the consent of the Commissioner of Internal Revenue to change its method of accounting under § 446(e) of the Internal Revenue Code and the Income Tax Regulations thereunder.

SECTION 2. BACKGROUND AND CHANGES

.01 *Change in method of accounting defined.*

(1) Section 1.446–1(e)(2)(ii)(*a*) of the Income Tax Regulations provides that a change in 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. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which income is reported, it involves timing and is therefore a method of accounting. *See* Rev. Proc. 91–31 (1991–1 C.B. 566).

(2) Although a method of accounting may exist under this definition without a pattern of consistent treatment of an item, a method of accounting is not adopted in most instances without consistent treatment. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of § 1.446–1(e)(2)(ii)(*a*). If a taxpayer treats an item properly in the first return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns to have adopted a method of accounting. If a taxpayer has adopted a method of accounting under these rules, the taxpayer may not change the method by amending its prior income tax return(s). *See* Rev. Rul. 90–38 (1990–1 C.B. 57).

(3) A change in the characterization of an item may also constitute a change in method of accounting if the change has the effect of shifting income from one period to another. For example, a change from treating an item as income to treating the item as a deposit is a change in method of accounting. *See* Rev. Proc. 91–31.

(4) 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). *See* § 1.446–1(e)(2)(ii)(*b*).

.02 *Securing permission to make a method change.* Sections 446(e) and 1.446–1(e) state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446–1(e)(3)(i) requires that, in order to obtain the Commissioner's consent to a method change, a taxpayer must file a Form 3115, *Application for Change in Accounting Method*, during the taxable year in which the taxpayer wants to make the proposed change.

.03 *Terms and conditions of a method change.* Section 1.446–1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e). The terms and conditions the Commissioner may prescribe include the year of change, whether the change is to be made with a § 481(a) adjustment or on a cut-off basis, and the § 481(a) adjustment period.

.04 *No retroactive method change.* Unless specifically authorized by the Commissioner, a taxpayer may not request, or otherwise make, a retroactive change in method of accounting, regardless of whether the change is from a permissible or an impermissible method. *See generally* Rev. Rul. 90–38.

.05 *Method change with § 481(a) adjustment.*

(1) *Need for adjustment.* Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used.

Example. A taxpayer that is not required to use inventories uses the overall cash receipts and disbursements method and changes to an overall accrual method. The taxpayer has $120,000 of income earned but not yet received (accounts receivable) and $100,000 of expenses incurred but not yet paid (accounts payable) as of the end of the taxable year preceding the year of change. A positive § 481(a) adjustment of $20,000 ($120,000 accounts receivable less $100,000 accounts payable) is required as a result of the change.

(2) *Adjustment period.* Section 481(c) and §§ 1.446–1(e)(3)(ii) and 1.481–4 provide that the adjustment required by § 481(a) may be taken into account in determining taxable income in the manner and subject to the conditions agreed to by the Commissioner and the taxpayer. Generally, in the absence of such an agreement, the § 481(a) adjustment is taken into account completely in the year of change, subject to § 481(b) which limits the amount of tax where the § 481(a) adjustment is substantial. However, under the Commissioner's authority in § 1.446–1(e)(3)(ii) to prescribe terms and conditions for changes in methods of accounting, this revenue procedure provides specific adjustment periods that are intended to achieve an appropriate balance between the goals of mitigating distortions of income that result from accounting method changes and providing appropriate incentives for voluntary compliance.

.06 *Method change using a cut-off method.* The Commissioner may determine that certain changes in methods of accounting will be made without a § 481(a) adjustment, using a "cut-off method." Under a cut-off method, only the items arising on or after the beginning of the year of change (or other operative date) are accounted for under the new

method of accounting. Any items arising before the year of change (or other operative date) continue to be accounted for under the taxpayer's former method of accounting. See, for example, sections 1.01 and 7A.01 of the APPENDIX of this revenue procedure. Because no items are duplicated or omitted from income when a cut-off method is used to effect a change in accounting method, no § 481(a) adjustment is necessary.

.07 *Consistency and clear reflection of income*. Methods of accounting should clearly reflect income on a continuing basis, and the Internal Revenue Service exercises its discretion under §§ 446(e) and 481(c) in a manner that generally minimizes distortions of income across taxable years and on an annual basis.

.08 *Separate trades or businesses*.

(1) Sections 1.446–1(d)(1) and (2) provide that when 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 of accounting used for each trade or business clearly reflects the overall income of the taxpayer as well as that of each particular trade or business. No trade or business is separate and distinct unless a complete and separable set of books and records is kept for that trade or business.

(2) Section 1.446–1(d)(3) provides that 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 are not separate and distinct.

.09 *Penalties*. Any otherwise applicable penalty, addition to the tax, or additional amount for the failure of a taxpayer to change its method of accounting (for example, the accuracy-related penalty under § 6662 or the fraud penalty under § 6663) may be imposed if the taxpayer does not timely file a request to change a method of accounting. *See* § 446(f). Additionally, the taxpayer's return preparer may also be subject to the preparer penalty under § 6694. However, penalties, additions to the tax, or additional amounts will not be imposed when a taxpayer changes from an impermissible method of accounting to a permissible one by complying with all applicable provisions of this revenue procedure.

.10 *Change made as part of an examination*. Sections 446(b) and 1.446–1(b)(1) provide that if a taxpayer does not regularly employ a method of accounting that clearly reflects its income, the computation of taxable income must be made in a manner that, in the opinion of the Commissioner, does clearly reflect income. If a taxpayer under examination is not eligible to change a method of accounting under this revenue procedure, the change may be made by the director. A change resulting in a positive § 481(a) adjustment will ordinarily be made in the earliest taxable year under examination with a one-year § 481(a) adjustment period.

.11 *Significant changes*. Significant changes to Rev. Proc. 99–49 include:

(1) The term "applicable provisions" is now defined in new section 3.02.

(2) The term "director" as defined in section 3.11 of this revenue procedure replaces the term "district director" as defined in section 3.11 of Rev. Proc. 99–49.

(3) The scope exclusion in section 4.02(7), relating to a taxpayer engaging in transactions to which § 381(a) applies, has been narrowed to exclude certain transactions under § 381(a).

(4) The consent provisions of section 6.01 have been clarified.

(5) A new section 6.02(1), clarifying the form and content of applications, has been added.

(6) The instructions in section 6.02(6)(c) for hand delivery of applications to the national office have been modified.

(7) A new section 6.02(9) has been added, which provides that where a particular change waives the scope limitations of section 4.02 of this revenue procedure, a taxpayer making such a change that is under examination, before an appeals office, or before a federal court is required to provide a copy of its application to the examining agent(s), appeals officer(s), or counsel(s) for the government, as appropriate. This requirement was repeated throughout the APPENDIX of Rev. Proc. 99–49 in each of the various changes that waived the scope limitations of section 4.02. The addition of new section 6.02(9) consolidates these various requirements into a single uniform provision, and allows the requirements to be removed throughout the APPENDIX.

(8) A new section 6.03(5) has been added, permitting a taxpayer under examination to change its method of accounting under this revenue procedure if the APPENDIX of this revenue procedure provides that the audit protection provisions of section 7 of this revenue procedure do not apply to the change made by the taxpayer.

(9) A new section 9.02, relating to taxpayers that have made a change in method of accounting without complying with all the applicable provisions of this revenue procedure, has been added.

(10) Section 10.02(2) has been expanded to clarify the procedures applicable to a taxpayer that does not qualify for automatic consent procedures of this revenue procedure because the taxpayer has failed to provide on a timely basis the additional information requested by the national office.

(11) Section 10.04(1) has been expanded to clarify that in no event will an application under this revenue procedure be treated as an application under Rev. Proc. 97–27 (or any successor).

(12) The first sentence of section 13.02, relating to the transition rules, has been rephrased to express more clearly the intended scope of the rule.

(13) Section 4.01 of the APPENDIX is modified to include certain additional uniform capitalization (UNICAP) changes by resellers.

(14) Section 5.01 of the APPENDIX is modified to allow certain taxpayers producing real or tangible personal property to change from the cash receipts and disbursements method or a hybrid method to an overall accrual method (or to the overall accrual method in conjunction with the recurring item exception under § 461(h)(3)).

(15) Section 8.01 is modified by the removal of provisions relating to bonuses, which are transferred to section 4B.02 of the APPENDIX.

(16) Section 8.02 of the APPENDIX is modified to include personal property taxes and state income taxes.

(17) Section 13.02 of the APPENDIX is modified to be applicable to all cash method banks.

(18) The following changes in method of accounting have been added to the APPENDIX of this revenue procedure:

(a) Section 1 of the APPENDIX, relating to Commodity Credit Corporation loans.

(b) Section 1A.03 of the APPENDIX, relating to aircraft maintenance costs.

(c) Section 1A.04 of the APPENDIX, relating to ISO 9000 costs.

(d) Section 1A.05 of the APPENDIX, relating to railroad track structure expenditures.

(e) Section 1A.06 of the APPENDIX, relating to restaurant smallwares.

(f) Section 1B.01 of the APPENDIX, relating to bad debts.

(g) Section 2.04 of the APPENDIX, relating to golf course greens.

(h) Section 2B of the APPENDIX, relating to computer software expenditures.

(i) Section 3.03 of the APPENDIX, relating to costs of retiring or removing depreciable assets.

(j) Section 4.02 of the APPENDIX, relating to uniform capitalization (UNICAP) changes by producers of real or tangible personal property.

(k) Section 4.03 of the APPENDIX, relating to uniform capitalization (UNICAP) changes by taxpayers engaged in a farming business.

(l) Section 4.04 of the APPENDIX, relating to capitalization of research and experimental expenditures into inventory under uniform capitalization (UNICAP).

(m) Section 4A.01 of the APPENDIX, relating to the disallowance or deferral under § 267 of certain deductions attributable to transactions between related taxpayers.

(n) Section 4B.02 of the APPENDIX, relating to bonuses and vacation pay.

(o) Section 5.05 of the APPENDIX, relating to the use of the cash and disbursements method of accounting by certain small taxpayers.

(p) Section 5.06 of the APPENDIX, relating to the nonaccrual experience method.

(q) Section 5A.02 of the APPENDIX, relating to cash advances of insurance commissions.

(r) Section 5A.03 of the APPENDIX, relating to advance rentals.

(s) Sections 7A.01 and 7A.02 of the APPENDIX, relating to long-term contracts.

(t) Section 8.06 of the APPENDIX, relating to distribution fees of open-end regulated investment companies.

(u) Section 9.03 of the APPENDIX, relating to an exemption for certain small taxpayers from the requirement to maintain inventories.

(v) Section 9.04 of the APPENDIX, relating to payments made or received on "floor stocks."

(w) Section 9.05 of the APPENDIX, relating to volume related trade discounts.

(x) Section 9.06 of the APPENDIX, relating to certain impermissible methods of inventory valuation.

(y) Section 10.04 of the APPENDIX, relating to the used vehicle alternative LIFO method.

(z) Section 10.06 of the APPENDIX, relating to changes to the inventory price index computation (IPIC) method.

(aa) Section 10.07 of the APPENDIX, relating to changes within the inventory price index computation (IPIC) method.

(bb) Section 11A.01 of the APPENDIX, relating to transactions involving computer programs.

(cc) Section 11B.01 of the APPENDIX, relating to functional currency changes.

(19) The following changes in method of accounting have been removed from the APPENDIX of this revenue procedure:

(a) Section 8A of the APPENDIX of Rev. Proc. 99–49, relating to rental agreements.

(b) Section 10A.01 of the APPENDIX of Rev. Proc. 99–49, relating to mark-to-market accounting for nonfinancial customer paper.

(c) Section 12A.02 of the APPENDIX of Rev. Proc. 99–49, relating to pools of debt instruments.

SECTION 3. DEFINITIONS

.01 *Application*. The term "application" includes a Form 3115, or any statement that is authorized under the APPENDIX of this revenue procedure to be filed in lieu of a Form 3115, and any attachments.

.02 *Applicable provisions*. The term "applicable provisions" means all provisions of this revenue procedure pertinent to the taxpayer or its requested change, including but not limited to:

(1) the scope requirements and limitations of section 4 of this revenue procedure;

(2) the terms and conditions of change in section 5 of this revenue procedure;

(3) the requirements regarding the form and content of an application in section 6 of this revenue procedure;

(4) the filing requirements of section 6 of this revenue procedure; and

(5) the APPENDIX of this revenue procedure, including

(a) the available changes in method of accounting;

(b) any restrictions on the availability of a requested change to the taxpayer (including provisions that render the change inapplicable to the taxpayer); and

(c) any special terms and conditions applicable to a change, such as the use of a cut-off method or a § 481(a) adjustment, the spread period for any § 481(a) adjustment, and the year of change.

.03 *Taxpayer*.

(1) *In general*. The term "taxpayer" has the same meaning as the term "person" defined in § 7701(a)(1) (rather than the meaning of the term "taxpayer" defined in § 7701(a)(14)).

(2) *Consolidated group*. For purposes of (a) sections 3.08(1), 3.09(1), and 4.02(1) of this revenue procedure (taxpayer under examination), (b) sections 3.09(2) and 4.02(2) of this revenue procedure (taxpayer before an appeals office), or (c) sections 3.09(3) and 4.02(3) of this revenue procedure (taxpayer before a federal court), the term "taxpayer" includes a consolidated group.

.04 *Timely mailing as timely filing*. Under the provisions of section 7502, any form (including an application), statement, or other document required to be filed under this revenue procedure is considered timely filed if it is timely postmarked and mailed, postage prepaid, to the proper address (or an address similar enough to complete delivery). If these requirements are met, the date of filing is the date of the U.S. postmark or the applicable date recorded or marked by a designated private delivery service. *See* Notice

2001–62 (2001–40, I.R.B. 307). If the requirements of section 7502 are not met, the form, statement, or other document is considered filed on the date it is delivered to the Service.

.05 *Timely performance of acts*. The rules of § 7503 apply when the last day for the taxpayer's timely performance of any act (for example, filing an application or submitting additional information) falls on a Saturday, Sunday, or legal holiday. The performance of any act is timely if the act is performed on the next succeeding day that is not a Saturday, Sunday, or legal holiday.

.06 *Year of change*. The year of change is the taxable year for which a change in method of accounting is effective, that is, the first taxable year the new method is to be used, even if no affected items are taken into account for that year.

.07 *Section 481(a) adjustment period*. The § 481(a) adjustment period is the applicable number of taxable years for taking into account the § 481(a) adjustment required as a result of the change in method of accounting. The year of change is the first taxable year in the adjustment period and the § 481(a) adjustment is taken into account ratably over the number of taxable years in the adjustment period. The applicable adjustment periods are set forth in section 5.04 of this revenue procedure.

.08 *Under examination*.

(1) *In general*.

(a) Except as provided in section 3.08(2) of this revenue procedure, an examination of a taxpayer with respect to a federal income tax return begins on the date the taxpayer is contacted in any manner by a representative of the Service for the purpose of scheduling any type of examination of the return. An examination ends:

(i) in a case in which the Service accepts the return as filed, on the date of the "no change" letter sent to the taxpayer;

(ii) in a fully agreed case, on the earliest of the date the taxpayer executes a waiver of restrictions on assessment or acceptance of overassessment (for example, Form 870, 4549, or 4605), the date the taxpayer makes a payment of tax that equals or exceeds the proposed deficiency, or the date of the "closing" letter (for example, Letter 891(IN) or 987(DO)) sent to the taxpayer; or

(iii) in an unagreed or a partially agreed case, on the earliest of the date the taxpayer (or its representative) is notified by Appeals that the case has been referred by the examining agent(s) to Appeals, the date the taxpayer files a petition in the Tax Court, the date on which the period for filing a petition with the Tax Court expires, or the date of the notice of claim disallowance.

(b) An examination does not end as a result of the early referral of an issue to Appeals under the provisions of Rev. Proc. 99–28 (1999–2 C.B. 109).

(c) An examination resumes on the date the taxpayer (or its representative) is notified by Appeals (or otherwise) that the case has been referred to the examining agent(s) for reconsideration.

(2) *Partnerships and S corporations subject to TEFRA*. For an entity (including a limited liability company), treated as a partnership or an S corporation for federal income tax purposes, that is subject to the TEFRA unified audit and litigation provisions for partnerships and S corporations, an examination begins on the date of the notice of the beginning of an administrative proceeding sent to the Tax Matters Partner/Tax Matters Person (TMP). An examination ends:

(a) in a case in which the Service accepts the partnership or S corporation return as filed, on the date of the "no adjustments" letter or the "no change" notice of final administrative adjustment sent to the TMP;

(b) in a fully agreed case, when all the partners, members, or shareholders execute a Form 870–P, 870–L, or 870–S; or

(c) in an unagreed or a partially agreed case, on the earliest of the date the TMP (or its representative) is notified by Appeals that the case has been referred by the examining agent(s) to Appeals, the date the TMP (or a partner, member, or shareholder) requests judicial review, or the date on which the period for requesting judicial review expires. But see section 4.02(5) of this revenue procedure for certain rules that preclude an entity from requesting a change in accounting method. Also note that S corporations are not subject to the TEFRA unified audit and litigation provisions for taxable years beginning after December 31, 1996. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104–188, § 1317(a), 110 Stat. 1755, 1787 (1996).

.09 *Issue under consideration*.

(1) *Under examination*. A taxpayer's method of accounting for an item is an issue under consideration for the taxable years under examination if the taxpayer receives written notification (for example, by examination plan, information document request (IDR), or notification of proposed adjustments or income tax examination changes) from the examining agent(s) specifically citing the treatment of the item as an issue under consideration. For example, a taxpayer's method of pooling under the dollar-value, last-in, first-out (LIFO) inventory method is an issue under consideration as a result of an examination plan that identifies LIFO pooling as a matter to be examined, but it is not an issue under consideration as a result of an examination plan that merely identifies LIFO inventories as a matter to be examined. Similarly, a taxpayer's method of determining inventoriable costs under § 263A is an issue under consideration as a result of an IDR that requests documentation supporting the costs included in inventoriable costs, but it is not an issue under consideration as a result of an IDR that requests documentation supporting the amount of cost of goods sold reported on the return. The question of whether a method of accounting is an issue under consideration may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2001–2 (2001–1 I.R.B. 79) (or any successor).

(2) *Before an appeals office*. A taxpayer's method of accounting for an item is an issue under consideration for the taxable years before an appeals office if the treatment of the item is included as an item of adjustment in the examination report referred to Appeals or is specifically identified in writing to the taxpayer by Appeals.

(3) *Before a federal court*. A taxpayer's method of accounting for an item is an issue under consideration for the taxable years before a federal court if the treatment of the item is included in the statutory notice of deficiency, the notice of claim disallowance, the notice of final administrative adjustment, the pleadings

(for example, the petition, complaint, or answer) or amendments thereto, or is specifically identified in writing to the taxpayer by the counsel for the government.

.10 *Change within the LIFO inventory method*. A change within the LIFO inventory method is a change from one LIFO inventory method or sub-method to another LIFO inventory method or sub-method. A change within the LIFO inventory method does not include a change in method of accounting that could be made by a taxpayer that does not use the LIFO inventory method (for example, a method governed by § 471 or 263A).

.11 *Director*. The term "director" has the same meaning as this term has in Rev. Proc. 2001–1 (2001–1 I.R.B. 1) (or any successor).

SECTION 4. SCOPE

.01 *Applicability*. This revenue procedure applies to a taxpayer requesting the Commissioner's consent to change to a method of accounting described in the APPENDIX of this revenue procedure. This revenue procedure is the exclusive procedure for a taxpayer within its scope to obtain the Commissioner's consent.

.02 *Inapplicability*. Except as otherwise provided in the APPENDIX of this revenue procedure (see, for example, section 1.01 of the APPENDIX of this revenue procedure), this revenue procedure does not apply in the following situations:

(1) *Under examination*. If, on the date the taxpayer would otherwise file a copy of the application with the national office, the taxpayer is under examination (as provided in section 3.08 of this revenue procedure), except as provided in sections 6.03(2) (90–day window), 6.03(3) (120-day window), 6.03(4) (director consent) and 6.03(5) (changes lacking audit protection) of this revenue procedure;

(2) *Before an appeals office*. If, on the date the taxpayer would otherwise file a copy of the application with the national office, the taxpayer is before an appeals office with respect to any income tax issue and the method of accounting to be changed is an issue under consideration by the appeals office (as provided in section 3.09(2) of this revenue procedure);

(3) *Before a federal court*. If, on the date the taxpayer would otherwise file a copy of the application with the national office, the taxpayer is before a federal court with respect to any income tax issue and the method of accounting to be changed is an issue under consideration by the federal court (as provided in section 3.09(3) of this revenue procedure);

(4) *Consolidated group member*. A corporation that is (or was formerly) a member of a consolidated group is under examination, before an appeals office, or before a federal court (for purposes of sections 4.02(1), (2), and (3) of this revenue procedure) if the consolidated group is under examination, before an appeals office, or before a federal court for a taxable year(s) that the corporation was a member of the group;

(5) *Partnerships and S corporations*. For an entity (including a limited liability company) treated as a partnership or an S corporation for federal income tax purposes, if, on the date the entity would otherwise file a copy of the application with the national office, the entity's accounting method to be changed is an issue under consideration in an examination of a partner, member, or shareholder's federal income tax return or an issue under consideration by an appeals office or by a federal court with respect to a partner, member, or shareholder's federal income tax return;

(6) *Prior change*. If the taxpayer, within the last five taxable years (including the year of change), (a) has made a change in the same method of accounting (with or without obtaining the Commissioner's consent), or (b) has applied to change the same method of accounting without effecting the change (whether, for example, the application to change was withdrawn, not perfected, not granted, or denied). For purposes of this paragraph 4.02(6), a change in method of accounting does not include the adoption of a method of accounting in the initial tax return of a taxpayer or in the first taxable year in which the taxpayer has the item to which the method of accounting relates;

(7) *Section 381(a) transaction*. Except as otherwise provided in this section 4.02(7), if the taxpayer engages in a transaction to which § 381(a) applies within the proposed taxable year of change (determined without regard to any potential closing of the year under § 381(b)(1)).

(a) *No differences in methods*. An acquiring corporation may change its method of accounting pursuant to this revenue procedure if the acquiring corporation would be permitted to continue to use its prior method of accounting under the rules of §§ 1.381(c)(4)–1(b)(1) and (3)(i) (taking into account the third sentence of § 1.381(c)(4)–1(b)(4) relating to no prior method established by a party to the transaction) or §§ 1.381(c)(5)–1(b)(1) and (3)(i) (taking into account the second sentence of § 1.381(c)(5)–1(b)(4)(i) relating to no prior inventory method established by a party to the transaction) because all of the parties to the transaction used the same method of accounting on the date of distribution or transfer. The change pursuant to this revenue procedure is ignored for purposes of determining whether on the date of distribution or transfer the parties to the transaction used the same methods of accounting under 1.381(c)(4)–1(b) or § 1.381(c)(5)–1(b), and thus §§ 1.381(c)(4)–1(b)(3)(ii) and (c) and §§ 1.381(c)(5)–1(b)(3)(ii) and (c) will not apply.

(b) *Separate trades or businesses*. An acquiring corporation may change pursuant to this revenue procedure a method of accounting used by a trade or business operated by such corporation if the trade or business would be permitted to continue to use its prior method of accounting under the rules of §§ 1.381(c)(4)–1(b)(2) or §§ 1.381(c)(5)–1(b)(2). The change pursuant to this revenue procedure is ignored for purposes of determining whether on the date of distribution or transfer the parties to the transaction used the same methods of accounting under § 1.381(c)(4)–1(b) or § 1.381(c)(5)–1(b), and thus §§ 1.381(c)(4)–1(b)(3) and (c) and §§ 1.381(c)(5)–1(b)(3) and (c) will not apply.

(8) *Final year of trade or business*. If the taxpayer would be required by section 5.04(3)(c) of this revenue procedure to take the entire amount of the § 481(a) adjustment into account in computing taxable income for the year of change.

.03 *Nonautomatic changes*. If a taxpayer is precluded by other than sections 4.02(1) through 4.02(5) of this revenue procedure from using this revenue procedure to make a change in method of accounting, the taxpayer requesting such a change must file a Form 3115 with the Commissioner in accordance with the requirements of § 1.446–1(e)(3)(i) and

Rev. Proc. 97–27 (1997–1 C.B. 680) (or any other applicable Code, regulation, or administrative provision).

SECTION 5. TERMS AND CONDITIONS OF CHANGE

.01 *In general*. An accounting method change filed under this revenue procedure must be made pursuant to the terms and conditions provided in this revenue procedure.

.02 *Year of change*. The year of change is the taxable year designated on the application and for which the application is timely filed under section 6.02(3).

