

§ 1.461-1 General rule for taxable year of deduction.

(a) *General rule*—(1) *Taxpayer using cash receipts and disbursements method.* Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures. See section 467 and the regulations thereunder for rules under which a liability arising out of the use of property pursuant to a section 467 rental agreement is taken into account.

(2) *Taxpayer using an accrual method*—(i) *In general.* Under an accrual method of accounting, a liability (as defined in § 1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of

the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of this section for examples of liabilities that may not be taken into account until a taxable year subsequent to the taxable year incurred, and see §§ 1.461-4 through 1.461-6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that the deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of § 1.263A-1(c)(3)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and guidance published by the Secretary. The principles of this paragraph (a)(2) also apply in the calculation of earnings and profits and accumulated earnings and profits.

(ii) *Uncertainty as to the amount of a liability.* While no liability shall be taken into account before economic performance and all of the events that fix the liability have occurred, the fact that the exact amount of the liability cannot be determined does not prevent a taxpayer from taking into account that portion of the amount of the liability which can be computed with reasonable accuracy within the taxable year. For example, A renders services to B during the taxable year for which A charges \$10,000. B admits a liability to A for \$6,000 but contests the remainder. B may take into account only \$6,000 as an expense for the taxable year in which the services were rendered.

(iii) *Alternative timing rules.* (A) If any provision of the Code requires a liability to be taken into account in a taxable year later than the taxable year provided in paragraph (a)(2)(i) of this section, the liability is taken into account as prescribed in that Code provision. See, for example, section 267 (transactions between related parties) and section 464 (farming syndicates).

(B) If the liability of a taxpayer is subject to section 170 (charitable contributions), section 192 (black lung benefit trusts), section 194A (employer liability trusts), section 468 (mining and solid waste disposal reclamation and closing costs), or section 468A (certain nuclear decommissioning costs), the liability is taken into account as determined under that section and not under section 461 or the regulations thereunder. For special rules relating to certain loss deductions, see sections 165(e), 165(i), and 165(l), relating to theft losses, disaster losses, and losses from certain deposits in qualified financial institutions.

(C) Section 461 and the regulations thereunder do not apply to any amount allowable under a provision of the Code as a deduction for a reserve for estimated expenses.

(D) Except as otherwise provided in any Internal Revenue regulations, revenue procedure, or revenue ruling, the economic performance requirement of section 461(h) and the regulations thereunder is satisfied to the extent that any amount is otherwise deductible under section 404 (employer contributions to a plan of deferred compensation), section 404A (certain foreign deferred compensation plans), or section 419 (welfare benefit funds). See § 1.461-4(d)(2)(iii).

(E) Except as otherwise provided by regulations or other published guidance issued by the Commissioner (See § 601.601(b)(2) of this chapter), in the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, the all events test (including economic performance) is considered met in the taxable year in which the liability is to be taken into account under section 467 and the regulations thereunder.

(3) *Effect in current taxable year of improperly accounting for a liability in a*

prior taxable year. Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year generally cannot be used to reduce the income of a subsequent year. A taxpayer may not take into account in a return for a subsequent taxable year liabilities that, under the taxpayer's method of accounting, should have been taken into account in a prior taxable year. If a taxpayer ascertains that a liability should have been taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a liability was improperly taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file an amended return and pay any additional tax due. However, except as provided in section 905(c) and the regulations thereunder, if a liability is properly taken into account in an amount based on a computation made with reasonable accuracy and the exact amount of the liability is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year.

(4) *Deductions attributable to certain foreign income.* In any case in which, owing to monetary, exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in gross income of the taxpayer for that year, the deductions and credits properly chargeable against the amount so restricted shall not be deductible in such year but shall be deductible proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See paragraph (b) of § 1.905-1 for rules relating to credit for foreign income taxes when foreign income is subject to exchange controls.

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

there shall be deducted only amounts properly deductible under the method of accounting used by the taxpayer. However, if the taxpayer used an accrual method of accounting, no deduction shall be allowed for amounts accrued only by reason of his death. For rules relating to the inclusion of items of partnership deduction, loss, or credit in the return of a decedent partner, see subchapter K, chapter 1 of the Code, and the regulations thereunder.