.03 *Section 481(a) adjustment*. Unless otherwise provided in this revenue procedure, a taxpayer making a change in method of accounting under this revenue procedure must take into account a § 481(a) adjustment in the manner provided in section 5.04 of this revenue procedure.

.04 *Section 481(a) adjustment period*.

(1) *In general*. Except as otherwise provided in section 5.04(3) or the APPENDIX of this revenue procedure, the § 481(a) adjustment period for positive and negative § 481(a) adjustments is four taxable years.

(2) *Short period as a separate taxable year*. If the year of change, or any taxable year during the § 481(a) adjustment period, is a short taxable year, the § 481(a) adjustment must be included in income as if that short taxable year were a full 12–month taxable year. *See* Rev. Rul. 78–165 (1978–1 C.B. 276).

Example 1. A calendar year taxpayer received permission to change an accounting method beginning with the 2001 calendar year. The § 481(a) adjustment is $30,000 and the adjustment period is four taxable years. The taxpayer subsequently receives permission to change its annual accounting period to September 30, effective for the taxable year ending September 30, 2002. The taxpayer must include $7,500 of the § 481(a) adjustment in gross income for the short period from January 1, 2002, through September 30, 2002.

Example 2. Corporation X, a calendar year taxpayer, received permission to change an accounting method beginning with the 2001 calendar year. The § 481(a) adjustment is $30,000 and the adjustment period is four taxable years. On July 1, 2003, Corporation *Z* acquires Corporation *X* in a transaction to which § 381(a) applies. Corporation *Z* is a calendar year taxpayer that uses the same method of accounting to which Corporation *X* changed in 2001. Corporation *X* must include $7,500 of the § 481(a) adjustment in gross income for its short period income tax return for January 1, 2003, through June 30, 2003. In addition, Corporation *Z* must include $7,500 of the § 481(a) adjustment in gross income in its income tax return for calendar year 2003.

(3) *Shortened or accelerated adjustment periods*. The § 481(a) adjustment period provided in section 5.04(1) or the APPENDIX of this revenue procedure will be shortened or accelerated in the following situations.

(a) *De minimis rule*. A taxpayer may elect to use a one-year adjustment period in lieu of the § 481(a) adjustment period otherwise provided by this revenue procedure if the entire § 481(a) adjustment is less than $25,000 (either positive or negative). A taxpayer makes an election under this *de minimis* rule by so indicating on the application. For example, for a taxpayer filing a Form 3115, the taxpayer must complete the appropriate line on the Form 3115 to elect this *de minimis* rule.

(b) *Cooperatives*. A cooperative within the meaning of § 1381(a) generally must take the entire amount of a § 481(a) adjustment into account in computing taxable income for the year of change. *See* Rev. Rul. 79–45 (1979–1 C.B. 284).

(c) *Ceasing to engage in the trade or business or terminating existence*.

(i) *In general*. A taxpayer that ceases to engage in a trade or business or terminates its existence must take the remaining balance of any § 481(a) adjustment relating to the trade or business into account in computing taxable income in the taxable year of the cessation or termination. Except as provided in sections 5.04(3)(c)(iv) and (v) of this revenue procedure, a taxpayer is treated as ceasing to engage in a trade or business if the operations of the trade or business cease or substantially all the assets of the trade or business are transferred to another taxpayer. For this purpose, "substantially all" has the same meaning as in section 3.01 of Rev. Proc. 77–37 (1977–2 C.B. 568).

(ii) *Examples of transactions that are treated as the cessation of a trade or business*. The following is a nonexclusive list of transactions that are treated as the cessation of a trade or business for purposes of accelerating the § 481(a) adjustment under section 5.04(3)(c) of this revenue procedure:

(A) the trade or business to which the § 481(a) adjustment relates is incorporated;

(B) the trade or business to which the § 481(a) adjustment relates is purchased by another taxpayer in a transaction to which § 1060 applies;

(C) the trade or business to which the § 481(a) adjustment relates is terminated or transferred pursuant to a taxable liquidation;

(D) a division of a corporation ceases to operate the trade or business to which the § 481(a) adjustment relates; or

(E) the assets of a trade or business to which the § 481(a) adjustment relates are contributed to a partnership.

(iii) *Conversion to or from S corporation status*. Except as provided in section 10.01 of the APPENDIX of this revenue procedure, no acceleration of a § 481(a) adjustment is required under section 5.04(3)(c) of this revenue procedure when a C corporation elects to be treated as an S corporation or an S corporation terminates its S election and is then treated as a C corporation.

(iv) *Certain transfers to which § 381(a) applies*. No acceleration of the § 481(a) adjustment is required under section 5.04(3)(c) of this revenue procedure when a taxpayer transfers substantially all the assets of the trade or business that gave rise to the § 481(a) adjustment to another taxpayer in a transfer to which § 381(a) applies and the accounting method (the change to which gave rise to the § 481(a) adjustment) is a tax attribute that is carried over and used by the acquiring corporation immediately after the transfer pursuant to § 381(c). The acquiring corporation is subject to any terms and conditions imposed on the transferor (or any predecessor of the transferor) as a result of its change in method of accounting.

(v) *Certain transfers pursuant to § 351 within a consolidated group*.

(A) *In general*. No acceleration of the § 481(a) adjustment is required under section 5.04(3)(c) of this revenue procedure when one member of an affiliated group filing a consolidated return transfers substantially all the assets of the trade or business that gave rise to the § 481(a) adjustment to another member of the same consolidated group in an exchange qualifying under § 351 and the transferee member adopts and uses the same method of accounting (the change

to which gave rise to the § 481(a) adjustment) used by the transferor member. The transferor member must continue to take the § 481(a) adjustment into account pursuant to the terms and conditions set forth in this revenue procedure. The transferor member must take into account activities of the transferee member (or any successor) in determining whether acceleration of the § 481(a) adjustment is required. For example, except as provided in the following sentence, the transferor member must take any remaining § 481(a) adjustment into account in computing taxable income in the taxable year in which the transferee member ceases to engage in the trade or business to which the § 481(a) adjustment relates. The § 481(a) adjustment is not accelerated when the transferee member engages in a transaction described in section 5.04(3)(c)(iv) or 5.04(3)(c)(v)(A) of this revenue procedure.

(B) *Exception*. The provisions of section 5.04(3)(c)(v)(A) of this revenue procedure cease to apply and the transferor member must take any remaining balance of the § 481(a) adjustment into account in the taxable year immediately preceding any of the following: (1) the taxable year the transferor member ceases to be a member of the group; (2) the taxable year any transferee member owning substantially all the assets of the trade or business which gave rise to the § 481(a) adjustment ceases to be a member of the group; or (3) a separate return year of the common parent of the group. In applying the preceding sentence, the rules of paragraphs (j)(2), (j)(5), and (j)(6) of § 1.1502–13 apply, but only if the method of accounting to which the transferor member changed and to which the § 481(a) adjustment relates is adopted, carried over, or used by any transferee member acquiring the assets of the trade or business that gave rise to the § 481(a) adjustment immediately after acquisition of such assets. For example, the transferor member is not required to accelerate the § 481(a) adjustment if a transferee member ceases to be a member of a consolidated group by reason of an acquisition to which § 381(a) applies and the acquiring corporation (1) is a member of the same group as the transferor member, and (2) continues, under § 381(c)(4) and the regulations thereunder, to use the same method of accounting as that used by the transferor member with respect to the assets of the trade or business to which the § 481(a) adjustment relates.

.05 *NOL carryback limitation for taxpayer subject to criminal investigation*. Generally, no portion of any net operating loss that is attributable to a negative § 481(a) adjustment may be carried back to a taxable year prior to the year of change that is the subject of any pending or future criminal investigation or proceeding concerning (1) directly or indirectly, any issue relating to the taxpayer's federal tax liability, or (2) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability.

.06 *Change treated as initiated by the taxpayer*. For purposes of § 481, a change in method of accounting made under this revenue procedure is a change in method of accounting initiated by the taxpayer.

SECTION 6. GENERAL APPLICATION PROCEDURES

.01 *Consent*. Pursuant to § 1.446–1(e)(2)(i), the consent of the Commissioner is hereby granted to any taxpayer within the scope of this revenue procedure to change its method(s) of accounting as described in the APPENDIX to this revenue procedure. Such consent is granted only for the change(s) of accounting method and the affected item(s) that are clearly and expressly identified in the taxpayer's application. Such consent is granted only to the extent that the taxpayer complies with all the applicable provisions of this revenue procedure and implements the change in method of accounting for the requested year of change.

.02 *Filing requirements*.

(1) *Applications*.

(a) *Form*. Ordinarily, a taxpayer applies for consent to change a method of accounting pursuant to this revenue procedure by completing a Form 3115. In some cases, however, the provisions of this revenue procedure applicable to a particular change may require or allow a taxpayer to file a statement in lieu of a Form 3115 as an application for consent to make such change. See, for example, § 5.02 of the APPENDIX of this revenue procedure.

(b) *Separate applications*. Ordinarily, a taxpayer must submit a separate application for each change in method of accounting. In some cases, however, the provisions of this revenue procedure applicable to particular changes may require or allow a taxpayer to file a single application with respect to two or more changes. See, for example, § 5.05 of the APPENDIX of this revenue procedure.

(c) *Contents*. The taxpayer must submit a complete and accurate application. The application must clearly and expressly identify the method(s) of accounting to be changed and the item(s) to which the change(s) applies.

(2) *Waiver of taxable year filing requirement*. The requirement under § 1.446–1(e)(3)(i) to file a Form 3115 within the taxable year for which the change is requested is waived for any application for a change in method of accounting filed pursuant to this revenue procedure. *See* § 1.446–1(e)(3)(ii).

(3) *Timely duplicate filing requirement*.

(a) *In general*. A taxpayer changing a method of accounting pursuant to this revenue procedure must complete and file an application in duplicate. The original must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the year of change, and a copy (with signature) of the application must be filed with the national office (see section 6.02(6) of this revenue procedure for the address) no earlier than the first day of the year of change and no later than when the original is filed with the federal income tax return for the year of change.

(b) *Limited relief for late application*.

(i) *Automatic extension*. An automatic extension of 6 months from the due date of the return for the year of change (excluding extensions) is granted to file an application, provided the taxpayer (A) timely filed (including extensions) its federal income tax return for the year of change, (B) files an amended return within the 6–month extension period in a manner that is consistent with the new method of accounting, (C) attaches the original application to the amended return, (D) files a copy of the application with the national office no later than when the original is filed with the amended return, and (E) writes at the top

of the application "FILED PURSUANT TO § 301.9100–2."

(ii) *Other extensions*. A taxpayer that fails to file the application for the year of change as provided in section 6.02(3)(a) or 6.02(3)(b)(i) of this revenue procedure will not be granted an extension of time to file under § 301.9100 of the Procedure and Administration Regulations, except in unusual and compelling circumstances. *See* § 301.9100–3(c)(2).

(4) *Label*.

(a) In order to assist in processing an application under this revenue procedure, the section of the APPENDIX of this revenue procedure describing the specific change in method of accounting should be included in the application. For example, a phrase such as "Section 1.01 of the APPENDIX of Rev. Proc. 2002–9" should be included on the appropriate line on the Form 3115.

(b) If a taxpayer is authorized under the APPENDIX of this revenue procedure to file a statement in lieu of a Form 3115, the taxpayer must include the taxpayer's name and employer identification number (or social security number in the case of an individual) at the top of the first page of the statement underneath any other required label.

(5) *Signature requirements*. The copy of the application must be signed by, or on behalf of, the taxpayer requesting the change by an individual with authority to bind the taxpayer in such matters. For example, an officer must sign on behalf of a corporation, a general partner on behalf of a state law partnership, a member-manager on behalf of a limited liability company, a trustee on behalf of a trust, or an individual taxpayer on behalf of a sole proprietorship. If the taxpayer is a member of a consolidated group, an application submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. See the signature requirements set forth in the General Instructions attached to a current Form 3115 regarding those who are to sign. If an agent is authorized to represent the taxpayer before the Service, receive the original or a copy of the correspondence concerning the application, or perform any other act(s) regarding the application filed on behalf of the taxpayer, a power of attorney reflecting such authorization(s) must be attached to the copy of the application. In addition, the taxpayer must attach to the application either a power of attorney reflecting such authorization(s) or a statement thoroughly describing such authorizations(s). A taxpayer's representative without a power of attorney to represent the taxpayer as indicated in this section will not be given any information regarding the application.

(6) *Where to file copy*.

(a) For a taxpayer other than an exempt organization, the copy of the application must be addressed to the Commissioner of Internal Revenue, Attention: CC:IT&A (Automatic Rulings Branch), P.O. Box 7604, Benjamin Franklin Station, Washington, D.C. 20044 (or, in the case of a designated private delivery service: Commissioner of Internal Revenue, Attention: CC:IT&A (Automatic Rulings Branch), 1111 Constitution Avenue, NW, Washington, D.C. 20224).

(b) For an exempt organization, the copy of the application must be addressed to the Commissioner, Tax Exempt and Government Entities, Attention: TEGE:EO, P.O. Box 27720, McPherson Station, Washington, D.C. 20038 (or, in the case of a designated private delivery service: Commissioner, Tax Exempt and Government Entities, Attention: TEGE:EO, 1111 Constitution Avenue, NW, Washington, D.C. 20224).

(c) The copy of the application may also be hand delivered between the hours of 7:00 a.m. and 4:00 p.m., to the courier's desk at the 12th Street entrance of 1111 Constitution Avenue, NW, Washington, D.C. A receipt will be given at the courier's desk. For a taxpayer other than an exempt organization, the copy of the application must be addressed to the Commissioner of Internal Revenue, Attention: CC:IT&A (Automatic Rulings Branch), 1111 Constitution Avenue, NW, Washington, D.C. 20224. For an exempt organization, the copy of the application must be addressed to the Commissioner, Tax Exempt and Government Entities, Attention: TEGE:EO, 1111 Constitution Avenue, NW, Washington, D.C. 20224

(7) *No user fee*. A user fee is not required for an application filed under this revenue procedure, and, except as provided in section 6.02(6)(c) of this revenue procedure, the receipt of an application filed under this revenue procedure will not be acknowledged.

(8) *Single application for certain consolidated groups*. A parent corporation may file a single application to change an identical method of accounting on behalf of more than one member of a consolidated group. To qualify, the taxpayers in the consolidated group must be members of the same affiliated group under § 1504(a) that join in the filing of a consolidated tax return, and they must be changing from the identical present method of accounting to the identical proposed method of accounting. All aspects of the change in method of accounting, including the present and proposed methods, the underlying facts, and the authority for the change, must be identical, except for the § 481(a) adjustment. *See* section 15.07(3) of Rev. Proc. 2001–1 (2001–1 I.R.B. at 53) (or any successor) for the information required to be submitted with the application.

(9) *Additional copies required where scope restrictions waived*. If (a) one or more of the scope limitation provisions of section 4.02 this revenue procedure would otherwise preclude a taxpayer from making a change under this revenue procedure, but (b) the scope limitation provisions of section 4.02 of this revenue procedure do not apply to the change sought by the taxpayer (see, for example section 1.01 of the APPENDIX of this revenue procedure), and (c) the taxpayer is under examination (as provided in section 3.08 of this revenue procedure), before an appeals office, or before a federal court on the date it files the copy of its application with the national office, then the taxpayer must provide a copy of the application to the examining agent(s), appeals officer(s), or counsel(s) for the government, as appropriate, at the same time that it files a copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer(s) or counsel(s) for the government, as appropriate.

.03 *Taxpayer under examination*.

(1) *In general*. Except as otherwise provided in the APPENDIX of this revenue procedure (see, for example, section 1.01 of the APPENDIX of this revenue procedure), a taxpayer that is under examination may file an application to change a method of accounting under section 6 of this revenue procedure only if

the taxpayer is within the provisions of section 6.03(2) (90-day window), 6.03(3) (120-day window), 6.03(4) (director consent), or 6.03(5) (changes lacking audit protection) of this revenue procedure. A taxpayer that files an application beyond the time periods provided in the 90-day and 120-day windows is not eligible for the automatic extension of time and will not be granted an extension of time to file under § 301.9100, except in unusual and compelling circumstances.

(2) *90-day window period.*

(a) A taxpayer may file a copy of the application with the national office to change a method of accounting under this revenue procedure during the first 90-days of any taxable year (the "90-day window") if the taxpayer has been under examination for at least 12 consecutive months as of the first day of the taxable year. This 90-day window is not available if the method of accounting the taxpayer is changing is an issue under consideration at the time the copy of the application is filed or an issue the examining agent(s) has placed in suspense at the time the copy of the application is filed.

(b) A taxpayer changing a method of accounting under this 90-day window must provide a copy of the application to the examining agent(s) at the same time it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s). The taxpayer must attach to the application a separate statement certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration or an issue placed in suspense by the examining agent(s).

(3) *120–day window period.*

(a) A taxpayer may file a copy of the application with the national office to change a method of accounting under this revenue procedure during the 120-day period following the date an examination ends (the "120-day window"), regardless of whether a subsequent examination has commenced. This 120-day window is not available if the method of accounting the taxpayer is changing is an issue under consideration at the time a copy of the application is filed or an issue the examining agent(s) has placed in suspense at the time the copy of the application is filed.

(b) A taxpayer changing a method of accounting under this 120-day window must provide a copy of the application to the examining agent(s) for any examination that is in process at the same time it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s). The taxpayer must attach to the application a separate statement certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration or an issue placed in suspense by the examining agent(s).

(4) *Consent of director.*

(a) A taxpayer under examination may change its method of accounting under this revenue procedure if the director consents to the filing of the application. The director will consent to the filing of the application unless, in the opinion of the director, the method of accounting to be changed would ordinarily be included as an item of adjustment in the year(s) for which the taxpayer is under examination. For example, the director will consent to the filing of an application to change from a clearly permissible method of accounting, or from an impermissible method of accounting where the impermissible method was adopted subsequent to the years under examination. The question of whether the method of accounting from which the taxpayer is changing is permissible or was adopted subsequent to the years under examination may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 2001–2 (or any successor).

(b) A taxpayer changing a method of accounting under this revenue procedure with the consent of the director must attach to the copy of the application a statement from the director consenting to the filing of the application. In addition, the taxpayer must attach to its application a statement certifying that it has obtained the written consent of the director to the filing of the application and that the taxpayer will maintain a copy of such consent available for inspection. The taxpayer must provide a copy of the application to the director at the same time it files a copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s).

(5) *Changes lacking audit protection.*

(a) A taxpayer under examination may change its method of accounting under this revenue procedure if the description of the change in the APPENDIX of this revenue procedure provides that the change is not subject to the audit protection provisions of section 7 of this revenue procedure.

(b) A taxpayer changing a method of accounting under this section 6.03(5) must provide a copy of the application to the examining agent(s) for any examination that is in process at the same time it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s).

.04 *Taxpayer before an appeals office.* Except as otherwise provided in the APPENDIX of this revenue procedure (see, for example, section 1.01 of the APPENDIX of this revenue procedure), a taxpayer that is before an appeals office must attach to the application a separate statement certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration by the appeals office. The taxpayer must provide a copy of the application to the appeals officer at the same time it files a copy of the application with the national office. The application must contain the name and telephone number of the appeals officer.

.05 *Taxpayer before a federal court.* Except as otherwise provided in the APPENDIX of this revenue procedure (see, for example, section 1.01 of the APPENDIX of this revenue procedure), a taxpayer that is before a federal court must attach to the application a separate statement certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration by the federal court. The taxpayer must provide a copy of the application to the counsel for the government at the same time it files a copy of the application with the national office. The application must contain the name

and telephone number of the counsel for the government.

.06 *Compliance with provisions*. If a taxpayer to which this revenue procedure applies changes to a method of accounting without complying with all the applicable provisions of this revenue procedure (for example, the taxpayer changes to a method of accounting that varies from the applicable accounting method described in this revenue procedure or the taxpayer is outside the scope of this revenue procedure), the taxpayer has initiated a change in method of accounting without obtaining the consent of the Commissioner as required by § 446(e). *See* sections 9.02 and 10.04 of this revenue procedure.

SECTION 7. AUDIT PROTECTION FOR TAXABLE YEARS PRIOR TO YEAR OF CHANGE

.01 *In general*. Except as provided in sections 6.03(5) or 7.02 or in the APPENDIX of this revenue procedure, when a taxpayer timely files a copy of the application with the national office in compliance with all the applicable provisions of this revenue procedure, the Service will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change.

.02 *Exceptions*.

(1) *Change not made or made improperly*. The Service may change a taxpayer's method of accounting for prior taxable years if (a) the taxpayer fails to implement the change, (b) the taxpayer implements the change but does not comply with all the applicable provisions of this revenue procedure, or (c) the method of accounting is changed or modified because there has been a misstatement or omission of material facts (*see* section 8.02(2) of this revenue procedure).

(2) *Change in sub-method*. The Service may change a taxpayer's method of accounting for prior taxable years if the taxpayer is changing a sub-method of accounting within the method. For example, an examining agent may propose to terminate the taxpayer's use of the LIFO inventory method during a prior taxable year even though the taxpayer changes its method of valuing increments in the current year.

(3) *Prior year Service-initiated change*. The Service may make adjustments to the taxpayer's returns for the same item for taxable years prior to the requested year of change to reflect a prior year Service-initiated change reported as an issue pending or in a Revenue Agent's Report.

(4) *Criminal investigation*. The Service may change a taxpayer's method of accounting for the same item for taxable years prior to the year of change if there is any pending or future criminal investigation or proceeding concerning (a) directly or indirectly, any issue relating to the taxpayer's federal tax liability for any taxable year prior to the year of change, or (b) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability for any taxable year prior to the year of change.

SECTION 8. EFFECT OF CONSENT

.01 *In general*. A taxpayer that changes to a method of accounting pursuant to this revenue procedure may be required to change or modify that method of accounting for the following reasons:

(1) the enactment of legislation;

(2) a decision of the United States Supreme Court;

(3) the issuance of temporary or final regulations;

(4) the issuance of a revenue ruling, revenue procedure, notice, or other statement published in the Internal Revenue Bulletin;

(5) the issuance of written notice to the taxpayer that the change in method of accounting is not in accord with the current views of the Service; or

(6) a change in the material facts on which the consent was based.

.02 *Retroactive change or modification*. Except in rare or unusual circumstances, if a taxpayer that changes its method of accounting under this revenue procedure is subsequently required under section 8.01 of this revenue procedure to change or modify that method of accounting, the required change or modification will not be applied retroactively, provided that:

(1) the taxpayer complied with all the applicable provisions of this revenue procedure;

(2) there has been no misstatement or omission of material facts;

(3) there has been no change in the material facts on which the consent was based;

(4) there has been no change in the applicable law; and

(5) the taxpayer to whom consent was granted acted in good faith in relying on the consent, and applying the change or modification retroactively would be to the taxpayer's detriment.

SECTION 9. REVIEW BY DIRECTOR

.01 *In general*. The director must apply a change in method of accounting made in compliance with all the applicable provisions of this revenue procedure in determining the taxpayer's liability, unless the director recommends that the change in method of accounting should be modified or revoked. (See section 9.02 of this revenue procedure if a change in method of accounting is made without complying with all the applicable provisions of this revenue procedure.) The director will ascertain if the change in method of accounting was made in compliance with all the applicable provisions of this revenue procedure, including whether:

(1) the representations on which the change was based reflect an accurate statement of the material facts;

(2) the amount of the § 481(a) adjustment was properly determined;

(3) the change in method of accounting was implemented in compliance with all the applicable provisions of this revenue procedure.

The director will also ascertain whether:

(4) there has been any change in the material facts on which the change was based during the period the method of accounting was used; and

(5) there has been any change in the applicable law during the period the method of accounting was used.

.02 *Changes not made in compliance with all applicable provisions*. If the director determines that the taxpayer has

not complied with all of the other applicable provisions of this revenue procedure, the director may:

(1) deny the change in method of accounting and require the taxpayer to continue to use the prior method of accounting;

(2) deny the change in method of accounting and place the taxpayer on a proper method of accounting (see section 2.10 of this revenue procedure); or

(3) make any adjustments (including the amount of any § 481(a) adjustment) that are necessary to bring the change in method of accounting into compliance with all applicable provisions of this revenue procedure.

The director may impose any otherwise applicable penalty, addition to tax, or additional amount on the understatement of tax attributable to the change in method of accounting.

.03 *National office consideration*. If the director recommends that a change in method of accounting (other than the § 481(a) adjustment) made in compliance with all the applicable provisions of this revenue procedure should be modified or revoked, the director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 2001–2 (or any successor) will be followed.

SECTION 10. REVIEW BY NATIONAL OFFICE

.01 *In general*. Any application filed under this revenue procedure may be reviewed by the national office. If the application is reviewed by the national office, the procedures in sections 10.02 through 10.04 of this revenue procedure apply.

.02 *Incomplete application*.

(1) *30-day rule*. If the national office reviews an application and determines that the application is not properly completed in accordance with the instructions of the Form 3115 or the provisions of this revenue procedure, or if supplemental information is needed, the national office will notify the taxpayer. The notification will specify the information that needs to be provided, and the taxpayer will be permitted 30 days from the date of the notification to furnish the necessary information. The national office reserves the right to impose shorter reply periods if subsequent requests for additional information are made. An extension of the 30-day period to furnish information, not to exceed 30 days, may be granted to a taxpayer. A request for an extension of the 30-day period must be made in writing and submitted within the initial 30–day period. If the extension request is denied, there is no right of appeal.

(2) *Failure to provide additional information*. Ordinarily, if the taxpayer fails to provide the additional information on a timely basis, the application does not qualify for the automatic consent procedures of this revenue procedure. If the national office determines that the application does not qualify for the automatic consent procedures of this revenue procedure because the taxpayer has failed to provide the additional information on a timely basis, the national office will notify the taxpayer that consent to make the change in method of accounting is not granted.

.03 *Conference in the national office*. If the national office tentatively determines that the taxpayer has changed its method of accounting without complying with all the applicable provisions of this revenue procedure (for example, the taxpayer changed to a method of accounting that varies from the applicable accounting method described in this revenue procedure or the taxpayer is outside the scope of this revenue procedure), the national office will notify the taxpayer of its tentative adverse determination and will offer the taxpayer a conference of right, if the taxpayer has requested a conference. For conference procedures for taxpayers other than exempt organizations, see section 11 of Rev. Proc. 2001–1 (or any successor). For conference procedures for exempt organizations, see section 12 of Rev. Proc. 2001–4, 2001–1 I.R.B. 121 (or any successor).

.04 *National office determination*.

(1) *Consent not granted*. Except as provided in section 10.04(2) of this revenue procedure, if the national office determines that a taxpayer has changed its method of accounting without complying with all the applicable provisions of this revenue procedure, the national office will notify the taxpayer that consent to make the change in method of accounting is not granted. In no event will an application under this revenue procedure be treated as an application under Rev. Proc. 97–27 (or any successor).

(2) *Application changed*. If the national office determines that a taxpayer has changed its method of accounting without complying with all the applicable provisions of this revenue procedure, the national office, in its discretion, may allow the taxpayer (a) to make appropriate adjustments to conform its change in method of accounting to the applicable provisions of this revenue procedure, and (b) to make conforming amendments to any federal income tax returns filed for the year of change and subsequent taxable years. Any application changed under section 10.04(2) of this revenue procedure is subject to review by the director as provided in section 9 of this revenue procedure.

SECTION 11. APPLICABILITY OF REV. PROCS. 2001–1 AND 2001–4

Rev. Procs. 2001–1 and 2001–4 (or any successors) are applicable to applications filed under this revenue procedure, unless specifically excluded or overridden by other published guidance (including the special procedures in this document).

SECTION 12. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: CC:IT&A, 1111 Constitution Avenue, NW, Washington, D.C. 20224.

SECTION 13. EFFECTIVE DATE

.01 *In general*. Except as provided in sections 13.02 and 13.03 of this revenue procedure, this revenue procedure is effective for taxable years ending on or after January 7, 2002. The Service will return any application that is filed on or after December 31, 2001, if the application is filed with the national office pursuant to the Code, regulations, or administrative guidance other than this revenue procedure and the change in method of accounting is within the scope of this revenue procedure.

.02 *Transition rules*. If a taxpayer filed an application or ruling request with the

national office to make a change in method of accounting described in the APPENDIX of this revenue procedure for a year of change for which this revenue procedure is effective (see section 13.01 of this revenue procedure), and the application or ruling request is pending with the national office on January 7, 2002, the taxpayer may make the change under this revenue procedure. However, the national office will process the application or ruling request in accordance with the authority under which it was filed, unless prior to the later of February 15, 2002, or the issuance of the letter ruling granting or denying consent to the change, the taxpayer notifies the national office that it wants to make the change under this revenue procedure. If the taxpayer timely notifies the national office that it wants to make the method change under this revenue procedure, the national office will require the taxpayer to make appropriate modifications to the application or ruling request to comply with the applicable provisions of this revenue procedure. In addition, any user fee that was submitted with the application or ruling request will be returned to the taxpayer.

.03 *Special rules*.

(1) *Certain uniform capitalization (UNICAP) methods used by taxpayers in a farming business*. For a change in method of accounting described in section 4.03 of the APPENDIX of this revenue procedure, this revenue procedure is effective for the taxpayer's first taxable year ending after August 21, 2000 (in the case of property that is not inventory in the hands of the taxpayer), or the first taxable year beginning after August 21, 2000 (in the case of property that is inventory in the hands of the taxpayer), whichever is applicable.

(2) *Stated interest on short-term loans of cash banks*. For a change in method of accounting described in section 13.02(1)(a) of the APPENDIX of this revenue procedure, this revenue procedure is effective for taxable years ending on or after December 31, 2001, and for any taxable year ending before December 31, 2000, for which the requirements of section 13.02(2) of the APPENDIX of this revenue procedure are satisfied.

SECTION 14. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 99–49 is clarified, modified, amplified, and superseded.

.02 *Reserved*

SECTION 15. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1551. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are in sections 6, 10, and sections 1C, 2, 2B, 3, 4, 5, 5A, 6, 7, 9, 10, 10A, 12, 12A and 13 of the APPENDIX. This information is necessary and will be used to determine whether the taxpayer properly changed to a permitted method of accounting. The collections of information are required for the taxpayer to obtain consent to change its method of accounting. The likely respondents are the following: individuals, farms, business or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

The estimated total annual reporting and/or recordkeeping burden is 13,804 hours.

The estimated annual burden per respondent/recordkeeper varies from 1/6 hour to 8 1/2 hours, depending on individual circumstances, with an estimated average of 1 1/2 hours. The estimated number of respondents is 13,195. The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is Grant D. Anderson of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Anderson at (202) 622–4930 (not a toll-free call). For further information regarding the APPENDIX of this revenue procedure, contact the following individuals (calls are not toll-free): (1) for changes in method of accounting under sections 1A.03 and 3.03 of the APPENDIX of this revenue procedure, Merrill D. Feldstein of the Office of Associate Chief Counsel (Income Tax & Accounting) at (202) 622–4950; (2) for changes in method of accounting under section 1A.05 of the APPENDIX of this revenue procedure, Kimberly L. Koch of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622–5020; (3) for changes in method of accounting under section 1A.06 of the APPENDIX of this revenue procedure, Angella L. Warren of the Office of the Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4950; (4) for changes in methods of accounting under sections 1C.01 and 12A.01 of the APPENDIX of this revenue procedure, Christina Morrison of the Office of Associate Chief Counsel (Financial Institutions and Products) at (202) 622–3950; (5) for changes in methods of accounting under sections 2.01, 2.02, 2.04 and 2B of the APPENDIX of this revenue procedure, Douglas Kim of the Office of Associate Chief Counsel (Passthroughs and Special Industries) at (202) 622–3110; (6) for changes in methods of accounting under section 2A.01 of the APPENDIX of this revenue procedure, Lisa Shuman of the Office of Associate Chief Counsel (Passthroughs and Special Industries) at (202) 622–3120; (7) for changes in methods of accounting under section 4B of the APPENDIX of this revenue procedure, Norm Paul of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) at (202) 622–6060; (8) for changes in methods of accounting under sections 5.04, 6, 12, and 13 of the APPENDIX of this revenue procedure, William E. Blanchard of the Office of Associate Chief Counsel (Financial Institutions and Products) at (202) 622–3950; (9) for changes in method of accounting under sections 5.05 and 9.03, Cheryl Lynn Oseekey of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4960; (10) for changes in methods of

accounting under section 5A.01 of the APPENDIX of this revenue procedure, Timothy Sebastian of the Office of Associate Chief Counsel (Financial Institutions and Products) at (202) 622–3920; (11) for changes in methods of accounting under section 5A.02 of the APPENDIX of this revenue procedure, Leo F. Nolan II of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4970; (12) for changes in methods of accounting under sections 9.04, 10.06, and 10.07 of the APPENDIX of this revenue procedure, Jeffery G. Mitchell or Leo F. Nolan II of the Office of Associate Chief Counsel (Income Tax and Accounting) at (202) 622–4930; (13) for changes in methods of accounting under section 11 of the APPENDIX of this revenue procedure, Craig R. Wojay of the Office of Associate Chief Counsel (Financial Institutions and Products) at (202) 622–3920 (not a toll-free call); (14) for changes in method of accounting under section 11B of the APPENDIX of this revenue procedure, Milton Cahn of the Office of the Associate Chief Counsel (International) at (202) 622–3870; (15) for changes in methods of accounting under section 13.02 of the APPENDIX of this revenue procedure, William E. Blanchard or Marsha A. Sabin of the Office of the Associate Chief Counsel (Financial Institutions and Products) at (202) 622–3950; and for all other sections, Mr. Anderson at (202) 622–4930.

APPENDIX
CHANGES IN METHODS OF ACCOUNTING TO WHICH THIS REVENUE PROCEDURE APPLIES

SECTION 1. COMMODITY CREDIT LOANS (§ 77)

.01 *Treating amounts received as loans.*

(1) *Description of change and scope.* This change applies to a taxpayer that wants to change its method of accounting for loans received from the Commodity Credit Corporation from including the loan amount in gross income for the taxable year in which the loan is received to treating the loan amount as a loan.

(2) *Scope limitations inapplicable.* A taxpayer that wants to make this change is not subject to the scope limitations of section 4.02 of this revenue procedure.

(3) *Manner of making change.* This change is made on a cut-off basis. Accordingly, a § 481(a) adjustment is neither permitted nor required.

.02 *Reserved*

SECTION 1A. TRADE OR BUSINESS EXPENSES (§ 162)

.01 *Advances made by a lawyer on behalf of clients — Description of change and scope.* This change applies to a lawyer handling cases on a contingent fee basis that advances money to pay for costs of litigation or for other expenses on behalf of clients and that wants to change the method of accounting for such advances from treating them as deductible business expenses to treating them as loans. *See Boccardo v. United States*, 12 Cl. Ct. 184 (1987); *Canelo v. Commissioner*, 53 T.C. 217 (1969), *aff'd per curiam*, 447 F.2d 484 (9th Cir. 1971).

.02 *Year 2000 costs — Description of change and scope.* This change applies to a taxpayer that wants to change its method of accounting for Year 2000 costs (as defined in Rev. Proc. 97–50, 1997–2 C.B. 525) to conform to the method described in section 3 of Rev. Proc. 97–50. Section 3 of Rev. Proc. 97–50 provides that Year 2000 costs fall within the purview of Rev. Proc. 69–21 (1969–2 C.B. 303), *superceded by* Rev. Proc. 2000–50 (2000–52 I.R.B. 601), and that the Service will not disturb a taxpayer's treatment of its Year 2000 costs as deductible expenses or capital expenditures if the taxpayer treats these costs in accordance with Rev. Proc. 2000–50.

.03 *Aircraft maintenance costs.*

(1) *Description of change.* This change applies to a taxpayer that wants to change its method of accounting for costs incurred to perform work on aircraft airframes during heavy maintenance visits to conform with Rev. Rul. 2001–4 (2001–3 I.R.B. 295) and Notice 2001–23 (2001–12 I.R.B. 911).

(2) *Year of change.* This change applies only to the taxpayer's first or second taxable year ending after December 21, 2000.

(3) *Scope limitations inapplicable.* The scope limitations in section 4.02 of this revenue procedure are not applicable to this change unless the taxpayer's method of accounting for costs incurred to perform work on its aircraft airframes is an issue pending, within the meaning of section 6.01(6) of Rev. Proc. 2000–38 (2000–40 I.R.B. 310), at the time the copy of its application is filed with the national office.

(4) *Transition rule.* If a taxpayer filed an application to make this change under Rev. Proc. 97–27, and the application was pending with the national office on February 16, 2001, the taxpayer may change its method under Rev. Proc. 97–27 or this revenue procedure. However, the national office will process the application in accordance with the procedure under which it was filed, unless, prior to the later of April 1, 2001, or the issuance of the letter ruling granting or denying consent to the change, the taxpayer notifies the national office that it wants to change its method of accounting under this revenue procedure. If the taxpayer timely notifies the national office that it wants to change its method under this revenue procedure, the taxpayer must make appropriate modifications to comply with the applicable provisions of this revenue procedure. In addition, any application fee that was submitted with the application will be returned to the taxpayer.

.04 *ISO 9000 costs.*

(1) *Description of change.* This change applies to a taxpayer that wants to change its method of accounting for costs incurred to obtain, maintain and renew ISO 9000 certification to conform with Rev. Rul. 2000–4 (2000–4 I.R.B. 331).

(2) *Scope limitations inapplicable.* The scope limitations in section 4.02 of this revenue procedure are not applicable to this change.

.05 *Track structure expenditures.*

(1) *Description of change and scope.* This change applies to a taxpayer that wants to change its method of accounting for track structure expenditures (as defined by section 4.02 of Rev. Proc. 2001–46, 2001–37 I.R.B. 263) to the track maintenance allowance method described in Rev. Proc. 2001–46.

(2) *Year of change*. This change may be made for the taxpayer's first or second taxable year ending on or after December 31, 2000.

(3) *Scope limitations inapplicable*. The scope limitations in section 4.02 of this revenue procedure do not apply to this change.

(4) *Special filing requirements for certain taxpayers*. A taxpayer that wants to make this change for its first taxable year ending on or after December 31, 2000, and that files its return for such taxable year on or before October 22, 2001, is not subject to the filing requirements in section 6.02(2)(a) of this revenue procedure, provided that it complies with the following filing requirements. The original application must be attached to the taxpayer's amended federal income tax return for its first taxable year ending on or after December 31, 2000. This amended return must be filed no later than January 28, 2002. A copy of the application must be filed with the national office no later than when the taxpayer's amended return is filed.

(5) *Manner of making change*.

(a) *Section 481(a) adjustment*. If a taxpayer wants to make this change and the taxpayer's treatment of its track structure expenditures is not an issue under consideration in examination, before an area appeals office, or before a federal court (within the meaning of section 3.08 of Rev. Proc. 97–27, 1997–1 C.B. 680) on August 21, 2001, the taxpayer must make the change using an adjustment under § 481(a). If the taxpayer did not file Form R–1 for one or more of the taxable years to which the § 481(a) adjustment relates, the taxpayer must compute the § 481(a) adjustment based on information equivalent to that required by Form R–1.

(b) *Cut-off method*. If a taxpayer wants to make this change and the taxpayer's treatment of its track structure expenditures is an issue under consideration in examination, before an area appeals office, or before a federal court (within the meaning of section 3.08 of Rev. Proc. 97–27, 1997–1 C.B. 680) on August 21, 2001, the taxpayer must make the change using a cut-off method. Under a cut-off method, only the items arising on or after the beginning of the year of change are accounted for under the track maintenance allowance method. Any items arising before the year of change continue to be accounted for under the taxpayer's former method of accounting. Because no items are duplicated or omitted from income when a cut-off method is used to effect a change in accounting method, no § 481(a) adjustment is necessary.

(6) *Audit protection*. If a taxpayer's treatment of its track structure expenditures is an issue under consideration in examination, before an area appeals office, or before a federal court (within the meaning of section 3.08 of Rev. Proc. 97–27, 1997–1 C.B. 680) on August 21, 2001, the taxpayer does not receive audit protection under the provisions of section 7 of this revenue procedure.

(7) *Effect of consent*. For purposes of section 8.01 of this revenue procedure, a change in the material fact on which the consent was based includes a material change in how a taxpayer reports amounts on the Form R–1 or a change in the taxpayer's obligation to file a Form R–1.

.06 *Restaurant smallwares packages*.

(1) *Description of change*. This change applies to a taxpayer engaged in the trade or business of operating a restaurant or tavern (within the meaning of section 4.01 of Rev. Proc. 2002–12, 2002–3 I.R.B. 374) who wants to change its method of accounting for the cost of restaurant smallwares to the smallwares method described in Rev. Proc. 2002–12 (*i.e.*, as materials and supplies that are not incidental under § 1.162–3).

(2) *Scope limitations inapplicable*. The scope limitations in section 4.02 of this revenue procedure are not applicable to this change.

(3) *Section 481(a) adjustment*. A taxpayer changing its method of accounting for restaurant smallwares under this section must take the entire § 481(a) adjustment into account in computing taxable income in the year of change.

SECTION 1B. BAD DEBTS (§ 166)

.01 *Change from reserve method to specific charge-off method — description of change and scope*. This change applies to a taxpayer (other than a bank as defined in § 585(a)(2)) that wants to change its method of accounting for bad debts from a reserve method (or other improper method) to a specific charge-off method that complies with § 166. For procedures applicable to banks, *see* § 585 (c) (and the regulations thereunder) and section 11 of the APPENDIX of this revenue procedure.

.02 *Reserved*.

SECTION 1C. AMORTIZABLE BOND PREMIUM (§ 171)

.01 *Revocation of § 171(c) election*.

(1) *Description of change and scope*. This change applies to a taxpayer that wants to change its method of accounting for amortizable bond premium by revoking its § 171(c) election. Under § 171(c), a taxpayer that holds certain taxable bonds may elect to amortize any bond premium on the bonds in accordance with regulations prescribed by the Secretary. Sections 1.171–1 through 1.171–5 provide rules relating to the amortization of bond premium by a taxpayer. Section 1.171–4 provides the procedures to make a § 171(c) election to amortize bond premium.

(2) *Revocation of election*. The revocation of a § 171(c) election applies to all taxable bonds that are held by the taxpayer on the first day of the first taxable year for which the revocation is effective (year of change), and to all taxable bonds that are subsequently acquired by the taxpayer.

(3) *Manner of making the change*. This change is made using a cut-off method and applies only to taxable bonds held during or after the year of change. Consequently, for taxable bonds held at the beginning of the year of change, the taxpayer may not amortize any remaining bond premium on the bonds. Because cut-off treatment is prescribed for this change, the basis of any bond, adjusted for amounts previously amortized during the period of the election, is not affected by the revocation.

(4) *Additional requirements*. On a statement attached to the application, the taxpayer must provide:

(a) the reason(s) for revoking the election; and

(b) a description of the method by which, and the date on which, the taxpayer made the § 171(c) election that is proposed to be revoked.

(5) *Audit protection*. A taxpayer receives audit protection under section 7 of this revenue procedure in connection

with this change. However, the audit protection applicable to this change does not preclude the Commissioner from examining the method used by the taxpayer to determine the amount of amortizable bond premium under § 171(b) for a taxable year prior to the year of change.

.02 *Reserved.*

SECTION 2. DEPRECIATION OR AMORTIZATION (§ 56(a)(1), 56(g)(4)(A), 167, 168, OR 197, OR FORMER § 168)

.01 *Impermissible to permissible method of accounting for depreciation or amortization.*

(1) *Description of change.*

(a) This change applies to a taxpayer that wants to change from an impermissible method of accounting for depreciation or amortization (depreciation) under which the taxpayer did not claim the depreciation allowable, to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable.

(b) A change from a taxpayer's impermissible method of accounting for depreciation under which the taxpayer did not claim the depreciation allowable to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable is a change in method of accounting for which the consent of the Commissioner is required. Sections 1.167(e)–1(a) and 1.446–1(e)(2)(ii)(*b*). This method change, however, does not include any correction of mathematical or posting errors. Section 1.446–1(e)(2)(ii)(*b*).

(2) *Scope.*

(a) *Applicability.* This change applies to any taxpayer that has used an impermissible method of accounting for depreciation in at least the two taxable years immediately preceding the year of change, and is changing that accounting method to a permissible method of accounting for depreciation, for any item of property:

(i) for which, under the taxpayer's impermissible method of accounting, the taxpayer has not taken into account any depreciation allowance or has taken into account some depreciation but less than or more than the depreciation allowable (claimed less than or more than the depreciation allowable);

(ii) for which depreciation is determined under—56(a)(1), 56(g)(4)(A), 167, 168, 197, or 168 prior to its amendment in 1986 (former § 168); and

(iii) that is owned by the taxpayer at the beginning of the year of change.

(b) *Certain scope limitations inapplicable.* The scope limitations in sections 4.02(7) and 4.02(8) of this revenue procedure are not applicable to this change.

(c) *Inapplicability.* This change does not apply to:

(i) any property to which § 1016(a)(3) (regarding property held by a tax-exempt organization) applies;

(ii) any taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 2.01 of this APPENDIX, if the taxpayer is not capitalizing the costs as required;

(iii) any intangible property subject to § 56(g)(4)(A) or 167, except for property subject to § 167(f) (regarding certain property excluded from § 197);

(iv) any property subject to § 167(g) (regarding property depreciated under the income forecast method);

(v) any § 1250 property that a taxpayer is reclassifying to an asset class of Rev. Proc. 87–56 (1987–2 C.B. 674), or Rev. Proc. 83–35 (1983–1 C.B. 745), as appropriate, that does not explicitly include § 1250 property (for example, asset class 57.0, Distributive Trades and Services);

(vi) any property for which a taxpayer is revoking a timely valid election, or making a late election, under § 167, 168, former § 168, or § 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (1993 Act), 1993–3 C.B. 1, 128 (relating to amortizable § 197 intangibles). A taxpayer may request consent to revoke or make the election by submitting a request for a letter ruling under Rev. Proc. 2001–1 (2001–1 I.R.B. 1) (or any successor);

(vii) any property subject to § 56(g)(4)(A) or 167 (other than § 167(f), regarding certain property excluded from § 197), for which a taxpayer is changing only the estimated useful life of the property. A change in the estimated useful life of property for which depreciation is determined under § 56(g)(4)(A) or 167 (other than § 167(f)) must be made prospectively (*see, for example*, § 1.167(b)–2(c)). (In contrast, section 2.01 of this APPENDIX generally applies to a change in the recovery period of property for which depreciation is determined under § 56(a)(1), 56(g)(4)(A), 168 or former § 168);

(viii) any depreciable property that changes use but continues to be owned by the same taxpayer (*see*, for example, § 168(i)(5));

(ix) any property for which depreciation is determined in accordance with § 1.167(a)–11 (regarding the Class Life Asset Depreciation Range System (ADR));

(x) any change in method of accounting involving a change from deducting the cost or other basis of any property as an expense to capitalizing and depreciating the cost or other basis;

(xi) any change in method of accounting involving a change from one permissible method of accounting for the property to another permissible method of accounting for the property. For example:

(A) a change from the straight-line method of depreciation to the income forecast method of depreciation for videocassettes. *See* Rev. Rul. 89–62 (1989–1 C.B. 78); or

(B) a change from charging the depreciation reserve with costs of removal and crediting the depreciation reserve with salvage proceeds to deducting costs of removal as an expense (provided the costs of removal are not required to be capitalized under any provision of the Code, such as, § 263(a)) and including salvage proceeds in taxable income (see section 2.02 of this APPENDIX for making this change for property for which depreciation is determined under § 167);

(xii) any change in method of accounting involving both a change from treating the cost or other basis of the property as nondepreciable property to treating the cost or other basis of the property as depreciable property and the adoption of a method of accounting for depreciation requiring an election under § 167, 168, former § 168, or § 13261(g)(2) or (3) of the 1993 Act (for example, a change in the treatment of the space consumed in landfills placed in service in 1990 from nondepreciable to depreciable property (assuming section

2.01(2)(c)(xiii) of the APPENDIX does not apply) and the making of an election under § 168(f)(1) to depreciate this property under the unit-of-production method of depreciation under § 167);

(xiii) any change in method of accounting for an item of income or deduction other than depreciation, even if a taxpayer's present method of accounting may have resulted in the taxpayer claiming less than or more than the depreciation allowable. For example, a change in method of accounting involving:

(A) a change in inventory costs (for example, when property is reclassified from inventory property to depreciable property, or vice versa) (but see section 3.02 of this APPENDIX for making a change from inventory property to depreciable property for unrecoverable line pack gas or unrecoverable cushion gas); or

(B) a change in the character of a transaction from sale to lease, or vice versa (but see section 2.03 of this APPENDIX for making this change); or

(xiv) a change from determining depreciation under § 168 to determining depreciation under former § 168 for any property subject to the transition rules in § 203(b) or 204(a) of the Tax Reform Act of 1986, 1986–3 (Vol. 1) C.B. 1, 60–80.

(3) *Additional requirements*. A taxpayer also must comply with the following:

(a) *Permissible depreciation method*. A taxpayer must change to a permissible method of accounting for depreciation for the item of property. This method is the same method that determines the depreciation allowable for the item of property (as provided in section 2.01(6) of this APPENDIX).