(c) *Accrual of real property taxes*—(1) *In general.* If the accrual of real property taxes is proper in connection with one of the methods of accounting described in section 461(c), any taxpayer using such a method of accounting may elect to accrue any real property tax, which is related to a definite period of time, ratably over that period in the manner described in this paragraph. For example, assume that such an election is made by a calendar-year taxpayer whose real property taxes, applicable to the period from July 1, 1955, to June 30, 1956, amount to \$1,200. Under section 461(c), \$600 of such taxes accrue in the calendar year 1955, and the balance accrues in 1956. For special rule in the case of certain contested real property taxes in respect of which the taxpayer transfers money or other property to provide for the satisfaction of the contested tax, see § 1.461-2. For general rules relating to deductions for taxes, see section 164 and the regulations thereunder.

(2) *Special rules*—(i) *Effective date.* Section 461(c) and this paragraph do not apply to any real property tax allowable as a deduction under the Internal Revenue Code of 1939 for any taxable year beginning before January 1, 1954.

(ii) If real property taxes which relate to a period prior to the taxpayer's first taxable year beginning on or after January 1, 1954, would, but for section 461(c), be deductible in such first taxable year, the portion of such taxes which applies to the prior period is deductible in such first taxable year (in addition to the amount allowable under section 461(c)(1)).

(3) *When election may be made*—(i) *Without consent.* A taxpayer may elect to accrue real property taxes ratably in accordance with section 461(c) and this

paragraph without the consent of the Commissioner for his first taxable year beginning after December 31, 1953, and ending after August 16, 1954, in which the taxpayer incurs real property taxes. Such election must be made not later than the time prescribed by law for filing the return for such year (including extensions thereof). An election may be made by the taxpayer for each separate trade or business (and for nonbusiness activities, if accounted for separately). Such an election shall apply to all real property taxes of the trade, business, or nonbusiness activity for which the election is made. The election shall be made in a statement submitted with the taxpayer's return for the first taxable year to which the election is applicable. The statement should set forth:

(a) The trades or businesses, or non-business activity, to which the election is to apply, and the method of accounting used therein;

(b) The period of time to which the taxes are related; and

(c) The computation of the deduction for real property taxes for the first year of the election (or a summary of such computation).

(ii) *With consent.* A taxpayer may elect with the consent of the Commissioner to accrue real property taxes ratably in accordance with section 461(c) and this paragraph. A written request for permission to make such an election shall be submitted to the Commissioner of Internal Revenue, Washington, D.C. 20224, within 90 days after the beginning of the taxable year to which the election is first applicable, or before March 26, 1958, whichever date is later. The request for permission shall state:

(a) The name and address of the taxpayer;

(b) The trades or businesses, or non-business activity, to which the election is to apply, and the method of accounting used therein;

(c) The taxable year to which the election first applies;

(d) The period to which the real property tax relate;

(e) The computation of the deduction for real property taxes for the first year of election (or a summary of such computation); and

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(f) An adequate description of the manner in which all real property taxes were deducted in the year prior to the year of election.

(4) *Binding effect of election.* An election to accrue real property taxes ratably under section 461(c) is binding upon the taxpayer unless the consent of the Commissioner is obtained under section 446(e) and paragraph (e) of § 1.446-1 to change such method of deducting real property taxes. If the last day prescribed by law for filing a return for any taxable year (including extensions thereof) to which section 461(c) is applicable falls before March 25, 1958, consent is hereby given for the taxpayer to revoke an election previously made to accrue real property taxes in the manner prescribed by section 461(c). If the taxpayer revokes his election under the preceding sentence, he must, on or before March 25, 1958, notify the district director for the district in which the return was filed of such revocation. For any taxable year for which such revocation is applicable, an amended return reflecting such revocation shall be filed on or before March 25, 1958.

(5) *Apportionment of taxes on real property between seller and purchaser.* For apportionment of taxes on real property between seller and purchaser, see section 164(d) and the regulations thereunder.

(6) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). A taxpayer on an accrual method reports his taxable income for the taxable year ending June 30. He elects to accrue real property taxes ratably for the taxable year ending June 30, 1955 (which is his first taxable year beginning on or after January 1, 1954). In the absence of an election under section 461(c), such taxes would accrue on January 1 of the calendar year to which they are related. The real property taxes are \$1,200 for 1954; \$1,600 for 1955; and \$1,800 for 1956. Deductions for such taxes for the fiscal years ending June 30, 1955, and June 30, 1956, are computed as follows:

FISCAL YEAR ENDING JUNE 30, 1955	
July through December 1954	¹ None
January through June 1955 (½ of \$1,600)	\$800
Deduction for fiscal year ending June 30, 1955	800

¹The taxes for 1954 were deductible in the fiscal year ending June 30, 1954, since such taxes accrued on January 1, 1954.