(b) *Statements required*. A taxpayer must provide the following statements, if applicable, and attach them to the completed application:

(i) a detailed description of the former and new methods of accounting. A general description of these methods of accounting is unacceptable (for example, MACRS to MACRS or erroneous method to proper method);

(ii) to the extent not provided elsewhere on the application, a statement describing the taxpayer's business or income-producing activities. Also, if the taxpayer has more than one business or income-producing activity, a statement describing the taxpayer's business or income-producing activity in which the item of property at issue is primarily used by the taxpayer;

(iii) to the extent not provided elsewhere on the application, a statement of the facts and law supporting the new method of accounting, new classification of the item of property, and new asset class in, as appropriate, Rev. Proc. 87–56 or Rev. Proc. 83–35. If the taxpayer is the owner and lessor of the item of property at issue, the statement of the facts and law supporting the new asset class also must describe the business or income-producing activity in which that item of property is primarily used by the lessee;

(iv) to the extent not provided elsewhere on the application, a statement identifying the year in which the item of property was placed in service;

(v) if the item of property is depreciated under former § 168, a statement identifying the asset class in Rev. Proc. 83–35 that applies under the taxpayer's former and new methods of accounting (if none, state and explain);

(vi) if any item of property is public utility property within the meaning of § 168(i)(10) or former § 167(l)(3)(A), as applicable, a statement providing that the taxpayer agrees to the following additional terms and conditions:

(A) a normalization method of accounting (within the meaning of former § 167(l)(3)(G), former § 168(e)(3)(B), or § 168(i)(9), as applicable) will be used for the public utility property subject to the application;

(B) as of the beginning of the year of change, the taxpayer will adjust its deferred tax reserve account or similar reserve account in the taxpayer's regulatory books of account by the amount of the deferral of federal income tax liability associated with the § 481(a) adjustment applicable to the public utility property subject to the application; and

(C) within 30 calendar days of filing the federal income tax return for the year of change, the taxpayer will provide a copy of the completed application to any regulatory body having jurisdiction over the public utility property subject to the application;

(vii) if the taxpayer is changing the classification of an item of § 1250 property placed in service after August 19, 1996, to a retail motor fuels outlet under § 168(e)(3)(E)(iii), a statement containing the following representation: "For purposes of § 168(e)(3)(E)(iii) of the Internal Revenue Code, the taxpayer represents that (A) 50 percent or more of the gross revenue generated from the item of § 1250 property is from the sale of petroleum products (not including gross revenue from related services, such as the labor cost of oil changes and gross revenue from the sale of nonpetroleum products such as tires and oil filters), (B) 50 percent or more of the floor space in the item of property is devoted to the sale of petroleum products (not including floor space devoted to related services, such as oil changes and floor space devoted to nonpetroleum products such as tires and oil filters), or (C) the item of § 1250 property is 1,400 square feet or less."; and

(viii) if the taxpayer is changing the classification of an item of property from § 1250 property to § 1245 property under § 168 or former § 168, a statement of the facts and law supporting the new § 1245 property classification, and a statement containing the following representation: "Each item of property that is the subject of the application filed under section 2.01 of the APPENDIX of Rev. Proc. 2002–9 for the year of change beginning [*Insert the date*], and that is reclassified from [*Insert, as appropriate: nonresidential real property, residential rental property, 19–year real property, 18–year real property, or 15–year real property*] to an asset class of [*Insert, as appropriate, either: Rev. Proc. 87–56, 1987–2 C.B. 674, or Rev. Proc. 83–35, 1983–1 C.B. 745*] that does not explicitly include § 1250 property, is § 1245 property for depreciation purposes."

(4) *Section 481(a) adjustment*. Because the adjusted basis of the property is changed as a result of a method change made under section 2.01 of this APPENDIX (*see* section 2.01(5) of this APPENDIX), items are duplicated or omitted. Accordingly, this change is made with a § 481(a) adjustment. This adjustment may result in either a negative § 481(a) adjustment (a decrease in taxable income) or a positive § 481(a) adjustment (an increase in taxable income) and may be a different

amount for regular tax, alternative minimum tax, and adjusted current earnings purposes. This § 481(a) adjustment equals the difference between the total amount of depreciation taken into account in computing taxable income for the property under the taxpayer's former method of accounting, and the total amount of depreciation allowable for the property under the taxpayer's new method of accounting (as determined under section 2.01(6) of this APPENDIX), for open and closed years prior to the year of change. However, the amount of the § 481(a) adjustment must be adjusted to account for the proper amount of the depreciation allowable that is required to be capitalized under any provision of the Code (for example, § 263A) at the beginning of the year of change.

(5) *Basis adjustment*. As of the beginning of the year of change, the basis of depreciable property to which section 2.01 of this APPENDIX applies must reflect the reductions required by § 1016(a)(2) for the depreciation allowable for the property (as determined under section 2.01(6) of this APPENDIX).

(6) *Meaning of depreciation allowable*.

(a) *In general*. Section 2.01(6) of this APPENDIX provides the amount of the depreciation allowable, determined under § 56(a)(1), 56(g)(4)(A), 167, 168, 197, or former § 168. This amount, however, may be limited by other provisions of the Code (for example, § 280F).

(b) *Section 56(a)(1) property*. The depreciation allowable for any taxable year for property for which depreciation is determined under § 56(a)(1) is determined by using the depreciation method, recovery period, and convention provided for under § 56(a)(1) that applies for the property's placed-in-service date.

(c) Section 56(g)(4)(A) property. The depreciation allowable for any taxable year for property for which depreciation is determined under § 56(g)(4)(A) is determined by using the depreciation method, recovery period or useful life, as applicable, and convention provided for under § 56(g)(4)(A) that applies for the property's placed-in-service date.

(d) *Section 167 property*. Generally, for any taxable year, the depreciation allowable for property for which depreciation is determined under § 167, is determined either:

(i) under the depreciation method adopted by a taxpayer for the property; or

(ii) if that depreciation method does not result in a reasonable allowance for depreciation or a taxpayer has not adopted a depreciation method for the property, under the straight-line depreciation method.

For determining the estimated useful life and salvage value of the property, see §§ 1.167(a)–1(b) and (c), respectively. The depreciation allowable for any taxable year for property subject to § 167(f) (regarding certain property excluded from § 197) is determined by using the depreciation method and useful life prescribed in § 167(f).

(e) *Section 168 property*. The depreciation allowable for any taxable year for property for which depreciation is determined under § 168, is determined by using either:

(i) the general depreciation system in § 168(a); or

(ii) the alternative depreciation system in § 168(g) if the property is required to be depreciated under the alternative depreciation system pursuant to § 168(g)(1) or other provisions of the Code (for example, property described in § 263A(e)(2)(A) or 280F(b)(1)). Property required to be depreciated under the alternative depreciation system pursuant to § 168(g)(1) includes property in a class (as set out in § 168(e)) for which the taxpayer made a timely election under § 168(g)(7).

(f) *Section 197 property*. The depreciation allowable for any taxable year for an amortizable § 197 intangible (including any property for which a timely election under § 13261(g)(2) of the 1993 Act was made) is determined in accordance with § 1.197–2(f) of the Income Tax Regulations.

(g) Former § 168 property. The depreciation allowable for any taxable year for property subject to former § 168 is determined by using either:

(i) the accelerated method of cost recovery applicable to the property (for example, for 5–year property, the recovery method under former § 168(b)(1)); or

(ii) the straight-line method applicable to the property if the property is required to be depreciated under the straight-line method (for example, property described in former § 168(f)(12) or former § 280F(b)(2)) or if the taxpayer elected to determine the depreciation allowance under the optional straight-line percentage (for example, the straight-line method in former § 168(b)(3)).

.02 *Permissible to permissible method of accounting for depreciation*.

(1) *Description of change*. This change applies to a taxpayer that wants to change from a permissible method of accounting for depreciation under § 56(g)(4)(A)(iv) or 167 to another permissible method of accounting for depreciation under § 56(g)(4)(A)(iv) or 167. Pursuant to §§ 1.167(a)–7(a) and (c), a taxpayer may account for depreciable property either by treating each individual asset as an account or by combining two or more assets in a single account and, for each account, depreciation allowances are computed separately.

(2) *Scope*.

(a) *Applicability*. This change applies to any taxpayer wanting to make a change in method of accounting for depreciation specified in section 2.02(3) of this APPENDIX for the property in an account:

(i) for which the present and proposed methods of accounting for depreciation specified in section 2.02(3) of this APPENDIX are permissible methods for the property under § 56(g)(4)(A)(iv) or 167; and

(ii) that is owned by the taxpayer at the beginning of the year of change.

(b) *Certain scope limitations inapplicable*. The scope limitations in sections 4.02(7) and 4.02(8) of this revenue procedure are not applicable to this change.

(c) *Inapplicability*. This change does not apply to:

(i) any taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 2.02 of this APPENDIX, if the taxpayer is not capitalizing the costs as required;

(ii) any property to which § 1016(a)(3) (regarding property held by a tax-exempt organization) applies;

(iii) any intangible property, except distributor commissions (as defined by section 2 of Rev. Proc. 2000–38, 2000–40 I.R.B. 310) that are not

amortizable section 197 intangibles and for which the taxpayer is making the change in method of accounting for depreciation specified in section 2.02(3)(l) or (m) of this APPENDIX;

(iv) any property described in § 167(f) (regarding certain property excluded from § 197);

(v) any property subject to § 167(g) (regarding property depreciated under the income forecast method);

(vi) any property for which depreciation is determined under § 56(a)(1), 56(g)(4)(A)(i), (ii), (iii), or (v), 168 or § 168 prior to its amendment in 1986 (former § 168);

(vii) any property that the taxpayer elected under § 168(f)(1) or former § 168(e)(2) to exclude from the application of, respectively, § 168 or former § 168;

(viii) any property for which depreciation is determined in accordance with § 1.167(a)–11 (regarding the Class Life Asset Depreciation Range System (ADR));

(ix) any depreciable property for which the taxpayer is changing the depreciation method pursuant to § 1.167(e)–1(b) (change from declining-balance method to straight-line method), § 1.167(e)–1(c) (certain changes for § 1245 property), or § 1.167(e)–1(d) (certain changes for § 1250 property). These changes must be made prospectively and are not permitted under the cited regulations for property for which the depreciation is determined under § 168 or former § 168; or

(x) any distributor commissions (as defined by section 2 of Rev. Proc. 2000–38, 2000–40 I.R.B. 310) for which the taxpayer is changing the useful life under the distribution fee period method or the useful life method (both described in Rev. Proc. 2000–38). A change in this useful life must be made prospectively (*see*, *for example*, § 1.167(b)–2(c)).

(3) *Changes covered*. Section 2.02 of this APPENDIX only applies to the following changes in methods of accounting for depreciation:

(a) a change from the straight-line method to the sum-of-the-years-digits method, the sinking fund method, the unit-of-production method, or the declining-balance method using any proper percentage of the straight-line rate;

(b) a change from the declining-balance method using any percentage of the straight-line rate to the sum-of-the-years-digits method, the sinking fund method, or the declining-balance method using a different proper percentage of the straight-line rate;

(c) a change from the sum-of-the-years-digits method to the sinking fund method, the declining-balance method using any proper percentage of the straight-line rate, or the straight-line method;

(d) a change from the unit-of-production method to the straight-line method;

(e) a change from the sinking fund method to the straight-line method, the unit-of-production method, the sum-of-the-years-digits method, or the declining-balance method using any proper percentage of the straight-line rate;

(f) a change in the interest factor used in connection with a compound interest method or sinking fund method;

(g) a change in averaging convention as set forth in § 1.167(a)–10(b). However, as specifically provided in § 1.167(a)–10(b), in any taxable year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used (*see* Rev. Rul. 73–202, 1973–1 C.B. 81);

(h) a change from charging the depreciation reserve with costs of removal and crediting the depreciation reserve with salvage proceeds to deducting costs of removal as an expense and including salvage proceeds in taxable income as set forth in § 1.167(a)–8(e)(2). *See* Rev. Rul. 74–455, 1974–2 C.B. 63. This change, however, may be made under this revenue procedure only if:

(i) the change is applied to all items in the account for which the change is being made; and

(ii) the removal costs are not required to be capitalized under any provision of the Code (for example, § 263(a), 263A, or 280B);

(i) a change from crediting the depreciation reserve with the salvage proceeds realized on normal retirement sales to computing and recognizing gains and losses on such sales (*see* Rev. Rul. 70–165, 1970–1 C.B. 43);

(j) a change from crediting ordinary income (including the combination method of crediting the lesser of estimated salvage value or actual salvage proceeds to the depreciation reserve, with any excess of salvage proceeds over estimated salvage value credited to ordinary income) with the salvage proceeds realized on normal retirement sales, to computing and recognizing gains and losses on such sales (*see* Rev. Rul. 70–166, 1970–1 C.B. 45);

(k) a change from item accounting for specific assets to multiple asset accounting for the same assets, or vice versa;

(l) a change from one method described in Rev. Proc. 2000–38 for amortizing distributor commissions (as defined by section 2 of Rev. Proc. 2000–38, 2000–40 I.R.B. 310) to another method described in Rev. Proc. 2000–38 for amortizing distributor commissions; or

(m) a change from pooling to a single asset, or vice versa, for distributor commissions (as defined by section 2 of Rev. Proc. 2000–38, 2000–40 I.R.B. 310) for which the taxpayer is using the distribution fee period method or the useful life method (both described in Rev. Proc. 2000–38).

(4) *Additional requirements*. A taxpayer also must comply with the following:

(a) *Basis for depreciation*. At the beginning of the year of change, the basis for depreciation of property to which this change applies is the adjusted basis of the property as provided in § 1011 at the end of the taxable year immediately preceding the year of change (determined under the taxpayer's present method of accounting for depreciation). If applicable under the taxpayer's proposed method of accounting for depreciation, this adjusted basis is reduced by the estimated salvage value of the property (for example, a change to the straight-line method).

(b) *Rate of depreciation*. The rate of depreciation for property changed to:

(i) the straight-line or sum-of-the-years-digits method of depreciation must be based on the remaining useful life of the property as of the beginning of the year of change; or

(ii) the declining-balance method of depreciation must be based on the useful life of the property measured from the placed-in-service date, and not the

expected remaining life from the date the change becomes effective.

(c) *Regulatory requirements*. For changes in method of depreciation to the sum-of-the-years-digits or declining-balance method, the property must meet the requirements of § 1.167(b)–0 or 1.167(c)–1, as appropriate.

(d) *Public utility property*. If any item of property is public utility property within the meaning of former § 167(l)(3)(A), the taxpayer must attach to the application a statement providing that the taxpayer agrees to the following additional terms and conditions:

(i) a normalization method of accounting within the meaning of former § 167(l)(3)(G) will be used for the public utility property subject to the application; and

(ii) within 30 calendar days of filing the federal income tax return for the year of change, the taxpayer will provide a copy of the completed application to any regulatory body having jurisdiction over the public utility property subject to the application.

(5) *Section 481(a) adjustment*. Because the adjusted basis of the property is not changed as a result of a method change made under section 2.02 of this APPENDIX, no items are being duplicated or omitted. Accordingly, the § 481(a) adjustment is zero.

.03 *Sale or lease transactions*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to a taxpayer that wants to change its method of accounting from:

(i) improperly treating property as sold by the taxpayer to properly treating property as leased by the taxpayer;

(ii) improperly treating property as leased by the taxpayer to properly treating property as sold by the taxpayer;

(iii) improperly treating property as purchased by the taxpayer to properly treating property as leased by the taxpayer; and

(iv) improperly treating property as leased by the taxpayer to properly treating property as purchased by the taxpayer.

(b) *Inapplicability*. This change does not apply to:

(i) a rent-to-own dealer that wants to change its method of accounting for rent-to-own contracts described in section 3 of Rev. Proc. 95–38 (1995–2 C.B. 397); or

(ii) a taxpayer that holds assets for sale or lease, if any asset so held is not the subject of a sale or lease transaction as of the beginning of the year of change.

(2) *Manner of making the change*.

(a) The change in method of accounting under section 2.03 of this APPENDIX is made using a cut-off method and applies to transactions entered into on or after the beginning of the year of change. *See* section 2.06 of this revenue procedure.

(b) If a taxpayer wants to change its method of accounting for existing sale or lease transactions, the taxpayer must file an application with the Commissioner in accordance with the requirements of § 1.446–1(e)(3)(i) and Rev. Proc. 97–27. A change involving existing sale or lease transactions will require a § 481(a) adjustment. Consent to change a method of accounting for an existing sale or lease transaction is granted only in unusual and compelling circumstances.

(3) *No audit protection*. A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

.04 *Modern golf course greens*.

(1) *Description of change and scope*. This change applies to a taxpayer wanting to change the method of accounting for the cost of modern golf course greens owned by the taxpayer at the beginning of the year of change to conform with the holding in Rev. Rul. 2001–60 (2001–51 I.R.B. 587). Rev. Rul. 2001–60 holds that the costs of land preparation undertaken by a taxpayer in the original construction or reconstruction of modern greens (as described in Rev. Rul. 2001–60) that is so closely associated with depreciable assets, such as a network of underground drainage tiles or pipes, that the land preparation will be retired, abandoned, or replaced contemporaneously with those depreciable assets are to be capitalized and depreciated over the recovery period of the depreciable assets with which the land preparation is associated. However, the general earthmoving, grading, and initial shaping of the area surrounding and underneath the modern green that occur before the construction are inextricably associated with the land and, therefore, the costs attributable to this land preparation are added to the taxpayer's cost basis in the land and are not depreciable.

(2) *Additional requirements*. A taxpayer that changes its method of accounting for the cost of modern golf course greens under section 2.04 of this APPENDIX must change to a permissible method of accounting for depreciation of modern greens. For purposes of § 168, the modern green is includible in asset class 00.3, Land Improvements, of Rev. Proc. 87–56 (1987–2 C.B. 674).

SECTION 2A. RESEARCH AND EXPERIMENTAL EXPENDITURES (§ 174)

.01 *Changes to a different method or different amortization period*.

(1) *Description of change*.

(a) This change applies to a taxpayer that wants to change the treatment of expenditures that qualify as research and experimental expenditures under § 174.

(b) Section 174 and the regulations thereunder provide the specific rules for changing a method of accounting under § 174 for research and experimental expenditures. Under § 174, a taxpayer may treat research and experimental expenditures that are paid or incurred by the taxpayer during the taxable year in connection with the taxpayer's trade or business as expenses under § 174(a) or as deferred expenses amortizable ratably over a period of not less than 60 months under § 174(b). Pursuant to § 1.174–1, research and experimental expenditures that are not treated as expenses or deferred expenses under § 174 must be treated as capital expenditures. Further, § 1.174–1 provides that the expenditures to which § 174 applies may relate either to a general research program or to a particular project.

(c) If a taxpayer has not treated research and experimental expenditures as expenses under § 174(a), §§ 174(a)(2)(B) and 1.174–3(b)(2) provide that the taxpayer may, with consent, adopt the expense method at any time.

(d) If a taxpayer has treated research and experimental expenditures as expenses under § 174(a), §§ 174(a)(3) and 1.174–3(b)(3) provide that the taxpayer may, with consent, change to a different method of treating research and experimental expenditures.

(e) If a taxpayer has treated research and experimental expenditures as deferred expenses under § 174(b), §§ 174 (b)(2) and 1.174–4(b)(2) provide that the taxpayer may, with consent, change to a different method of treating research or experimental expenditures or to a different period of amortization for deferred expenses.

(2) *Scope*.

(a) *Applicability*. This change applies to any taxpayer that is changing:

(i) from treating research and experimental expenditures for a particular project or projects as expenses under § 174(a) to treating such expenditures as deferred expenses under § 174(b), or vice versa;

(ii) to a different period of amortization for research and experimental expenditures for a particular project or projects that are being treated as deferred expenses under § 174(b); or

(iii) from treating research and experimental expenditures for a particular project or projects as expenses under § 174(a) or deferred expenses under § 174(b) to treating such expenditures as a capital expenditure under § 263(a), or vice versa.

(b) *Scope limitations clarified*. The scope limitation under section 4.02(6) of this revenue procedure is applied on a project by project basis.

(c) *Inapplicability*. This change does not apply to:

(i) a portion of the research and experimental expenditures paid or incurred for a particular project during the year of change or in subsequent taxable years (that is, the change must apply to all of such expenditures; *see* §§ 1.174–3(a) and 1.174–4(a)(5));

(ii) a change in the treatment of computer software costs under Rev. Proc. 2000–50 (2000–52 I.R.B. 601) (but see section 2B of this APPENDIX for making this change); or

(iii) a change in the treatment of Year 2000 costs under Rev. Proc. 97–50 (1997–2 C.B. 525) (but see section 1A.02 of this APPENDIX for making this change).

(3) *Manner of making the change*.

(a) This change is made using a cut-off method and applies to all research and experimental expenditures paid or incurred for a particular project or projects during the year of change and in subsequent taxable years. *See* section 2.06 of this revenue procedure and §§ 174(b)(2), 1.174–3(a), 1.174–3(b)(2), and 1.174–4(a)(5).

(b) The requirement under §§ 1.174–3(b)(2), 1.174–3(b)(3), and 1.174–4(b)(2) to file an application no later than the end of the first taxable year in which the different method or different amortization period is to be used is waived for this change. However, see section 6 of this revenue procedure for filing requirements applicable under this revenue procedure.

(c) The consent granted under this revenue procedure satisfies the consent required under §§ 174(a)(2)(B), 174(a)(3), 174(b)(2), 1.174–3(b)(2), 1.174–3(b)(3), and 1.174–4(b)(2).

(4) *Additional requirement*. A taxpayer must attach to the application a written statement providing:

(a) the information required in § 1.174–3(b)(2) if the taxpayer is changing to treating research and experimental expenditures as expenses under § 174(a);

(b) the information required in § 1.174–3(b)(3) if the taxpayer is changing from treating research and experimental expenditures as expenses under § 174(a); or

(c) the information required in § 1.174–4(b)(2) if the taxpayer is changing from treating research and experimental expenditures as deferred expenses method under § 174(b) or is changing to a different period of amortization for research and experimental expenditures being treated as deferred expenses under § 174(b).

(5) *No audit protection*. A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

.02 *Reserved*.

SECTION 2B. COMPUTER SOFTWARE EXPENDITURES (§§ 162, 167, AND 197)

.01 *Description of change*. This change applies to a taxpayer that wants to change its method of accounting for the costs of computer software to a method described in Rev. Proc. 2000–50 (2000–52 I.R.B. 601). Section 5 of Rev. Proc. 2000–50 describes the methods applicable to the costs of developing computer software. Section 6 of Rev. Proc. 2000–50 describes the method applicable to the costs of acquired computer software. Section 7 of Rev. Proc. 2000–50 describes the method applicable to leased or licensed computer software. If a taxpayer treats the costs of computer software in accordance with the applicable method described in Rev. Proc. 2000–50, the Service will not disturb the taxpayer's treatment of its costs of computer software.

.02 *Scope*. This change applies to all costs of computer software as defined in section 2 of Rev. Proc. 2000–50. However, this change does not apply to any computer software that is subject to amortization as an "amortizable section 197 intangible" as defined in § 197(c) and the regulations thereunder, or to costs that a taxpayer has treated as research and experimentation expenditures under § 174.

.03 *Inapplicability*. This change does not apply to a change in useful life under the method described in sections 5.01(2) or 6.01(2) of Rev. Proc. 2000–50.

.04 *Statement required*. If a taxpayer is changing to the method described in section 5.01(2) of Rev. Proc. 2000–50, the taxpayer must attach to the application a statement providing the information required in section 8.02(2) of Rev. Proc. 2000–50.

SECTION 3. CAPITAL EXPENDITURES (§ 263)

.01 *Package design costs*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to a taxpayer that wants to change its method of accounting for package design costs that are within the scope of Rev. Proc. 97–35 (1997–2 C.B. 448) to one of the three alternative methods of accounting for package design costs described in section 5 of Rev. Proc. 97–35. The three alternative methods of accounting for package design costs described are: (1) the capitalization

method, (2) the design-by-design capitalization and 60–month amortization method, and (3) the pool-of-cost capitalization and 48–month amortization method.

(b) *Inapplicability*. This change does not apply to a taxpayer that wants to change to the capitalization method for costs of developing (or modifying) any package design that has an ascertainable useful life.

(2) *Additional requirements*. If a taxpayer is changing its method of accounting for package design costs to the capitalization method or the design-by-design capitalization and 60–month amortization method, the taxpayer must attach a statement to its timely filed application. The statement must provide a description of each package design, the date on which each was placed in service, and the cost basis of each (as determined under sections 5.01(2) or 5.02(2) of Rev. Proc. 97–35).

.02 *Line pack gas; cushion gas*.

(1) *Description of change and scope*. This change applies to a taxpayer that wants to change its method of accounting for line pack gas or cushion gas to a method consistent with the holding in Rev. Rul. 97–54 (1997–2 C.B. 23). Rev. Rul. 97–54 holds that the cost of line pack gas or cushion gas is a capital expenditure under § 263, the cost of recoverable line pack gas or recoverable cushion gas is not depreciable, and the cost of unrecoverable line pack gas or unrecoverable cushion gas is depreciable under §§ 167 and 168.

(2) *Additional requirements*. A taxpayer that changes its method of accounting for unrecoverable line pack gas or unrecoverable cushion gas under section 3.02 of this APPENDIX must change to a permissible method of accounting for depreciation for the cost of that gas.

.03 *Removal costs*.

(1) *Description of change*. This change applies to a taxpayer that wants to change its method of accounting for certain costs incurred in the retirement and removal of depreciable assets to conform with Rev. Rul. 2000–7 (2000–9 I.R.B. 712).

(2) *Additional requirements*.

(a) Except for assets for which depreciation is determined in accordance with § 1.167(a)–11 (ADR), the taxpayer's new method of treating removal costs for assets accounted for in a multiple asset account must be consistent with the taxpayer's method of treating salvage proceeds. *See* Rev. Rul. 74–455 (1974–2 C.B. 63). (*See* section 2.02 of the APPENDIX of this revenue procedure for changing a taxpayer's present method of treating salvage proceeds.)

(b) If this change involves assets that are public utility property within the meaning of § 168(i)(10) or former § 167(l)(3)(A), the taxpayer must comply with the terms and conditions in section 2.01(3)(b)(vi) of the APPENDIX of this revenue procedure.

(3) *Scope limitations inapplicable*. The scope limitations in section 4.02 of this revenue procedure are not applicable to this change.

SECTION 4. UNIFORM CAPITALIZATION (§ 263A)

.01 *Certain uniform capitalization (UNICAP) methods used by resellers and reseller-producers*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to:

(i) a small reseller of personal property changing from a permissible UNICAP method to a permissible non-UNICAP inventory capitalization method in any taxable year that it qualifies as a small reseller;

(ii) a formerly small reseller changing from a permissible non-UNICAP inventory capitalization method to a permissible UNICAP method in the first taxable year that it does not qualify as a small reseller;

(iii) a reseller-producer changing from a permissible UNICAP method for both its production and resale activities to a permissible simplified resale method described in § 1.263A–3(d)(3) in any taxable year that it qualifies to use a simplified resale method for both its production and resale activities under § 1.263A–3(a)(4) (resellers with *de minimis* production activities);

(iv) a reseller-producer changing from a permissible simplified resale method described in § 1.263A–3(d)(3) for both its production and resale activities to a permissible UNICAP method for both its production and resale activities in the first taxable year that it does not qualify to use a simplified resale method for both its production and resale activities under § 1.263A–3(a)(4);

(v) a reseller that wants to change its permissible UNICAP method to include a special reseller cost allocation rule; or

(vi) a reseller changing from a non-UNICAP method to a UNICAP method specifically described in the regulations in any taxable year, other than the first taxable year, that it does not qualify as a small reseller.

(b) *Scope limitations inapplicable*. A taxpayer that wants to make a change described in sections 4.01(1)(a)(i) through 4.01(1)(a)(iv) of this APPENDIX is not subject to the scope limitations in section 4.02 of this revenue procedure.

(c) *Inapplicability*. This change does not apply to a taxpayer making an historic absorption ratio election under §§ 1.263 A–2(b)(4) or 1.263A–3(d)(4), or to a taxpayer that wants to revoke an election to use the historic absorption ratio with the simplified resale method (*see* § 1.263A–3(d)(4)(iii)(B)).

(2) *Definitions*.

(a) "Reseller" means a taxpayer that acquires real or personal property described in § 1221(1) for resale.

(b) "Small reseller" means a reseller whose average annual gross receipts for the three immediately preceding taxable years (or fewer, if the taxpayer has not been in existence during the three preceding taxable years) do not exceed $10,000,000. *See* § 263A(b)(2)(B).

(c) "Formerly small reseller" means a reseller that no longer qualifies as a small reseller.

(d) "Producer" means a taxpayer that produces real or tangible personal property.

(e) "Reseller-producer" means a taxpayer that is both a producer and a reseller.

(f) "Permissible UNICAP method" means a method of capitalizing costs that is permissible under § 263A.

(g) "UNICAP method specifically described in the regulations" includes the simplified service cost method using a labor-based allocation ratio (§ 1.263A–1(h)) and the simplified resale method without an historic absorption ratio election (§ 1.263A–3(d)), but does not

include any other reasonable allocation method within the meaning of § 1.263A–1(f)(4).

(h) "Special reseller cost allocation rule" means the 90–10 *de minimis* rule to allocate a mixed service department's costs to property acquired for resale (§ 1.263A–1(g)(4)(ii)), the 1/3 - 2/3 rule to allocate labor costs of personnel to purchasing activities (§ 1.263A–3(c)(3)(ii)(A)), and the 90–10 de minimis rule to allocate a dual-function storage facility's costs to property acquired for resale (§ 1.263A–3(c)(5)(iii)(C)).

(i) "Permissible non-UNICAP inventory capitalization method" means a method of capitalizing inventory costs that is permissible under § 471.

(3) *Section 481(a) adjustment*. Beginning with the year of change, a taxpayer changing its method of accounting for costs pursuant to sections 4.01(1)(a)(i), 4.01(1)(a)(iii), or 4.01(1)(a)(iv) of this APPENDIX generally must take any applicable § 481(a) adjustment into account ratably over the same number of taxable years, not to exceed four, that the taxpayer used its former method of accounting. A taxpayer changing its method of accounting for costs pursuant to sections 4.01(1)(a)(ii), 4.01(1)(a)(v), or 4.01(1)(a)(vi) of this APPENDIX generally must taken any applicable § 481(a) adjustment into account ratably over four taxable years. See section 5.04(3) of this revenue procedure for exceptions to this general rule.

(4) *Multiple changes*. Taxpayers making both this change and another change in method of accounting in the same year of change must comply with the ordering rules of § 1.263A–7(b)(2).

(5) *Example*. The following example illustrates the principles of section 4.01 of this APPENDIX for small resellers and formerly small resellers.

Assume X, a corporate reseller of personal property, incorporated January 2, 1991, adopted a taxable year ending December 31. X determines that its average annual gross receipts for the three taxable years (or fewer, if applicable) immediately preceding taxable years 1991 through 2000 are as shown in the table below:

	Average Annual Gross Receipts for the Three Taxable Years Immediately Preceding the Current Taxable Year
1991	$ 0
1992	5,000,000
1993	6,000,000
1994	7,000,000
1995	11,000,000
1996	11,000,000
1997	9,000,000
1998	8,000,000
1999	11,000,000
2000	12,000,000

Furthermore, X, which adopted the dollar-value LIFO inventory method, has the following LIFO inventory balances determined without considering the effects of the UNICAP method:

	Beginning	*Ending*
1995	$1,000,000	$1,100,000
1996	1,100,000	1,200,000
1997	1,200,000	1,300,000
1998	1,300,000	1,400,000
1999	1,400,000	1,500,000
2000	1,500,000	1,600,000

X was required by § 263A to change to the UNICAP method for 1995 because its average annual gross receipts for the three taxable years immediately preceding 1995 were $11,000,000, which exceeded the $10,000,000 ceiling permitted by the small reseller exception. Assume that X was required to capitalize $80,000 of "additional § 263A costs" to the cost of its 1995 beginning inventory because of this change in inventory method. In addition, X was required to include one-fourth of the § 481(a) adjustment when computing taxable income for each of the four taxable years beginning with 1995. Thus, X was required to include a $20,000 positive § 481(a) adjustment in its 1995 taxable income.

X elected to use the simplified resale method without an historic absorption ratio election under § 1.263A–3(d)(3) for

determining the amount of additional § 263A costs to be capitalized to each LIFO layer. Assume that X was required to add $10,000 of additional § 263A costs to the cost of its 1995 ending inventory because of the $100,000 increment for 1995.

X's 1995 Ending Inventory:	
Beginning Inventory (Without UNICAP costs)	$1,000,000
1995 Increment	100,000
Additional § 263A Costs in Beginning Inventory	80,000
Additional § 263A Costs in 1995 Increment	10,000
Total 1995 Ending Inventory	$1,190,000

X's Unamortized 1995 § 481(a) adjustment:	
1995 § 481(a) Adjustment	$80,000
Amount Included in 1995 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/95	$60,000

Because X failed to satisfy the small reseller exception for 1996, X was required to continue using the UNICAP method for its inventory costs. Furthermore, X was required to include $20,000 of the unamortized 1995 positive § 481(a) adjustment in 1996 taxable income. Assume that X was required to add $10,000 of additional § 263A costs to the cost of its 1996 ending inventory because of the $100,000 increment for 1996.

X's 1996 Ending Inventory:	$1,190,000
Beginning Inventory (With UNICAP costs)	100,000
1996 Increment	
Additional § 263A Costs in 1996 Increment	10,000
Total 1996 Ending Inventory	$1,300,000

X's Unamortized 1995 § 481(a) Adjustment:	
Unamortized 1995 § 481(a) Adjustment—12/31/95	$60,000
Amount Included in 1996 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/96	$40,000

Because X satisfies the small reseller exception for 1997, X may change voluntarily from the UNICAP method to a permissible non-UNICAP inventory capitalization method under section 4.01 of this APPENDIX. To reflect the removal of the additional § 263A costs from the cost of its 1997 beginning inventory, X must compute a corresponding § 481(a) adjustment, which is a negative $100,000 ($1,200,000 — $1,300,000). Because X used the UNICAP method for only two years (that is, 1995 and 1996), X must include one-half of the § 481(a) adjustment when computing taxable income for each of the two taxable years beginning with 1997. Thus, X must include a $50,000 negative § 481(a) adjustment in 1997 taxable income. In addition, X must include $20,000 of the unamortized 1995 § 481(a) adjustment in 1997 taxable income.

X's 1997 Ending Inventory:	
Beginning Inventory (With UNICAP costs)	$1,300,000
1997 Increment	100,000
1997 § 481(a) Adjustment <Negative>	<100,000>
Total 1997 Ending Inventory	$1,300,000

X's Unamortized 1995 § 481(a) Adjustment:	
Unamortized 1995 § 481(a) Adjustment—12/31/96	$40,000
Amount Included in 1997 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/97	$20,000

X's Unamortized 1997 § 481(a) Adjustment:	
1997 § 481(a) Adjustment <Negative>	$ <100,000>
Amount Included in 1997 Taxable Income	50,000
Unamortized 1997 § 481(a) Adjustment—12/31/97	$ <50,000>

X also satisfies the small reseller exception for 1998 and, therefore, is not required to return to the UNICAP method for 1998. X, however, must include $20,000 of the unamortized 1995 positive § 481(a) adjustment and $50,000 of the unamortized 1997 negative § 481(a) adjustment in 1998 taxable income.

X's 1998 Ending Inventory:	
Beginning Inventory (Without UNICAP costs)	$1,300,000
1998 Increment	100,000
Total 1998 Ending Inventory	1,400,000

X's Unamortized 1995 § 481(a) Adjustment:	
Unamortized 1995 § 481(a) Adjustment—12/31/97	$20,000
Amount Included in 1998 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/98	$ 0

X's Unamortized 1997 § 481(a) Adjustment:	
Unamortized 1997 § 481(a) Adjustment—12/31/97	<50,000>
Amount Included in 1998 Taxable Income	50,000
Unamortized 1997 § 481(a) Adjustment—12/31/98	$ 0

In 1999, X fails to satisfy the small reseller exception and, therefore, must return to the UNICAP method as provided under section 4.01 of this APPENDIX. X changes to the simplified resale method without a historic absorption ratio election under § 1.263A–3(d)(3). Assume that X must capitalize $120,000 of additional § 263A costs to the cost of its 1999 beginning inventory because of this change in inventory method. In addition, X must include one-fourth of the § 481(a) adjustment when computing taxable income for each of the four taxable years beginning with 1999. Thus, X must include a $30,000 positive § 481(a) adjustment in its 1999 taxable income. Assume that X must add $10,000 of additional § 263A costs to the cost of its 1999 ending inventory because of the $100,000 increment for 1999.

X's 1999 Ending Inventory:	
Beginning Inventory (Without UNICAP costs)	$1,400,000
1999 Increment	100,000
Additional § 263A costs in Beginning Inventory	120,000
Additional § 263A costs in 1999 Increment	10,000
Total 1999 Ending Inventory	$1,630,000

X's Unamortized 1999 § 481(a) adjustment:	
1999 § 481(a) Adjustment	$120,000
Amount Included in 1999 Taxable Income	<30,000>
Unamortized 1999 § 481(a) Adjustment—12/31/99	$ 90,000

Because X fails to satisfy the small reseller exception for 2000, X must continue using the UNICAP method for its inventory costs. Furthermore, X is required to include $30,000 of the unamortized 1999 positive § 481(a) adjustment in 2000 taxable income. Assume that X is required to add $10,000 of additional § 263A costs to the cost of its 2000 ending inventory because of the $100,000 increment for 2000.

X's 2000 Ending Inventory:	
Beginning Inventory (With UNICAP costs)	$1,630,000
2000 Increment	100,000
Additional § 263A Costs in 2000 Increment	10,000
Total 2000 Ending Inventory	$1,740,000

X's Unamortized 1999 § 481(a) Adjustment:	
Unamortized 1999 § 481(a) Adjustment—12/31/99	$90,000
Amount Included in 2000 Taxable Income	<30,000>
Unamortized 1999 § 481(a) Adjustment—12/31/00	$ 60,000

.02 *Certain uniform capitalization (UNICAP) methods used by producers.*

(1) *Applicability*. This change applies to a producer of real or tangible personal property described in § 1.263A–2 that wants to change to a UNICAP method (or methods) specifically described in the regulations.

(2) *Inapplicability*. This change does not apply to a producer of real or tangible personal property described in § 1.263A–2 that wants to revoke an election to use the historic absorption ratio with the simplified production method (*see* § 1.263A–2(b)(4)(iii)(B)).

(3) *Definition*. A "UNICAP method specifically described in the regulations" includes the specific identification method (§ 1.263A–1(f)(2)), the burden rate method (§ 1.263A–1(f)(3)), the standard cost method (§ 1.263A–1(f)(3)), the direct reallocation method (§ 1.263A–1(g)(4)(iii)(A)), the step-allocation method (§ 1.263A–1(g)(4)(iii)(B)), the simplified service-cost method (§ 1.263A–1(h)), and the simplified production method without the historic absorption ratio election (§ 1.263A–2(b)), but does not include any other reasonable allocation method within the meaning of § 1.263A–1(f)(4).

(4) *Multiple changes*. Taxpayers making both this change and another change in method of accounting in the same year of change must comply with the ordering rules of § 1.263A–7(b)(2).

.03 *Certain uniform capitalization (UNICAP) methods used by taxpayers in a farming business.*

(1) *Description of change and scope*. This change applies to a taxpayer in a farming business that wants to change its method or methods of accounting to comply with § 1.263A–4.

(2) *Year of change*. This change only applies to the taxpayer's first taxable year ending after August 21, 2000 (in the case of property that is not inventory in the hands of the taxpayer), or the first taxable year beginning after August 21, 2000 (in the case of property that is inventory in the hands of the taxpayer), whichever is applicable.

(3) *Scope limitations inapplicable*. The scope limitations in section 4.02 of this revenue procedure do not apply, provided the taxpayer's method of accounting for property produced in a farming business is not an issue under consideration within the meaning of section 3.09 of this revenue procedure.

(4) *Manner of making change; audit protection.*

(a) *Non-inventory property*. In the case of property that is not inventory in the hands of the taxpayer, the change applies to costs incurred after August 21, 2000, is made on a cut-off basis as described in section 2.06 of this revenue procedure, and is not subject to the audit protection provisions of section 7 of this revenue procedure. However, a taxpayer

may receive such audit protection for non-inventory property by taking into account any § 481(a) adjustment that results from the change in method of accounting for non-inventory property to comply with § 1.263A–4. A taxpayer that opts to determine a § 481(a) adjustment (and, thus, obtain audit protection) for non-inventory property must take into account only additional section 263A costs incurred after December 31, 1986, in taxable years ending after December 31, 1986.

(b) *Inventory property*. In the case of property that is inventory in the hands of the taxpayer, the change applies to costs incurred after December 31, 1986, in taxable years ending after December 31, 1986, and is made by taking into account an adjustment under § 481(a). Such adjustment must take into account only additional section 263A costs incurred after December 31, 1986, in taxable years ending after December 31, 1986.

(5) *Multiple changes*. Taxpayers making both this change and another change in method of accounting in the same year of change must comply with the ordering rules of § 1.263A–7(b)(2).

.04 *Change to no longer capitalize research and experimental expenditures under uniform capitalization (UNICAP)*

(1) *Description of change and scope*. This change applies to a taxpayer who no longer wants to capitalize research and experimental expenditures to inventory under § 263A and the regulations thereunder. A taxpayer making this change must be in compliance with all other aspects of § 263A and the regulations thereunder and must have an effective election under either § 174(a) or § 174(b).

(2) *Manner of making the change*. A taxpayer must attach to the application the following:

(a) a representation that the § 174 costs the taxpayer proposes not to capitalize to inventory under § 263A and the regulations thereunder are costs that are subject to the taxpayer's effective election under either § 174(a) or § 174(b) and the regulations thereunder (Indicate which section applies to the taxpayer); and

(b) for the § 174 costs that it proposes to remove from inventory costs, a representation that the taxpayer had identified the § 174 costs as § 174 costs at the time that the costs were capitalized to inventory under § 263A and the regulations thereunder.

(3) *No audit protection*. A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

SECTION 4A. LOSSES, EXPENSES AND INTEREST WITH RESPECT TO TRANSACTIONS BETWEEN RELATED TAXPAYERS (§ 267)

.01 *Change to comply with § 267*. This change applies to a taxpayer that wants to change its method or methods of accounting to comply with the requirements of § 267, which disallows or defers certain deductions attributable to transactions between related taxpayers. However, this change applies to a change for stated interest only to the extent the stated interest is qualified stated interest (as defined in § 1.1273–1(c)).

.02 *Reserved*.

SECTION 4B. DEFERRED COMPENSATION (§ 404)

.01 *Change to comply with § 404(a)(11)*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to a taxpayer required to change its method of accounting for its first taxable year ending after July 22, 1998, to comply with § 404(a)(11). Section 404(a)(11) provides that, for purposes of determining under § 404 whether compensation of an employee is deferred compensation and when deferred compensation is paid, no amount is treated as received by the employee, or paid, until it is actually received by the employee. Section 404(a)(11) overturns the decision in *Schmidt Baking Co. v. Commissioner*, 107 T.C. 271 (1996), in which the court held that a § 83(a) income inclusion event upon securitization of vacation and severance pay benefits with a letter of credit constitutes receipt of those benefits by employees for purposes of determining whether an employer's deduction for the benefits is subject to § 404. *See* Notice 99–16 (1999–1 C.B. 687) (March 29, 1999).

(b) *Scope limitations inapplicable*. A taxpayer changing its method of accounting to comply with § 404(a)(11) is not subject to the scope limitations in section 4.02 of this revenue procedure.

(2) *Section 481(a) adjustment period*. A taxpayer must take the § 481(a) adjustment into account ratably over three taxable years.

(3) *No audit protection*. A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

.02 *Deferred compensation*.

(1) *Applicability*. This change applies to an accrual method taxpayer that wants to change its method of accounting to treat bonuses or vacation pay as follows (see § 404(a)(5) and § 1.404(b)–1T, Q&A 2):

(a) *Bonuses*.

(i) *Bonuses not subject to capitalization under § 263A*. If by the end of the taxable year all the events have occurred that establish the fact of the liability to pay a bonus and the amount of the liability can be determined with reasonable accuracy (see § 1.446–1(c)(1)(ii)), and the bonus is otherwise deductible, but the bonus is received by the employee after the 15th day of the 3rd calendar month after the end of that taxable year, to treat the bonus as deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the bonus is includible in the gross income of the employee; or

(ii) *Bonuses that are subject to capitalization under § 263A*. If by the end of the taxable year all the events have occurred that establish the fact of the liability to pay a bonus and the amount of the liability can be determined with reasonable accuracy (see § 1.446–1(c)(1)(ii)), and the bonus is otherwise deductible (without regard to § 263A), but the bonus is received by the employee after the 15th day of the 3rd calendar month after the end of that taxable year, to treat the bonus as capitalizable (within the meaning of § 1.263A–1(c)(3)) in the taxable year of the employer in which or with which ends the taxable year of the employee in which the bonus is includible in the gross income of the employee; or

(b) *Vacation pay*.

(i) *Vacation pay not subject to capitalization under § 263A*. If by the end of the taxable year all the events have occurred that establish the fact of the liability to pay vacation pay and the

amount of the liability can be determined with reasonable accuracy (see § 1.446–1(c)(1)(ii)), and the vacation pay is otherwise deductible, but the vacation pay is received by the employee after the 15th day of the 3rd calendar month after the end of that taxable year, to treat the vacation pay as deductible in the taxable year of the employer in which the vacation pay is paid to the employee; or

(ii) *Vacation pay that is subject to capitalization under § 263A*. If by the end of the taxable year all the events have occurred that establish the fact of the liability to pay vacation pay and the amount of the liability can be determined with reasonable accuracy (see § 1.446–1(c)(1)(ii)), and the vacation pay is otherwise deductible (without regard to § 263A), but the vacation pay is received by the employee after the 15th day of the 3rd calendar month after the end of that taxable year, to treat the vacation pay as capitalizable (within the meaning of § 1.263A–1(c)(3)) in the taxable year of the employer in which the vacation pay is paid to the employee.

(2) *Inapplicability*. This change does not apply to the extent that it is also described in section 4B.01 of this APPENDIX. This change also does not apply to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting if the taxpayer is not capitalizing the costs as required.

SECTION 5. METHODS OF ACCOUNTING (§ 446)

.01 *Cash or hybrid method to accrual method*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to:

(i) a taxpayer that wants to change to an overall accrual method, or to an overall accrual method in conjunction with the recurring item exception under § 461(h)(3), from the cash receipts and disbursements method (cash method), or from a hybrid method (the use of a combination of accounting methods under which an item or items of income or expense are reported on the cash method and another item or other items of income or expense are reported on an accrual method); or

(ii) a taxpayer that is required to change to an overall accrual method under § 448, but is ineligible to make the change under § 1.448–1(h)(2) (relating to the "first § 448 year").

(b) *Inapplicability*. This change does not apply to:

(i) a farmer;

(ii) a cooperative organization described in § 501(c)(12), 521, or 1381;

(iii) an individual taxpayer, except for activities conducted as a sole proprietorship;

(iv) a taxpayer required to use an inventory method of accounting, unless:

(A) the taxpayer is using or adopts a proper inventory method under § 471 and the regulations thereunder, the taxpayer is a small reseller within the meaning of § 1.263A–3(a), and, if the taxpayer has production activities, the taxpayer's production activities qualify under the *de minimis* presumption of § 1.263A–3(a)(2)(iii);

(B) the taxpayer is using or adopts a proper inventory method under § 471 and the regulations thereunder, the taxpayer is a reseller eligible to use the simplified resale method under § 1.263A–3(d), and the taxpayer is using or adopts a proper method under that section for the year of change;

(C) the taxpayer is a producer of real or tangible personal property described in § 1.263A–2, and is using both a proper inventory method under § 471 and the regulations thereunder and a proper capitalization method under § 263A and the regulations thereunder; or

(D) the taxpayer is a producer of real or tangible personal property described in § 1.263A–2, is using or adopts a proper inventory method under § 471 and the regulations thereunder, and adopts a UNICAP method or methods specifically described in the regulations. A "UNICAP method specifically described in the regulations" includes the specific identification method (§ 1.263A–1(f)(2)), the burden rate method (§ 1.263A–1(f)(2)), the standard cost method (§ 1.263A–1(f)(3)), the direct reallocation method (§ 1.263A–1(g)(4)(iii)(A)), the step-allocation method (§ 1.263A–1(g)(4)(iii)(B)), the simplified service cost method (§ 1.263A–1(h)), or the simplified production method without the historic absorption ratio election (§ 1.263A–2(b)), but does not include any other reasonable allocation method within the meaning of § 1.263A–1(f)(4).

(v) a taxpayer required or wanting to use a special method of accounting, unless the taxpayer is permitted to change automatically to the special method under this revenue procedure. A special method of accounting is a method that deviates from the normal tax accounting rules, such as the method of accounting for advance payments pursuant to either Rev. Proc. 71–21 (1971–2 C.B. 549), or § 1.451–5, the installment method of accounting under § 453, or a long-term contract method, such as the percentage of completion method or the completed contract method;

(vi) a taxpayer required to change to an overall accrual method under § 448 and eligible to make the change under § 1.448–1(h)(2). *See* § 1.448–1(h)(2), which provides an automatic consent procedure for a taxpayer changing for the first taxable year that it is subject to § 448. *See also* § 1.448–1(h)(1), which provides that § 1.448–1(h) does not apply to a change required under any Code section (or regulations thereunder) other than § 448 (for example, a taxpayer with inventories); or

(vii) a taxpayer engaged in two or more trades or businesses, unless the taxpayer uses or adopts the same overall accrual method for each such trade or business.

(2) *Section § 481(a) adjustment*.

(a) *In general*. The § 481(a) adjustment takes into account the accounts receivable, accounts payable, inventory, and any other item determined to be necessary in order to prevent items from being duplicated or omitted. The § 481(a) adjustment does not include any item of income accrued but not received that was worthless or partially worthless (within the meaning of § 166(a)) on the last day of the year preceding the year of change.

(b) *Recurring item exception*. As part of the change to an overall accrual method, a taxpayer may adopt the recurring item exception for the year of change if the taxpayer is eligible and follows the procedures of § 1.461–5(d). If the taxpayer is eligible and wants to adopt this method as specified in § 461(h)(3), the amount of the § 481(a) adjustment must

be modified to account for the amount of any additional deduction.

(3) *Change to a special method of accounting*. If a taxpayer that wants to change to an accrual method in conjunction with a change to a special method of accounting is not permitted to make the change under this revenue procedure, the taxpayer may request to make both changes only by filing one application under the provisions of Rev. Proc. 97–27 (1997–1 C.B. 680). Only one user fee will be required for these changes.

(4) *Coordination with section 13.01 of the APPENDIX for short-term obligations*. If a taxpayer subject to § 1281 wants to change its method of accounting under this section 5.01 of the APPENDIX and, as part of the change, is changing its method of accounting for interest income on short-term obligations, then the change for interest income on short-term obligations should be made under section 13.01 of the APPENDIX of this revenue procedure and not under this section 5.01 of the APPENDIX.

.02 *Multi-year service warranty contracts*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to an eligible accrual method manufacturer, wholesaler, or retailer of motor vehicles or other durable consumer goods that wants to change to the service warranty income method described in section 5 of Rev. Proc. 97–38 (1997–2 C.B. 479). Under the service warranty income method, a qualifying taxpayer may, in certain specified and limited circumstances, include a portion of an advance payment related to the sale of a multi-year service warranty contract in gross income generally over the life of the service warranty obligation.

(b) *Inapplicability*. This change does not apply to a taxpayer outside the scope of Rev. Proc. 97–38.

(2) *Manner of making the change*.

(a) This change is made using a cut-off method, under which the taxpayer begins the use of the service warranty income method for all qualified advance payment amounts received in the year of change and thereafter. *See* section 2.06 of this revenue procedure.

(b) In accordance with § 1.446–1(e)(3)(ii), the requirement of § 1.446–1(e)(3)(i) to file an application on Form 3115 is waived and a statement in lieu of the Form 3115 is authorized for this change. The statement must be identified at the top as follows: **"CHANGE TO THE SERVICE WARRANTY INCOME METHOD UNDER SECTION 5.02 OF THE APPENDIX OF REV. PROC. 2002–9."** The statement must set forth the information required under section 6.03 of Rev. Proc. 97–38, except that the statement under section 6.03(2) (that the taxpayer agrees to all of the terms and conditions of the revenue procedure) also should refer to Rev. Proc. 2002–9.

(c) A taxpayer changing to the service warranty income method of accounting under section 5.02 of this APPENDIX must satisfy the annual reporting requirement set forth in section 6.04 of Rev. Proc. 97–38.

.03 *Multi-year insurance policies for multi-year service warranty contracts — Description of change and scope*.

(1) *Applicability*. This change applies to a manufacturer, wholesaler, or retailer of motor vehicles or other durable consumer goods that wants to change its method of accounting for insurance costs paid or incurred to insure its risks under multi-year service warranty contracts to the method described in section 5.03(3) of this APPENDIX. Multi-year service warranty contracts to which this change applies include only those separately priced contracts sold by a manufacturer, wholesaler, or retailer also selling the motor vehicles or other durable consumer goods (to the ultimate customer or to an intermediary) underlying the contracts. The classification of goods as "durable consumer goods" for purposes of this change depends on the common usage of the goods, rather than the purchaser's actual intended use of the goods.

(2) *Inapplicability*. This change does not apply to a taxpayer that covers its risks under its multi-year service warranty contracts through arrangements not constituting insurance.

(3) *Description of method*. If a taxpayer purchases a multi-year service warranty insurance policy (in connection with its sale of multi-year service warranty contracts to customers) by paying a lump-sum premium in advance, the taxpayer must capitalize the amount paid or incurred and may only obtain deductions for that amount by prorating (or amortizing) it over the life of the insurance policy (whether the cash method or an accrual method of accounting is used to account for service warranty transactions).

.04 *Interest accruals on short-term consumer loans — Rule of 78s method*.

(1) *Description of change and scope*. This change applies to a taxpayer that wants to change its method of accounting from the Rule of 78s method to the constant yield method for stated interest (including stated interest that is original issue discount) on short-term consumer loans described in Rev. Proc. 83–40, 1983–1 C.B. 774, which was obsoleted by Rev. Proc. 97–37 (1997–2 C.B. 455). However, this change only applies to loans issued on or after the first day of the taxpayer's first taxable year that begins on or after January 1, 1999.

(2) *Background*.

(a) A short-term consumer loan is described in Rev. Proc. 83–40, provided:

(i) the loan is a self-amortizing loan that requires level payments, at regular intervals at least annually, over a period not in excess of five years (with no balloon payment at the end of the loan term); and

(ii) the loan agreement between the borrower and the lender provides that interest is earned, or upon the prepayment of the loan interest is treated as earned, in accordance with the Rule of 78s method.

(b) In general, the Rule of 78s method allocates interest over the term of a loan based, in part, on the sum of the periods' digits for the term of the loan. See Rev. Rul. 83–84 (1983–1 C.B. 97) for a description of the Rule of 78s method.

(c) In general, the constant yield method allocates interest and original issue discount over the term of a loan based on a constant yield. See § 1.1272–1(c) for a description of the constant yield method. The Rule of 78s method generally front-loads interest as compared to the constant yield method.

(d) Rev. Proc. 83–40 was obsoleted because, under §§ 1.446–2 and 1.1272–1 (which were effective for debt instruments issued on or after April 4, 1994), taxpayers generally must account for stated interest and original issue discount on a debt instrument (loan) by using a constant yield method. As a result, the

Rule of 78s method is no longer an acceptable method of accounting for federal income tax purposes.

(e) Notwithstanding §§ 1.446–2 and 1.1272–1, as a matter of administrative convenience, the Service will allow a taxpayer to use the Rule of 78s method for stated interest on short-term consumer loans described in Rev. Proc. 83–40 if the loans were issued prior to the first day of the taxpayer's first taxable year that begins on or after January 1, 1999.

(3) *Manner of making the change.* This change applies to loans issued on or after the first day of the taxpayer's first taxable year that begins on or after January 1, 1999. As a result, any § 481 adjustment will be computed only with respect to those loans.

.05 *Small taxpayers changing to overall cash method.*

(1) *Description of change.* This change applies to a taxpayer (other than a taxpayer described in § 448(a)(3)) with "average annual gross receipts" (as defined in section 5.01 of Rev. Proc. 2001–10, 2001–2 I.R.B. 272) of $1,000,000 or less that wants to change to the overall cash method of accounting as described in Rev. Proc. 2001–10.

(2) *Scope limitations inapplicable.* The scope limitations in section 4.02 of this revenue procedure do not apply to this change.

(3) *Manner of making the change.* Taxpayers making this change are urged to consult Rev. Proc. 2001–10 for additional guidance on the computation of the § 481(a) adjustment and the completion of the application.

(4) *Automatic changes to treating inventoriable items as nonincidental materials and supplies under Rev. Proc. 2001–10.* A taxpayer desiring to make both this change and the change to treating inventoriable items as materials and supplies that are not incidental under § 1.162–3 (see section 9.03 of the APPENDIX of this revenue procedure) may file a single application for both changes.

.06 *Nonaccrual-experience method.*

(1) *Applicability.* This change applies to a taxpayer using an overall accrual method that wants to change, and is eligible to change, to the nonaccrual-experience method of accounting under § 448(d)(5) and regulations thereunder for amounts to be received for the performance of services by the taxpayer which (on the basis of experience) will not be collected.

(2) *Inapplicability.* This change does not apply to any amount:

(a) if interest is required to be paid on such amount; or

(b) if a penalty is imposed for failure to timely pay such amount.

(3) *Scope limitations inapplicable.* The scope limitations in section 4.02 of this revenue procedure are not applicable to this change.

SECTION 5A. TAXABLE YEAR OF INCLUSION (§ 451)

.01 *Accrual of interest on nonperforming loans.*

(1) *Description of change and scope.*

(a) This change applies to an accrual method taxpayer that is a bank as defined in § 581 (or whose primary business is making or managing loans) and wants to change its method of accounting to comply with §§ 451 and 1.451–1(a) for qualified stated interest (as defined in § 1.1273–1(c)) on nonperforming loans.

(b) Section 1.451–1(a) requires income to be accrued when all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy. A taxpayer may not stop accruing qualified stated interest on a nonperforming loan for federal income tax purposes merely because payments on the loan are overdue by a certain length of time, such as 90 days, even if a federal, state, or other regulatory authority having jurisdiction over the taxpayer permits or requires that the overdue interest not be accrued for regulatory purposes.

(c) Under §§ 451 and 1.451–1(a), a taxpayer must continue accruing qualified stated interest on any nonperforming loan until either (i) the loan is worthless under § 166 and charged off as a bad debt, or (ii) the interest is determined to be uncollectible. In order for interest to be determined uncollectible, the taxpayer must substantiate, taking into account all the facts and circumstances, that it has no reasonable expectation of payment of the interest. This substantiation requirement is applied on a loan by loan basis.

(d) A taxpayer that changes its method of accounting under section 5A.01 of this APPENDIX must do so for all of its loans.

(2) *Section 481(a) adjustment.* In general, the § 481(a) adjustment for a method change under section 5A.01 of this APPENDIX represents the amount of qualified stated interest, on the taxpayer's nonperforming loans outstanding as of the beginning of the year of change, that should have been accrued under §§ 451 and 1.451–1(a) and was not accrued. Interest for which the taxpayer, as of the beginning of the year of change, has no reasonable expectation of payment is not taken into account in determining the amount of the § 481(a) adjustment.

.02 *Cash advances on insurance commissions.*

(1) *Description of change.*

(a) This change applies to an insurance company that wishes to change its method of accounting for cash advances on commissions paid to its agents from deducting a cash advance in the taxable year in which the advance is paid to the agent to deducting a cash advance in the taxable year in which the advance is earned by the agent. This change applies only to cash advances qualifying as loans under Rev. Proc. 2001–24 (2001–10 I.R.B. 788). An insurance company making this change must comply with all other applicable provisions of Rev. Proc. 2001–24.

(b) An agent of an insurance company making this change is granted consent to change the agent's method of accounting to report cash advances in the year earned rather than in the year paid, so long as the agent's change in method of accounting is consistent with the insurance company's reporting. No separate filing is required by an agent.

(2) *Year of change.* This change applies only to the insurance company's first or second taxable year beginning after December 31, 1999.

(3) *Scope limitations inapplicable.* The scope limitations in section 4.02 of this revenue procedure do not apply.

(4) *Manner of making the change.*

(a) The insurance company must attach to the application a statement that complies with section 4.03 of Rev. Proc. 2001–24.

(b) This change is effected on a cut-off basis. *See* section 2.06 of this revenue

procedure. If the insurance company previously changed its method of accounting for cash advances from "loan" to "earned cash advances" and that change resulted in a § 481(a) adjustment that has not been fully included in the insurance company's taxable income, the insurance company must include the remaining § 481(a) adjustment in taxable income in the year of change. Similarly, if the insurance company previously changed its method of accounting for cash advances from "loans" to "earned cash advances" and that change resulted in a § 481(a) adjustment that has not been fully included in the agent's reported income, the insurance company must include the remaining § 481(a) adjustment on the agent's applicable Form 1099–MISC, *Miscellaneous Income*, or Form W–2, *Wage and Tax Statement*, for the year of change.

.03 *Advance rentals — description of change and scope*. This change applies to a taxpayer that wishes to change its method of accounting for advance rentals (other than advance rentals subject to § 467 and the regulations thereunder) to include such advance rentals in gross income in the taxable year received. *See* § 1.61–8(b).

SECTION 6. OBLIGATIONS ISSUED AT DISCOUNT (§ 454)

.01 *Series E, EE or I U.S. savings bonds*.

(1) *Description of change and scope*. This change applies to a cash method taxpayer that wants to change its method of accounting for interest income on Series E, EE, or I U.S. savings bonds. However, this change only applies to a taxpayer that has previously made an election under § 454 to report as interest income the increase in redemption price on a bond occurring in a taxable year, and that now wants to report this income in the taxable year in which the bond is redeemed, disposed of, or finally matures, whichever is earliest.

(2) *Manner of making the change*.

(a) This change is made using a cut-off method and is effective for any increase in redemption price occurring after the beginning of the year of change for all Series E, EE and I U.S. savings bonds held by the taxpayer on or after the beginning of the year of change. *See* section 2.06 of this revenue procedure.

(b) In accordance with § 1.446–1(e)(3)(ii), the requirement of § 1.446–1(e)(3)(i) to file an application on Form 3115 is waived and a statement in lieu of the Form 3115 is authorized for this change. The statement must be identified at the top as follows: **"CHANGE IN METHOD OF ACCOUNTING UNDER SECTION 6.01 OF THE APPENDIX OF REV. PROC. 2002–9."** The statement must set forth:

(i) the Series E, EE, or I U.S. savings bonds for which this change in accounting method is requested;

(ii) an agreement to report all interest on any bonds acquired during or after the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest; and

(iii) an agreement to report all interest on the bonds acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of any interest income previously reported in prior taxable years.

.02 *Reserved*.

SECTION 7. PREPAID SUBSCRIPTION INCOME (§ 455)

.01 *Prepaid subscription income*.

(1) *Description of change and scope*. This change applies to an accrual method taxpayer that wants to change its method of accounting for prepaid subscription income to the method described in § 455 and the regulations thereunder, including an eligible taxpayer that wants to make the "within 12 months" election under § 1.455–2.

(2) *Manner of making the change*.

(a) This change is made using a cut-off method and does not apply to any prepaid subscription income received before the first taxable year to which the change applies. Any prepaid subscription income arising prior to the year of change is accounted for under the taxpayer's former method of accounting. *See* section 2.06 of this revenue procedure.

(b) In accordance with § 1.446–1(e)(3)(ii), the requirement of § 1.446–1(e)(3)(i) to file an application on Form 3115 is waived and a statement in lieu of the Form 3115 is authorized for this change. The statement must be identified at the top as follows: **"CHANGE IN METHOD OF ACCOUNTING FOR PREPAID SUBSCRIPTION INCOME UNDER SECTION 7.01 OF THE APPENDIX OF REV. PROC. 2002–9."** The statement must set forth the information required under § 1.455–6(b).

(c) The consent granted under this revenue procedure satisfies the consent required under §§ 455(c)(3) and 1.455–6(b).

.02 *Reserved*.

SECTION 7A. SPECIAL RULES FOR LONG-TERM CONTRACTS (§ 460)

.01 *Change to comply with final regulations under § 460*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to taxpayers that must change their methods of accounting to comply with the provisions of §§ 1.460–1 through 1.460–5 for long-term contracts entered into on or after January 11, 2001. *See* § 1.460–1(c)(2) for a description of when a contract is viewed as "entered into."

(b) *Inapplicability*. This change does not apply to a taxpayer that wishes to change its exempt-contract method of accounting (as defined in § 1.460–4(c)). A taxpayer desiring to change its exempt-contract method of accounting must obtain consent for such change by filing an application under Rev. Proc. 97–27 (or successor).

(2) *Year of change*. The year of change for this change is the taxpayer's taxable year that includes January 11, 2001.

(3) *Manner of making change*. This change is made on a cut-off basis. Accordingly, a § 481(a) adjustment is neither permitted nor required.

(4) *Scope limitations inapplicable*. The scope limitations in section 4.02 of this revenue procedure do not apply to this change.

(5) *No audit protection*. A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

.02 *Change from exempt-contract method to percentage-of-completion method*.

(1) *Description of change and scope*. This change applies to a taxpayer that

(a) is not required by § 460 and regulations thereunder to use the percentage-of-completion method to account for its long-term contracts, and

(b) wants to change its method of accounting for long-term contracts from an exempt-contract method (*see* § 1.460–4(c)) to the percentage of completion method (*see* § 1.460–4(b)).

(2) *Manner of making change*. This change is made on a cut-off basis. Accordingly, a § 481(a) adjustment is neither permitted nor required. This change does not apply to any long-term contract entered into before the year of change. *See* § 1.460–1(c)(2) for a description of when a contract is viewed as "entered into."

(3) *No audit protection*. A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

SECTION 8. TAXABLE YEAR OF DEDUCTION (§ 461)

.01 *Timing of incurring liabilities for employee compensation*.

(1) *Self-insured employee medical benefits*.

(a) *Applicability*. This change applies to an accrual method taxpayer that wants to change its method of accounting to treat an obligation to pay an employee's medical expenses that is neither insured nor paid from a welfare benefit fund within the meaning of § 419(e) as a liability incurred in the taxable year in which the employee files the claim with the employer. *See United States v. General Dynamics Corp.*, 481 U.S. 239 (1987) (1987–2 C.B. 134).

(b) *Inapplicability*. This change does not apply to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.01 of this APPENDIX, if the taxpayer is not capitalizing the costs as required.

(2) *Amounts taken into account*. Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, direct labor costs must be included in inventory costs and may be recovered through cost of goods sold. *See* § 1.263A–1(e)(2)(i)(B). A taxpayer may not rely on the provisions of section 8.01 of this APPENDIX to take a current year deduction.

.02 *Timing of incurring liabilities for real property taxes, personal property taxes and state income taxes*.

(1) *Description of change*. An accrual method taxpayer generally incurs a liability in the taxable year that 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* § 1.446–1(c)(1)(ii). Under § 1.461–4(g)(6), if the liability of the taxpayer is to pay a tax, economic performance occurs as the tax is paid to the government authority that imposed the tax.

(2) *Scope*.

(a) *Applicability*. This change applies to an accrual method taxpayer that wants to change its method of accounting to:

(i) treat liabilities (for which the all events test of § 461(h)(4) is otherwise met) for real property taxes, personal property taxes, or state income taxes as incurred in the taxable year in which the taxes are paid, under §§ 461 and 1.461–4(g)(6);

(ii) account for real property taxes, personal property taxes or state income taxes under the recurring item exception to the economic performance rules under §§ 461(h)(3) and 1.461–5(b)(1); or

(iii) revoke an election under § 461(c) (ratable accrual election).

(b) *Inapplicability*. This change does not apply to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.02 of this APPENDIX, if the taxpayer is not capitalizing the costs as required.

(3) *Amounts taken into account*. Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, certain real property taxes must be included in inventory costs and may be recovered through cost of goods sold. *See* § 1.263A–1(e)(3)(ii)(L). A taxpayer may not rely on the provisions of section 8.02 of this APPENDIX to take a current year deduction.

.03 *Timing of incurring liabilities under a workers' compensation act, tort, breach of contract, or violation of law*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to an accrual method taxpayer that wants to change its method of accounting for self-insured liabilities (including any amounts not covered by insurance, such as a "deductible" amount under an insurance policy) arising under any workers' compensation act or out of any tort, breach of contract, or violation of law, to treating the liability for the workers' compensation, tort, breach of contract, or violation of law as being incurred in the taxable year in which all the events have occurred which establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and payment is made to the person to which the liability is owed. *See* §§ 461 and 1.461–4(g)(2).

(b) *Inapplicability*. This change does not apply:

(i) to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.03 of this APPENDIX, if the taxpayer is not capitalizing the costs as required;

(ii) if payment is made to a third party rather than to the person to which the liability is owed. *See* § 1.461–4(g)(1); or

(iii) if payment is made by a third party.

(2) *Amounts taken into account*. Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, certain employee benefit costs (including workers' compensation) must be included in inventory costs and may be recovered through costs of goods sold. *See* § 1.263A–1(e)(3)(ii)(D). A taxpayer may not rely on the provisions of section 8.03 of this APPENDIX to take a current year deduction.

.04 *Timing of incurring liabilities for payroll taxes*.

(1) *Applicability*. This change applies to:

(a) an accrual method employer that wants to change its method of accounting for

(i) FICA and FUTA taxes to a method consistent with the holding in Rev. Rul. 96–51 (1996–2 C.B. 36) (Rev. Rul. 96–51 holds that, under the all events test of § 461, an accrual method employer may deduct in Year 1 its otherwise deductible FICA and FUTA taxes imposed with respect to year-end wages properly accrued in Year 1, but paid in Year 2, if the requirements of the recurring item exception are met); and

(ii) state unemployment taxes and, in the event the taxpayer is an employer within the meaning of the Railroad Retirement Tax Act (*see* § 3231(a)), railroad retirement taxes to a method under which the taxpayer may deduct in Year 1 its otherwise deductible state unemployment taxes and railroad retirement taxes (if applicable) imposed with respect to year-end wages properly accrued in Year 1, but paid in Year 2, if the requirements of the recurring item exception are met (including the requirement that, as of the end of the taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy, *see* § 1.461–5(b)); or

(b) an accrual method employer that utilizes a method of accounting for FICA and FUTA taxes that is consistent with the holding in Rev. Rul. 96–51 (1996–2 C.B. 36) and wishes to change its method of accounting for state unemployment taxes and, in the event the employer is an employer within the meaning of the Railroad Retirement Tax Act (*see* § 3231(a)), railroad retirement taxes to a method under which the taxpayer may deduct in Year 1 its otherwise deductible state unemployment taxes and railroad retirement taxes (if applicable) imposed with respect to year-end wages properly accrued in Year 1, but paid in Year 2, if the requirements of the recurring item exception are met (including the requirement that, as of the end of the taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy, *see* § 1.461–5(b)).

(2) *Inapplicability*. This change does not apply to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.04 of this APPENDIX, if the taxpayer is not capitalizing the costs as required.

(3) *Recurring item exception*. A taxpayer that previously has not changed to or adopted the recurring item exception for FICA, FUTA, state unemployment taxes and railroad retirement taxes (if applicable) must change to the recurring item exception method for FICA, FUTA, state unemployment taxes and railroad retirement taxes (if applicable) as specified in § 461(h)(3) as part of this change.

(4) *Amounts taken into account*. Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, certain taxes must be included in inventory costs and may be recovered through cost of goods sold. *See* § 1.263A–1(e)(3)(ii)(L). A taxpayer may not rely on the provisions of section 8.04 of this APPENDIX to take a current year deduction.

.05 *Cooperative advertising*.

(1) *Description of change and scope*. This change applies to a taxpayer that wants to change its method of accounting for cooperative advertising costs to a method consistent with the holding in Rev. Rul. 98–39 (1998–2 C.B. 198). Rev. Rul. 98–39 generally provides that, under the all events test of § 461, an accrual method manufacturer's liability to pay a retailer for cooperative advertising services is incurred in the year in which the services are performed, provided the manufacturer is able to reasonably estimate this liability, and even though the retailer does not submit the required claim form until the following year.

(2) *Scope limitations inapplicable*. A taxpayer that wants to make this change for its first or second taxable year ending on or after August 17, 1998, is not subject to the scope limitations in section 4.02 of this revenue procedure.

.06 *Distributor commissions*.

(1) *Changes made under Rev. Proc. 2000–38*.

(a) *Description of change and scope*. This change applies to taxpayers that wish to change their method of accounting for distributor commissions (as defined by § 2 of Rev. Proc. 2000–38, 2000–40 I.R.B. 310) to the distribution fee period method, the 5–year method, or the useful life method (all described in Rev. Proc. 2000–38) for the taxpayer's taxable year that includes January 1, 2001.

(b) *Inapplicability*. This change does not apply to an amortizable section 197 intangible (including any property for which a timely election under § 13261(g)(2) of the 1993 Act was made).

(c) *Scope limitations*.

(i) A taxpayer that files a copy of its application for this change with the national office on or before April 2, 2001 is not subject to the scope limitations in section 4.02 of this revenue procedure, unless the taxpayer's method of accounting for distributor commissions is an issue under consideration before a federal court within the meaning of section 3.09(3) of this revenue procedure.

(ii) If the taxpayer's method of accounting for distributor commissions is an issue pending at the time that a Form 3115 is filed with the national office, the taxpayer also must provide to the examining agent or appeals officer, as appropriate, an executed closing agreement substantially in the form set forth in APPENDIX A of Rev. Proc. 2000–38. For purposes of this change, the taxpayer's method of accounting for distributor commissions is an issue pending if the Service has given the taxpayer written notification indicating an adjustment is being made or will be proposed with respect to the taxpayer's method of accounting for distributor commissions. This will normally occur after the Service has gathered information sufficient to determine that a proposed adjustment is appropriate and justified, although the exact amount of the adjustment may not yet be determined.

(d) *Manner of making the change*.

(i) *Cut-off method*. The change must be made using a cut-off method, and applies only to distributor commissions paid or incurred on or after January 1, 2001. Because no items are duplicated or omitted from income when a cut-off method is used, a § 481(a) adjustment

described in § 5.03 of this revenue procedure is not necessary. *See* section 2.06 of this revenue procedure.

(ii) *Year of change*. The year of change is the taxpayer's taxable year that includes January 1, 2001.

(iii) *Filing requirements*. Notwithstanding section 6.02(3)(a) of this revenue procedure, a taxpayer making this change may file the required copy of its application with the national office before the first day of the year of change if the taxpayer otherwise properly files its application under Rev. Proc. 2000–38.

(e) *Audit protection*. If a taxpayer complies with the requirements of Rev. Proc. 2000–38 and this revenue procedure for changing its method of accounting for distributor commissions to any of the three methods of accounting described in Rev. Proc. 2000–38, the treatment of distributor commissions will not be raised as an issue in any taxable year before the year of change and, if the treatment of distributor commissions has already been raised as an issue in a taxable year before the year of change, the treatment of distributor commissions will not be further pursued.

(2) *Changes not made under Rev. Proc. 2000–38*.

(a) *Change from deducting to capitalizing distributor commissions*.

(i) *Description of change and scope*. This section 8.06(2)(a) applies to a taxpayer that wishes to change from currently deducting distributor commissions (as defined by section 2 of Rev. Proc. 2000–38, 2000–40 I.R.B. 310) to a method of capitalizing and amortizing distributor commissions using the distribution fee period method, the 5–year method, or the useful life method (all described in Rev. Proc. 2000–38) for a taxable year other than the taxpayer's taxable year that includes January 1, 2001).

(ii) *Inapplicability*. This change does not apply to an amortizable section 197 intangible (including any property for which a timely election under § 13261 (g)(2) of the 1993 Act was made.

(iii) *Manner of making the change*. The change under this section 8.06(2)(a) must be made using the cut-off method, and applies only to distributor commissions paid or incurred on or after the first day of the year of change. Because no items are duplicated or omitted from income when a cut-off method is used, a § 481(a) adjustment described in § 5.03 of this revenue procedure is not necessary. *See* section 2.06 of this revenue procedure.

(b) *Other changes*. *See* section 2.02 of this APPENDIX for (i) changing from one method described in Rev. Proc. 2000–38 for amortizing distributor commissions (as defined by section 2 of Rev. Proc. 2000–38, 2000–40 I.R.B.310) to another method described in Rev. Proc. 2000–38 for amortizing distributor commissions, or (ii) changing from pooling to a single asset, or vice versa, for distributor commissions for which the taxpayer is using the distribution fee period method or the useful life method (both described in Rev. Proc. 2000–38).

SECTION 9. INVENTORIES (§ 471)

.01 *Cash discounts*

(1) *Description of change and scope*. This change applies to a taxpayer that wants to change its method of accounting for cash discounts (discounts granted for timely payment) when they approximate a fair interest rate, from a method of consistently including the price of the goods before discount in the cost of the goods and including in gross income any discounts taken (the "gross invoice method"), to a method of reducing the cost of the goods by the cash discounts and deducting as an expense any discounts not taken (the "net invoice method"), or vice versa. *See* Rev. Rul. 73–65 (1973–1 C.B. 216).

(2) *Computation of § 481 adjustment for changes to net invoice method*. In the case of a taxpayer changing from the gross invoice method to the net invoice method, a negative adjustment must be made to prevent duplications arising from the fact that the gross invoice method reported income upon timely payment for some or all of the goods that remain in inventory, and a positive adjustment must be made to prevent omissions arising from the fact that the gross method included the invoice price, unadjusted for the cash discounts, of some or all goods in cost of goods sold and the discount will be earned by payment in a subsequent taxable year. The net § 481 adjustment can be computed by deducting the "Applicable Discount" at the beginning of the year of change from the "Available Discount" at the beginning of the year of change. The Available Discount is equal to the difference between the accounts payable balance under the gross invoice method and the net invoice method. The Applicable Discount is equal to the difference between the beginning inventory value under the gross invoice method and the net invoice method.

Example. Taxpayer's accounts payable balance at the beginning of the year of change was $1,000x under the gross invoice method and $980x under the net invoice method. Taxpayer's inventory value was $3,000x under the gross invoice method and $2,955x under the net invoice method. The Available Discount is $20 ($1,000x — $980x) and the Applicable Discount is $45 ($3,000x — $2,955x). Thus, Taxpayer's net § 481(a) adjustment is a negative $25 ($20 — $45).

(3) *Computation of § 481 adjustment for changes to gross invoice method*. In the case of a taxpayer changing from the net invoice method to the gross invoice method, a positive adjustment must be made to prevent omissions arising from the fact that the net invoice method did not report income upon timely payment for some or all of the goods that remain in inventory, and a negative adjustment must be made to prevent duplications arising from the fact that the net method included the invoice price, adjusted for the cash discounts, of some or all goods in cost of goods sold and the discount will be earned by payment in a subsequent taxable year. The net § 481 adjustment can be computed by deducting the "Applicable Discount" at the beginning of the year of change from the "Available Discount" at the beginning of the year of change. The Available Discount is equal to the difference between the accounts payable balance under the gross invoice method and the net invoice method. The Applicable Discount is equal to the difference between the beginning inventory value under the gross invoice method and the net invoice method.

Example. Taxpayer's accounts payable balance at the beginning of the year of change was $980x under the net invoice method and $1,000x under the gross invoice method. Taxpayer's inventory value was $2,955x under the net invoice method $3,000x under the gross invoice method. The Applicable Discount is $45 ($3,000x — $2,955x) and the Available Discount is $20 ($1,000x — $980x). Thus, Taxpayer's net § 481(a) adjustment is a positive $25 ($20 — $45).

.02 *Estimating inventory "shrinkage"*.

(1) *Description of change and scope*. This change applies to a taxpayer that

wants to change to a method of accounting for estimating inventory shrinkage in computing ending inventory, using:

(a) the "retail safe harbor method" described in section 4 of Rev. Proc. 98–29 (1998–1 C.B. 857); or

(b) a method other than the retail safe harbor method, provided (i) the taxpayer's present method of accounting does not estimate inventory shrinkage, and (ii) the taxpayer's new method of accounting (that estimates inventory shrinkage) clearly reflects income under § 446(b).

(2) *Scope limitations inapplicable*. A taxpayer that wants to make this change is not subject to the scope limitations in section 4.02 of this revenue procedure.

(3) *Additional requirements*. If the taxpayer wants to change to a method of accounting for inventory shrinkage other than the retail safe harbor method, the taxpayer must attach to the application a statement setting forth a detailed description of all aspects of the new method of estimating inventory shrinkage (including, for LIFO taxpayers, the method of determining inventory shrinkage for, or allocating inventory shrinkage to, each LIFO pool).

(4) *Audit protection*. A taxpayer, whose present method of accounting estimates inventory shrinkage, does not receive audit protection under section 7 of this revenue procedure in connection with a change to the retail safe harbor method if, on the date the taxpayer files a copy of the Form 3115 with the national office, the taxpayer's present method of estimating inventory shrinkage is an issue under consideration within the meaning of section 3.09 of this revenue procedure.

(5) *Future change*. A taxpayer that changes to the retail safe harbor method described in Rev. Proc. 98–29 will not be precluded, solely by reason of such change, from changing to another safe harbor method for estimating inventory shrinkage in computing ending inventory in the first year that such other safe harbor method is available.

.03 *Small taxpayer exception from requirement to account for inventories under § 471*.

(1) *Description of change*. This change applies to a taxpayer (other than a taxpayer described in § 448(a)(3)) with "average annual gross receipts" (as defined in section 5.01 of Rev. Proc. 2001–10, 2001–2 I.R.B. 272) of $1,000,000 or less that wants to change from a method of accounting for inventoriable items (including, if applicable, from the method of capitalizing costs under § 263A) to the method described in Rev. Proc. 2001–10 for treating inventoriable items in the same manner as materials and supplies that are not incidental under § 1.162–3.

(2) *Scope limitations inapplicable*. The scope limitations in section 4.02 of this revenue procedure do not apply to this change.

(3) *Manner of making the change*. Taxpayers making this change should consult Rev. Proc. 2001–10 for additional guidance on the computation of the § 481(a) adjustment and the completion of the application.

(4) *Automatic changes to the cash method under Rev. Proc. 2001–10*. A taxpayer desiring to make both this change and the change to the overall cash method under Rev. Proc. 2001–10 (see section 5.05 of the APPENDIX of this revenue procedure) may file a single application for both changes.

.04 *"Floor stocks" payments made or received*.

(1) *Description of change and scope*. This change applies to a taxpayer that wants to change its method of accounting for payments made or received with respect to "floor stocks" to conform with the holding of Rev. Rul. 2001–8 (2001–9 I.R.B. 726), or to elect the simplifying assumption regarding goods on hand set forth in Rev. Rul. 2001–8.

(2) *Requirements*. This change may only be made for the first taxable year in which payments are made or received with respect to floor stocks subsequent to February 26, 2001.

(3) *Scope limitations inapplicable*. The scope limitations in section 4.02 of this revenue procedure do not apply to this change.

(4) *Manner of making the change*.

(a) The change is made using a cut-off method relative to payments made or received with respect to floor stocks on or before February 26, 2001. *See* section 2.06 of this revenue procedure.

(b) A taxpayer making this change should clearly indicate on its application, or in an attachment thereto, if it is electing to use the simplifying assumption of Rev. Rul. 2001–8 to identify the goods physically held on the floor stocks date for costing purposes.

.05 *Qualifying volume-related trade discounts*.

(1) *Description of change and scope*. This change applies to a taxpayer that wants to change its method of accounting to treat qualifying volume-related trade discounts as a reduction in the cost of merchandise purchased at the time the discount is recognized in accordance with § 1.471–3(b). A "qualifying volume-related trade discount" means a discount satisfying the following criteria:

(a) the taxpayer receives or earns the discount solely as the result of the purchase of the merchandise to which the discount relates;

(b) the taxpayer is neither obligated nor expected to perform or provide any services in exchange for the discount; and

(c) the discount is not a reimbursement of any expenditure incurred or to be incurred by the taxpayer.

(2) *Section 481 adjustment*. The net § 481 adjustment attributable to the change is computed in a manner similar to the computation of a net § 481 adjustment in the case of a change to the net invoice method of accounting for cash discounts. See section 9.01(2) of the APPENDIX.

.06 *Impermissible methods of valuation*. This change applies to a taxpayer changing a method of accounting to restore a writedown or discontinue maintaining a reserve specifically described within § 1.471–2(f).

SECTION 10. LAST-IN, FIRST-OUT (LIFO) INVENTORIES (§ 472)

.01 *Change from the LIFO inventory method*.

(1) *Description of change and scope*.

(a) *In general*. This change applies to any taxpayer that wants to:

(i) change from the LIFO inventory method for all its LIFO inventory or for a pool or pools within its LIFO inventory; and

(ii) change to the permitted method as determined in section 10.01(1)(b) of this APPENDIX.

(b) *Method to be used*.

(i) *Determining method to be used*. The inventory method to be used by a taxpayer is determined as follows:

(A) If the taxpayer has inventoriable goods not included in its LIFO inventory computations (non-LIFO inventory) and, for all the taxpayer's non-LIFO inventory, the taxpayer uses an inventory method that is a permitted method, then the taxpayer must use that same inventory method for all of its non-LIFO inventory, including the inventory that is the subject of this accounting method change.

(B) If the LIFO inventory method is used by the taxpayer with respect to all its inventoriable goods, then the taxpayer must use the same inventory method it used prior to the adoption of the LIFO inventory method, if that prior method is a permitted method.

(C) If the taxpayer has only LIFO inventory and the method used by the taxpayer prior to the adoption of the LIFO inventory method is not a permitted method, then the taxpayer must use a permitted method.

(D) If the taxpayer did not use an inventory method prior to the adoption of the LIFO inventory method and has no inventoriable goods other than its LIFO inventory, then the taxpayer must use a permitted method.

(ii) *Permitted method defined*. For purposes of section 10.01 of this APPENDIX, a permitted method is a method under which:

(A) the identification method is either the first-in, first-out (FIFO) inventory method or the specific identification inventory method; and

(B) the valuation method is cost; cost or market, whichever is lower; market (but only if the taxpayer is a dealer in securities, as defined in § 1.471–5); the "farm price method" or the "unit-livestock-price method" (but only if the taxpayer is a farmer permitted to use such methods); or the retail method, reduced to either approximate cost or approximate cost or market, whichever is lower (but only if the taxpayer is a retail merchant).

(iii) *Method not to be used*. The average cost method (sometimes also referred to as "the rolling average method") described in Rev. Rul. 71–234 (1971–1 C.B. 148), is not a permitted method.

(iv) *Determining permitted method*. Whether an inventory method is a permitted method is determined by the taxpayer's method of inventory identification and valuation, and not by which types and amounts of costs are capitalized under the taxpayer's method of computing inventory cost. *See* § 263A and the regulations thereunder, which govern the types and amounts of costs required to be included in inventory cost for taxpayers subject to those provisions.

(2) *Limitation on LIFO election*. The taxpayer may not re-elect the LIFO inventory method for a period of at least five taxable years beginning with the year of change unless, based on a showing of unusual and compelling circumstances, consent is specifically granted by the Commissioner to change the method of accounting at an earlier time. A taxpayer that wants to re-elect the LIFO inventory method within a period of five taxable years (beginning with the year of change) must file a Form 3115 in accordance with Rev. Proc. 97–27 (1997–1 C.B. 680). A taxpayer that wants to re-elect the LIFO inventory method after a period of five taxable years (beginning with the year of change) is not required to file a Form 3115 in accordance with Rev. Proc. 97–27, but must file a Form 970, *Application to Use LIFO Inventory Method*, in accordance with § 1.472–3.

(3) *Effect of subchapter S election by corporation*.

(a) *S election effective for year of LIFO discontinuance*. If a C corporation elects to be treated as an S corporation for the taxable year in which it discontinues use of the LIFO inventory method, § 1363(d) requires an increase in the taxpayer's gross income for the LIFO recapture amount (as defined in § 1363(d)(3)) for the taxable year preceding the year of change (the taxpayer's last taxable year as a C corporation), and a corresponding adjustment to the basis of the taxpayer's inventory as of the end of the taxable year preceding the year of change. Any increase in income tax as a result of the inclusion of the LIFO recapture amount is payable in four equal installments, beginning with the taxpayer's last taxable year as a C corporation as provided in § 1363(d)(2). Any corresponding basis adjustment is taken into account in computing the § 481(a) adjustment (if any) that results upon the discontinuance of the LIFO method by the corporation.

(b) *S election effective for a year after LIFO discontinuance*. If a C corporation elects to be treated as an S corporation for a taxable year after the taxable year in which it discontinued use of the LIFO inventory method, the remaining balance of any positive § 481(a) adjustment must be included in its gross income in its last taxable year as a C corporation. If this inclusion results in an increase in tax for its last taxable year as a C corporation, this increase in tax is payable in four equal installments, beginning with the taxpayer's last taxable year as a C corporation as provided in § 1363(d)(2), unless the taxpayer is required to take the remaining balance of the § 481(a) adjustment into account in the last taxable year as a C corporation under another acceleration provision in section 5.04(3)(c) of this revenue procedure.

(4) *Additional requirements*. The taxpayer must complete the following statements and attach them to the application:

(a) "The new method of identifying inventory goods is the [insert method; that is, specific identification; FIFO; retail; etc.] method."

(b) "The new method of valuing inventory goods is [insert method; that is, cost; cost or market, whichever is lower; etc.]."

(c) "The new method conforms to the requirements of section 10.01(1)(b)(i) [insert either (A), (B), (C), or (D)] of the APPENDIX of Rev. Proc. 2002–9 because [explain in detail how the new method conforms to the specific subdivision]."

.02 *Determining current-year cost under the LIFO inventory method*.

(1) *Description of change and scope*. This change applies to a LIFO taxpayer that wants to change to a method of determining current year cost:

(a) by reference to the actual cost of the goods most recently purchased or produced;

(b) by reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition; or

(c) by application of an average unit cost equal to the aggregate actual cost of all the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced. *See* § 1.472–8(e)(2)(ii).

(2) *Manner of making the change*. This change is made using a cut-off method. *See* section 2.06 of this revenue procedure.

.03 *Alternative LIFO inventory method for retail automobile dealers*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to a taxpayer engaged in the trade or business of retail sales of new automobiles or new light-duty trucks ("automobile dealer") that wants to change to the "Alternative LIFO Method" described in section 4 of Rev. Proc. 97–36 (1997–2 C.B. 450), for its LIFO inventories of new automobiles and new light-duty trucks. Light-duty trucks are trucks with a gross vehicle weight of 14,000 pounds or less, which also are referred to as class 1, 2, or 3 trucks.

(b) *Inapplicability*. This change does not apply to an automobile dealer that uses the inventory price index computation (IPIC) method for goods other than new automobiles, new light-duty trucks, parts and accessories, used automobiles, and used trucks.

(2) *Manner of making the change*.

(a) *Cut-off method*. This change is made using a cut-off method. *See* section 2.06 of this revenue procedure and section 5.03(6) of Rev. Proc. 97–36.

(b) *IPIC method changes*. An automobile dealer that uses the IPIC method also must change from the IPIC method under section 10.03 of this APPENDIX to another acceptable method for its goods other than new automobiles and new light-duty trucks. For parts and accessories, the automobile dealer must change to the dollar-value, index method, with all parts and accessories within each separate trade or business in a separate LIFO pool. For used vehicles, the automobile dealer must change to the dollar-value, link-chain method, with all used automobiles within each separate trade or business in one LIFO pool and all used trucks within each separate trade or business in another separate LIFO pool.

(c) *Additional requirements*. An automobile dealer also must comply with the following:

(i) the conditions in section 5.03 of Rev. Proc. 97–36; and

(ii) for an automobile dealer changing from the IPIC method, the automobile dealer also must attach to the application a schedule setting forth the classes of goods for which the automobile dealer has elected to use the LIFO method and the accounting method changes being made under section 10.03 of this APPENDIX for each class of goods.

.04 *Used vehicle alternative LIFO method*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to a taxpayer that sells used automobiles and used light-duty trucks ("used vehicle dealers") that wishes to change to the "Used Vehicle Alternative LIFO Method" as described in Rev. Proc. 2001–23 (2001–10 I.R.B. 784).

(b) *Inapplicability*. This change does not apply to used vehicle dealers that use the IPIC method and have in inventory goods other than new or used automobiles, new or used light duty trucks, and parts and accessories. *See* section 5.03(2) of Rev. Proc. 2001–23.

(2) *Additional requirements*. A taxpayer making this change must comply with the additional conditions set forth in section 5.04 of Rev. Proc. 2001–23.

(3) *Scope limitations inapplicable*. The scope limitations in section 4.02 of this revenue procedure do not apply to this change, provided that the change is made for the first or second taxable year ending on or after December 31, 2000, unless the taxpayer's method of valuing its LIFO inventories of used automobiles or used light-duty trucks is an issue pending within the meaning of section 6.01(6) of Rev. Proc. 2000–38 (2000–40 I.R.B. 310).

(4) *Manner of making change*.

(a) *Cut-off method*. This change must be effected on a cut-off method, which requires that the value of the taxpayer's used automobile and used light-duty truck inventory at the beginning of the year of change must be the same as the value of that inventory at the end of the preceding taxable year, plus cost restorations, if any, required by section 5.04(5) of Rev. Proc. 2001–23. However, if the taxpayer has previously improperly accounted for a bulk bargain purchase, the taxpayer, as part of a change to the Used Vehicle Alternative LIFO Method, must first change its method of accounting to comply with *Hamilton Industries, Inc. v. Commissioner*, 97 T.C. 120 (1991), and compute a § 481(a) adjustment for that part of the change (see Announcement 91–173, 1991–47 I.R.B. 29).

(b) *New base year*. In effecting a change to the Used Vehicle Alternative LIFO Method under this revenue procedure, any LIFO inventory cost increments previously determined and the value of those increments must be retained. Instead of using the earliest taxable year for which the taxpayer adopted LIFO as the base year, the year of change must be used as the new base year in determining the value of all existing LIFO cost increments for the year of change and later taxable years. (The cumulative index at the beginning of the year of change will be 1.00.) The base-year cost of all LIFO cost increments at the beginning of the year of change must be restated in terms of new base-year costs, using the year of change as the new base year, and the indexes for previously determined inventory increments must be recomputed accordingly. The new base-year cost of a pool is equal to the total current-year cost of all the vehicles in the pool.

(c) When filing their applications, taxpayers are reminded to complete all applicable parts of the Form 3115, including Part I of Schedule B.

(5) *Concurrent change available for certain IPIC taxpayers*. A used vehicle dealer using the IPIC method that also has parts and accessories, new automobiles, or new light-duty trucks in inventory may incorporate a change, using a cut-off method, from IPIC to another acceptable LIFO method for these other goods into this change. When changing from IPIC to a dollar-value LIFO method for parts and accessories, new automobiles, or new light-duty trucks, a separate inventory pool must be established for each of these types of inventory.

.05 *Determining the cost of used vehicles purchased or taken as a trade-in*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to a LIFO taxpayer that wants to:

(i) determine the cost of used vehicles acquired by trade-in using the average wholesale price listed by an official used car guide on the date of the trade-in. *See* Rev. Rul. 67–107 (1967–1 C.B. 115). The official used car guide selected must be consistently used;

(ii) determine the cost of used vehicles purchased for cash using the actual purchase price of the vehicle; or

(iii) reconstruct the beginning-of-the-year cost of used vehicles purchased for cash using values computed by national auto auction companies based on vehicles purchased for cash. The national auto auction company selected must be consistently used.

(b) *Inapplicability*. This change does not apply to taxpayers that have adopted or changed to the Used Vehicle Alternative LIFO Method (*see* section 10.06 of the APPENDIX of this revenue procedure).

(2) *Manner of making the change*. This change is made using a cut-off method and applies to used vehicles acquired during the year of change and all subsequent years. See section 2.06 of this revenue procedure.

.06 *Change to inventory price index computation (IPIC) method*.

(1) *Description of change and scope*.

(a) This change applies to a taxpayer that wants to change from a non-IPIC LIFO inventory method to the IPIC method in accordance with all relevant provisions of § 1.472–8(e)(3).

(b) A taxpayer may change its method of determining current-year cost as part of a change made under section 10.06 of this APPENDIX by also following the provisions of section 10.02 of this APPENDIX. These changes may be made using a single application, provided the application is labeled as being filed under both sections 10.02 and 10.06 of this APPENDIX. *See* section 6.02(4) of this revenue procedure.

(c) A taxpayer may change its method of pooling to a method permitted under § 1.472–8(b)(4) or § 1.472–8(c)(2) as part of a change made under section 10.06 of this APPENDIX by also following the provisions of section 10.07 of this APPENDIX. These changes may be made using a single application, provided the application is labeled as being filed under both sections 10.06 and 10.07 of this APPENDIX. See section 6.02(4) of this revenue procedure.

(2) *Manner of making the change*. This change is made using a cut-off method. *See* section 2.06 of this revenue procedure.

(3) *Bargain purchase*. If the taxpayer has previously improperly accounted for a bulk bargain purchase, the taxpayer must, as part of this change, first change its method of accounting to comply with *Hamilton Industries, Inc. v. Commissioner*, 97 T.C. 120 (1991), and compute a § 481(a) adjustment for that part of the change. *See* Announcement 91–173 (1991–47 I.R.B. 29). Upon examination, if a taxpayer has properly changed under section 10.04 of this APPENDIX except for complying with section 10.04(3) of this APPENDIX, an examining agent may not deny the taxpayer the change. However, the taxpayer does not receive audit protection under section 7 of this revenue procedure with respect to the improper method of accounting for the bargain purchase. Accordingly, the examining agent may make any necessary adjustments in any open year to effect compliance with *Hamilton Industries, Inc*.

.07 *Changes within inventory price index computation (IPIC) method*.

(1) *Description of change and scope*. This change applies to a taxpayer that wants to make one or more of the following changes:

(a) change from the double-extension IPIC method to the link-chain IPIC method, or vice versa. *See* §§ 1.472–8(e)(3)(iii)(E) for principles for computing the inventory price index under the double-extension IPIC method and the link-chain IPIC method;

(b) change to or from the 10 percent method. *See* § 1.472–8(e)(3)(iii)(C) for principles for assigning items in a dollar-value pool to BLS categories;

(c) change to a pooling method described in § 1.472–8(b)(4) or § 1.472–8(c)(2), including a change to begin or discontinue applying one or both of the 5 percent pooling rules;

(d) combine or separate pools as a result of the application of a 5 percent pooling rule described in § 1.472–8(b)(4) or § 1.472–8(c)(2);

(e) change its selection of BLS table from Table 3 (Consumer Price Index for All Urban Consumers (CPI-U): U.S. city average, detailed expenditure categories) of the monthly CPI Detailed Report to Table 6 (Producer price indexes and percent changes for commodity groupings and individual items, not seasonally adjusted) of the monthly PPI Detailed Report, or vice versa. *See* § 1.472–8(e)(3)(iii)(B) for principles for selecting a BLS table under the IPIC method; or

(f) change the representative month when necessitated because of a change in taxable year or a change in method of determining current-year cost made pursuant to section 10.02 of this APPENDIX. *See* § 1.472–8(e)(3)(iii)(B) for principles for determining a representative month under the IPIC method. A change in method of determining current-year cost and a change of the representative month may be made using a single application, provided the application is labeled as being filed under both sections 10.02 and 10.07 of this APPENDIX. *See* section 6.02(4) of this revenue procedure.

(2) *Manner of making the change*. Changes made pursuant to section 10.07 of this APPENDIX are made using a cut-off method. *See* section 2.06 of this revenue procedure. A taxpayer that changes pursuant to sections 10.07(a), (b) and (e) of this APPENDIX must establish a new base year in the year of change.

SECTION 10A. MARK-TO-MARKET ACCOUNTING METHOD FOR DEALERS IN SECURITIES (§ 475)

.01 *Reserved*.

.02 *Commodities dealers, securities traders, and commodities traders electing to use the mark-to-market method of accounting under § 475(e) or (f)*.

(1) *Description of change*. This change applies to certain taxpayers that have elected to use the mark-to-market method of accounting under § 475(e) or (f). Under § 475(e) and (f) and Rev. Proc. 99–17, 1999–1 C.B. 503, if a taxpayer makes an election under § 475(e) or (f), then beginning with the first taxable year for which the election is effective (election year), mark to market is the only permissible method of accounting for securities or commodities subject to the election. Thus, if the electing taxpayer's method of accounting for its taxable year immediately preceding the election year is inconsistent with § 475, the taxpayer is required to change its method of accounting to comply with the election. A taxpayer that makes a § 475(e) or (f) election but fails to change its method of accounting to comply with that election is using an impermissible method. *See* section 4 of Rev. Proc. 99–17.

(2) *Scope*

(a) *Applicability*. This change applies to a taxpayer if all of the following conditions are satisfied:

(i) The taxpayer is a commodities dealer, securities trader, or commodities trader that has made a valid election under § 475(e) or (f) (*see* section 5.02 or 5.03(1) of Rev. Proc. 99–17) and that is required to change its method of accounting to comply with the election;

(ii) The method of accounting to which the taxpayer changes is in accordance with its election under § 475(e) or (f); and

(iii) The year of change is the election year.

(b) *Scope limitations inapplicable*. A taxpayer making this change is not subject to the scope limitations in section 4.02 of this revenue procedure.

SECTION 11. BANK RESERVES FOR BAD DEBTS (§ 585)

.01 *Changing from the § 585 reserve method to the § 166 specific charge-off method*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to a bank (as defined in § 581, including a bank for which a qualified subchapter S subsidiary (QSSS) election is filed) that wants to change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method.

(b) *Certain scope limitations inapplicable*. A bank that changed from the § 593 reserve method under § 593(g) to the § 585 reserve method will not be prohibited under section 4.02(6) of this revenue procedure from changing its method of accounting for bad debts under section 11.01 of this APPENDIX solely because of the § 593(g) change. A bank for which a QSSS election is filed will not be prohibited under section 4.02(7) of this revenue procedure from changing its method of accounting for bad debts under section 11.01 of this APPENDIX solely because of the deemed liquidation of the bank arising from a QSSS election.

(c) *Inapplicability*. This change does not apply to a large bank as defined in § 585(c)(2).

(2) *Section 481(a) adjustment*. Generally, the amount of the § 481(a) adjustment for a change in method of accounting under section 11.01 of this APPENDIX is the amount of the bank's reserve for bad debts as of the close of the taxable year immediately before the year of change. However, the amount of the § 481(a) adjustment does not include the amount of a bank's pre–1988 reserves (as described in § 593(g)(2)(A)(ii), without taking into account § 593(g)(2)(B)) if the bank changed in a prior year from the § 593 reserve method to the § 585 reserve method and § 593(g) applied to that change. The deemed liquidation of a bank occurring solely because its parent makes a QSSS election does not accelerate the § 481(a) adjustment. In accordance with section 5.04(3)(c) of this revenue procedure, a bank that ceases to be a bank under § 581 must accelerate its § 481(a) adjustment.

(3) *Change from § 585 required when electing S corporation status*. A bank electing S corporation status (or a bank for which a QSSS election is filed) cannot use the § 585 reserve method. The filing by a bank of a Form 2553 (*Election by a Small Business Corporation*) or the filing by a bank's parent of a QSSS election with respect to the bank will constitute an agreement by the bank to change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method effective as of the taxable year for which the S corporation election or QSSS election is effective (year of change) in accordance with all of the applicable provisions of this revenue procedure (including section 6 of this revenue procedure, which requires filing a Form 3115 in duplicate). The § 481(a) adjustment is recognized built-in gain under §1374. See § 1.1374–4(d).

.02 *Reserved*.

SECTION 11A. INCOME FROM SOURCES WITHIN THE UNITED STATES (§ 861)

.01 *Transactions involving computer programs*. This change applies to a taxpayer that wishes to change its method of accounting for transactions involving computer programs to conform to the provisions of § 1.861–18(i)(4). This change applies only to transactions occurring pursuant to contracts entered into on or after December 31, 1998, or, in the case of a taxpayer making an election under § 1.861–18(i)(2)(ii), to transactions occurring pursuant to contracts entered into in taxable years ending on or after October 2, 1998.

.02 *Reserved*.

SECTION 11B. FUNCTIONAL CURRENCY (§ 985)

.01 *Change in functional currency*.

(1) *Description of change and scope*. This change applies to a taxpayer that wants to change its functional currency or the functional currency of a qualified business unit (QBU) of the taxpayer.

(2) *Manner of making change*. A taxpayer making this change must make all necessary adjustments required by such change. *See* §§ 1.985–5, 1.985–8(c).

.02 *Reserved*.

SECTION 12. ORIGINAL ISSUE DISCOUNT (§§ 1272, 1273)

.01 *De minimis original issue discount (OID)*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to a taxpayer that wants to change to the principal-reduction method of accounting described in section 5 of Rev. Proc. 97–39 (1997–2 C.B. 485). The principal-reduction method of accounting is an aggregate method of accounting for *de minimis* OID (discount) on certain loans originated by the taxpayer.

(b) *Scope limitations inapplicable*. A taxpayer that wants to make this change is not subject to the scope limitations in section 4.02 of this revenue procedure.

(c) *Description*. The principal-reduction method of accounting is a permissible method for use by taxpayers to account for discount on one or more categories of loans described in section 4.02 or 4.03 of Rev. Proc. 97–39. If the principal-reduction method is used to account for any loans in a category of loans, the method must be used for the entire category of loans. The principal-reduction method applies only to loans described in section 3 of Rev. Proc. 97–39.

(2) *Manner of making the change*.

(a) This change is made using a cut-off method and applies only to loans described in section 3 of Rev. Proc. 97–39 that were acquired on or after the

first day of the year of change. *See* section 2.06 of this revenue procedure.

(b) The taxpayer must maintain books and records sufficient to satisfy the director that old and new loans have been adequately segregated.

(3) *Additional requirements*. On a statement attached to the application, the taxpayer must:

(a) identify the categories of loans to which the new method will apply; and

(b) describe any "additional categories" permitted under section 4.03 of Rev. Proc. 97–39.

(4) *No audit protection*. A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

.02 *Reserved*.

SECTION 12A. MARKET DISCOUNT BONDS (§ 1278)

.01 Revocation of § 1278(b) election.

(1) *Description of change and scope*. This change applies to a taxpayer that wants to change its method of accounting for market discount bonds by revoking its § 1278(b) election. Under § 1278(b), a taxpayer may elect a method of accounting under which market discount is currently included in gross income for the taxable years to which the discount is attributable. See Rev. Proc. 92–67 (1992–2 C.B. 429), for the procedures to make a § 1278(b) election (including a deemed § 1278(b) election). The procedures for revoking a § 1278(b) election were formerly provided in section 7 of Rev. Proc. 92–67.

(2) *Revocation of election*. The revocation of a § 1278(b) election applies to all market discount bonds that are held by the taxpayer on the first day of the first taxable year for which the revocation is effective (year of change), and to all market discount bonds that are subsequently acquired by the taxpayer. If a § 1278(b) election is revoked, then, for purposes of § 1276(a), accrued market discount with respect to any bond previously subject to the election means accrued market discount as defined in § 1276(b) less any market discount included in income while the bond was subject to the § 1278(b) election.

(3) *Manner of making the change*. This change is made using a cut-off method and applies only to market discount accruing on or after the first day of the year of change. Market discount accruing on a bond prior to the year of change was currently included in income and market discount accruing on the bond on and after the first day of the year of change is included in income generally upon disposition of the bond. See § 1276(a). Because cut-off treatment is prescribed for this change, the basis of any bond, adjusted for amounts previously included in income during the period of the election, is not affected by the revocation.

(4) *Additional requirements*. On a statement attached to the application, the taxpayer must provide:

(a) the reason(s) for revoking the § 1278(b) election (or deemed § 1278(b) election);

(b) a description of the method by which, and the date on which, the taxpayer made the § 1278(b) election (or deemed § 1278(b) election) that is being revoked; and

(c) a statement that, after the revocation, the taxpayer will not make a constant interest rate election for any bond that has been subject to the § 1278(b) election (or deemed § 1278(b) election) being revoked and for which a constant interest rate election was not effective in the year of acquisition.

(5) *Audit protection*. A taxpayer receives audit protection under section 7 of this revenue procedure in connection with this change. However, the audit protection applicable to this change does not preclude the Commissioner from examining the method used by the taxpayer to determine the amount of accrued market discount under § 1276(b) for a taxable year prior to the year of change.

.02 *Reserved*.

SECTION 13. SHORT-TERM OBLIGATIONS (§ 1281)

.01 *Interest income on short-term obligations*.

(1) *Description of change and scope*.

(a) This change applies to a taxpayer that wants to change its method of accounting to comply with § 1281 for interest income on short-term obligations.

(b) Under § 1281, a holder of certain short-term obligations, including a bank as defined in § 581, must include in gross income any accrued interest income on such obligations, regardless of the holder's overall method of accounting. Section 1281 applies to all types of interest income, including acquisition discount, original issue discount (OID), and stated interest. *See* S. Rep. No. 99–313, 99th Cong., 2d Sess. 903 (1986), 1986–3 (Vol. 3) C.B. 903.

(c) Section 1283(a)(1) generally defines a short-term obligation as any bond, debenture, note, certificate, or other evidence of indebtedness that matures in one year or less from its issue date.

(d) Under §§ 1281(a) and 1283(c), a holder of a short-term obligation subject to § 1281 must include in gross income an amount equal to the sum of the daily portions of the acquisition discount or OID, whichever is applicable, on the obligation for each day during the taxable year that the obligation is held by the holder. See § 1283(b), as modified by § 1283(c), to determine the daily portions of acquisition discount or OID. In addition, § 1281(a) requires the holder to include in gross income any stated interest that is payable on the short-term obligation (other than stated interest taken into account to determine the amount of the acquisition discount or OID) as it accrues.

(2) *Section 481(a) adjustment period*. A taxpayer must take the entire § 481(a) adjustment into account in computing taxable income for the year of change.

.02 *Stated interest on short-term loans of cash method banks*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to a bank that uses the cash receipts and disbursements method of accounting as its overall accounting-method and that wants to change its method of accounting from accruing stated interest on short-term loans made in the ordinary course of business to using the cash method for that interest. For example, see *Security State Bank v. Commissioner*, 214 F.3d 1254 (10th Cir. 2000), *aff'g* 111 T.C. 210 (1998), *acq.*, 2001–5 I.R.B., and *Security Bank Minnesota v. Commissioner*, 994 F.2d 432 (8th Cir. 1993), *aff'g* 98 T.C. 33 (1992), in which the courts held that § 1281 does not apply to short-term loans made by a cash method bank in the ordinary course of its business.

(b) *Scope limitations inapplicable*. A taxpayer that wants to make this change is not subject to the scope limitations in section 4.02 of this revenue procedure.

(2) *Change for prior taxable years*. A taxpayer is permitted to make the change in accounting method described in section 13.02(1)(a) of this Appendix for any taxable year ending before December 31, 2000, provided the year is not barred by the statute of limitations, there is no closed taxable year after the year of change, and the taxpayer complies with the following requirements:

(a) the taxpayer must attach a completed Form 3115 to an amended return for the year of change, and must file, on or before December 31, 2001, that amended return and amended returns for all subsequent affected taxable years, if any; and

(b) the taxpayer must file a copy of the Form 3115 with the national office no later than when the original Form 3115 is filed with the amended return.

(3) *Section 481(a) adjustment period*. A taxpayer making this change must take the entire § 481(a) adjustment into account in computing taxable income for the year of change.

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26 CFR 601.204: Changes in accounting periods and methods of accounting.
(Also Part I, §§ 162, 263(a), 446, 481; 1.162–3, 1.263(a)–1, 1.446–1, 1.481–1.)

Rev. Proc. 2002–12

SECTION 1. PURPOSE

This revenue procedure provides taxpayers engaged in the trade or business of operating a restaurant or tavern (as defined in section 4.01 of this revenue procedure) with a safe harbor method of accounting for the cost of "smallwares" (as defined in section 4.02 of this revenue procedure) ("smallwares method"). This revenue procedure also provides a procedure for such taxpayers to obtain automatic consent of the Commissioner to change to the smallwares method.

SECTION 2. BACKGROUND

.01 The trade or business of operating a restaurant or tavern requires the use of many items in the preparation, service, and storage of food and beverages. Pots and pans, dishes, and glassware are common examples of these items, known as "smallwares" in the restaurant industry. Generally, an "opening package" of smallwares is purchased before a restaurant or tavern opens its doors to customers. Although an opening package is made up of hundreds or thousands of items, it is typically purchased as one unit from the same vendor. Replacement items are thereafter purchased on an ongoing basis. Industry data shows that the average cost of an opening package of smallwares ranges from $10,000 to $50,000, and that smallwares have an average useful life of slightly over one year.

.02 Section 162(a) of the Internal Revenue Code allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Under § 1.162–3 of the Income Tax Regulations, the cost of materials and supplies (other than incidental materials and supplies) may be deducted only to the extent that the materials and supplies are actually consumed and used in the taxpayer's business during the taxable year.

.03 Section 263(a) provides that no deduction is allowed for the cost of new buildings or of permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)–2(a) provides examples of capital expenditures, such as the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

.04 Except as otherwise provided, under §§ 446(e) and 1.446–1(e), a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446–1(e)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting. Section 481(a) generally requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when a taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year.

.05 To resolve disputes concerning whether the cost of smallwares should be accounted for as currently deductible expenses under § 162 or capital expenditures within the meaning of § 263(a), and to simplify the record keeping requirements with respect to smallwares, the Internal Revenue Service will permit a taxpayer engaged in the trade or business of operating a restaurant or tavern that complies with the requirements of this revenue procedure to account for the cost of smallwares using the smallwares method provided in section 5 of this revenue procedure.

SECTION 3. SCOPE

This revenue procedure applies to the cost of smallwares incurred by taxpayers engaged in the trade or business of operating a restaurant or tavern. It does not apply to the cost of smallwares that are start-up expenditures as defined in § 195. Thus, a taxpayer that is not already engaged in the trade or business of operating a restaurant that opens a new restaurant may not use the smallwares method provided in section 5 of this revenue procedure to account for the cost of smallwares paid or incurred before the new restaurant opens.

SECTION 4. DEFINITIONS

.01 *Trade or Business of Operating a Restaurant or Tavern*. For purposes of this revenue procedure, a taxpayer is engaged in the trade or business of operating a restaurant or tavern if the taxpayer's business consists of preparing food and beverages to customer order for immediate on-premises or off-premises consumption. These businesses include, for example, full-service restaurants; limited-service eating places; cafeterias; special food services, such as food service contractors, caterers, and mobile food services; and, bars, taverns, and other drinking places. For purposes of this revenue procedure, the trade or business of operating a restaurant or tavern also may include food or beverage services at grocery stores, hotels and motels,

amusement parks, theaters, casinos, country clubs, and similar social or recreational facilities.

.02 *Smallwares*. For purposes of this revenue procedure, smallwares consist of the following ten categories of items: (1) Glassware and paper or plastic cups; (2) Flatware (silverware) and plastic utensils; (3) Dinnerware (dishes) and paper or plastic plates; (4) Pots and Pans; (5) Table Top Items; (6) Bar Supplies; (7) Food Preparation Utensils and Tools; (8) Storage Supplies; (9) Service Items; and (10) Small Appliances that cost $500 or less. Categories 5 through 10 include, but are not limited to, the items listed below:

(5) *Table Top Items* include items placed on customer tables, such as salt and pepper shakers, cheese shakers, ash trays, teapots, cruets, sugar caddies, tablecloths, napkins, menu holders, menus, vases, candles, and candleholders.

(6) *Bar Supplies* include mixing glasses, bar strainers, cutting boards, liquor pourers, jiggers, corkscrews, bottle openers, storage bottles, wine and champagne stoppers, bar caddies, wine coolers, decanters, salt and sugar glass rimmers, slow pourers, and malt shakers.

(7) *Food Preparation Utensils and Tools* include hand utensils (spoons, spatulas, wisks, peelers, etc.), pastry and grill brushes, skimmers, knives, kitchen shears, cutting boards, strainers, colanders, shakers, dippers, measuring cups and spoons, thermometers, gloves, goggles, timers, scales, shaker baskets, salad spinners, lettuce crispers, sifters, pastry bags and tubes, mixing bowls, pot holders, kitchen towels, cheesecloths, and kitchen staff uniforms.

(8) *Storage Supplies* include food containers, flatware sorters, dish containers, and spice racks.

(9) *Service Items* include pepper mills, cheese graters, bread boards, pitchers, squeeze dispensers, coffee pots, napkin receptacles, flatware, plate, glass, and mug storage racks, wait staff and self-serve trays, soup and salad bar trays and containers, bus tubs, tray carts, booster seats, and wait staff uniforms.

(10) *Small Appliances* include iced tea dispensers, can openers, condiment pumps, individual food warmers, heat lamps, slicers, glass washers, electric knife sharpeners, blenders, juicers, and nonindustrial mixers. Small appliances do not include appliances that cost in excess of $500.

For purposes of this revenue procedure, smallwares do not include office supplies, general purpose cleaning supplies, or general purpose maintenance tools. In addition, smallwares do not include extraordinary items, such as collectibles or other items of significant artistic or intrinsic value, items that are accounted for separately for tax or financial purposes, or items that generally are listed as scheduled property for insurance purposes. Examples of extraordinary items are flatware or dinnerware made of precious metals, and antique vases used for centerpiece or display purposes.

SECTION 5. SMALLWARES METHOD

.01 Taxpayers within the scope of this revenue procedure are permitted to account for smallwares in the same manner as materials and supplies that are not incidental under § 1.162–3.

.02 Under § 1.162–3, the costs of materials and supplies that are not incidental are deductible in the year in which the materials and supplies are actually consumed and used in a taxpayer's business.

.03 For purposes of this revenue procedure, smallwares are consumed and used in a taxpayer's business, within the meaning of § 1.162–3, in the taxable year in which they are received at the restaurant and are available for use. For purposes of this revenue procedure, "received at the restaurant and available for use" does not include smallwares purchased and stored at a warehouse or facility other than the restaurant where the smallwares will be used.

SECTION 6. CHANGE IN METHOD OF ACCOUNTING

.01 *Limitations, Terms, and Conditions*. A change in a taxpayer's treatment of the cost of smallwares to the smallwares method provided in section 5 of this revenue procedure is a change in method of accounting to which §§ 446 and 481 apply. A taxpayer that wants to change its method of accounting for the cost of smallwares to the smallwares method provided in section 5 of this revenue procedure must follow the automatic change in method of accounting provisions of Rev. Proc. 2002–9 (2002–3 I.R.B. 327) (or its successor) with the following modification: the scope limitations in section 4.02 of Rev. Proc. 2002–9 do not apply. However, if a taxpayer is under examination, before an area appeals office, or before a federal court with respect to any income tax issue at the time that a copy of the Form 3115, *Application for Change in Accounting Method,* is filed with the national office, the taxpayer must provide a copy of the Form 3115 to the examining agent, appeals officer, or counsel for the government, as appropriate, at the same time the copy of the Form 3115 is filed with the national office. The Form 3115 must contain the name(s) and telephone number(s) of the examining agent, appeals officer, or counsel for the government, as appropriate.

.02 *Audit Protection*. If a taxpayer complies with the requirements of this revenue procedure and changes its method of accounting for the cost of smallwares to the smallwares method provided in section 5 of this revenue procedure, the treatment of those costs will not be raised as an issue in any taxable year before the year of change and, if the treatment of the cost of smallwares has already been raised as an issue in a taxable year before the year of change, that issue will not be further pursued.

.03 *Section 481(a) Adjustment*. A taxpayer changing its method of accounting under this revenue procedure for the cost of smallwares must take the entire net amount of any § 481(a) adjustment into account in computing taxable income for the year of change.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for taxable years ending on or after December 31, 2001.

DRAFTING INFORMATION

The principal author of this revenue procedure is Angella L. Warren of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Ms. Warren at (202) 622–4950 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

New Markets Tax Credit

REG–119436–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In T.D. 8971 on page 308 of this Bulletin, the IRS is issuing temporary regulations relating to the new markets tax credit. The text of those regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by February 25, 2002. Outlines of topics to be discussed at the public hearing scheduled for March 14, 2002, must be received by February 21, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–119436–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–119436–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may send submissions electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or directly to the IRS Internet site at *http://www.irs.gov/tax_regslist.html*. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Paul Handleman (202) 622–3040; concerning submissions, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garret (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR: MP:FP:S:O, Washington, DC 20224. Comments on the collection of information should be received by February 25, 2002.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The requirement for the collection of information in this notice of proposed rulemaking is in § 1.45D–1(g)(2). The information is required so that a taxpayer may claim a new markets tax credit on each credit allowance date during the 7-year credit period and report compliance with the requirements of section 45D and the regulations thereunder to the Secretary. The collection of information is mandatory. The likely respondents are businesses or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

Estimated total annual reporting burden: 378 hours.

The estimated annual burden per respondent 2.5 hours.

Estimated number of respondents: 151.

Estimated annual frequency of responses: once.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Temporary regulations in T.D. 8971, page 308, amend the Income Tax Regulations (26 CFR part 1) relating to section 45D. The temporary regulations provide guidance for taxpayers claiming the new markets tax credit under section 45D. The text of those regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that any burden on taxpayers is minimal. Accordingly, a Regulatory Flexibility

Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 14, 2002, at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must use the main building entrance on Constitution Avenue, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by February 21, 2002.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Paul F. Handleman, Office of the Associate Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805* * *

Section 1.45D–1 also issued under 26 U.S.C. 45D(i); * * *

Par. 2. Section 1.45D–1 is added to read as follows:

§ 1.45D–1 New markets tax credit.

[The text of proposed § 1.45D–1 is the same as the text of § 1.45D–1T published elsewhere in T.D. 8971].

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 21, 2001, 8:45 a.m., and published in the issue of the Federal Register for December 26, 2001, 66 F.R. 66376)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as"rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Intemal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.