FISCAL YEAR ENDING JUNE 30, 1956	
July through December 1955 (½ of \$1,600)	\$800
January through June 1956 (½ of \$1,800)	900

Deduction for fiscal year ending June 30, 1956

Example (2). A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461(c), such taxes would accrue on July 1 and are assessed for the 12-month period beginning on that date. The real property taxes assessed for the year ending June 30, 1954, are \$1,200; \$1,600 for the year ending June 30, 1955; and \$1,800 for the year ending June 30, 1956. Deductions for such taxes for the calendar years 1954 and 1955 are computed as follows:

YEAR ENDING DECEMBER 31, 1954	
January through June 1954	¹ None
July through December 1954 (½ of \$1,600)	\$800

Deduction for year ending December 31, 1954

¹The entire tax of \$1,200 for the year ended June 30, 1954, was deductible in the return for 1953, since such tax accrued on July 1, 1953.

YEAR ENDING DECEMBER 31, 1955	
January through June 1955 (½ of \$1,600)	\$800
July through December 1955 (½ of \$1,800)	900

Deduction for year ending December 31, 1955

Example (3). A calendar-year taxpayer on an accrual method elects to accrue real property taxes ratably for 1954. In the absence of an election under section 461(c), such taxes, which relate to the calendar year 1954, are accruable on December 1 of the preceding calendar year. No deduction for real property taxes is allowable for the taxable year 1954 since such taxes accrued in the taxable year 1953 under section 23(c) of the Internal Revenue Code of 1939.

Example (4). A taxpayer on an accrual method reports his taxable income for the taxable year ending March 31. He elects to accrue real property taxes ratably for the taxable year ending March 31, 1955. In the absence of an election under section 461(c), such taxes are accruable on June 1 of the calendar year to which they relate. The real property taxes are \$1,200 for 1954; \$1,600 for 1955; and \$1,800 for 1956. Deductions for such taxes for the taxable years ending March 31, 1955, and March 31, 1956, are computed as follows:

FISCAL YEAR ENDING MARCH 31, 1955	
April through December 1954 (½ of \$1,200)	\$900
January through March 1955 (½ of \$1,600)	400

Taxes accrued ratably in fiscal year ending March 31, 1955	1,800
Tax relating to period January through March 1954, paid in June 1954, and not deductible in prior taxable year (½ of \$1,200)	300

Deduction for fiscal year ending March 31, 1955

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FISCAL YEAR ENDING MARCH 31, 1956	
April through December 1955 (3/12 of \$1,600)	\$1,200
January through March 1956 (3/12 of \$1,800)	450

Deduction for fiscal year ending March 31, 1956	1,650
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Example (5). The facts are the same as in example (4) except that in June 1955, when the taxpayer pays his \$1,600 real property taxes for 1955, he pays \$400 of such amount under protest. Deductions for taxes for the taxable years ending March 31, 1955, and March 31, 1956, are computed as follows:

FISCAL YEAR ENDING MARCH 31, 1955	
April through December 1954 (9/12 of \$1,200)	\$900
January through March 1955 (3/12 of \$1,200, that is, \$1,600 minus \$400 (the contested portion which is not properly accruable))	300

Taxes accrued ratably in fiscal year ending March 31, 1955	1,200
Tax relating to period January through March 1954, paid in June 1954, and not deductible in prior taxable years (3/12 of \$1,200)	300

Deduction for fiscal year ending March 31, 1955	1,500
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FISCAL YEAR ENDING MARCH 31, 1956	
April through December 1955 (9/12 of \$1,200)	\$900
January through March 1956 (3/12 of \$1,800)	450

Taxes accrued ratably in fiscal year ending March 31, 1956	1,350
Contested portion of tax relating to period January through December 1955, paid in June 1955, and deductible, under section 461(f), for taxpayer's fiscal year ending March 31, 1956	400

Deduction for fiscal year ending March 31, 1956	1,750
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(d) *Limitation on acceleration of accrual of taxes.* (1) Section 461(d)(1) provides that, in the case of a taxpayer whose taxable income is computed under an accrual method of accounting, to the extent that the time for accruing taxes is earlier than it would be but for any action of any taxing jurisdiction taken after December 31, 1960, such taxes are to be treated as accruing at the time they would have accrued but for such action. Any such action which, but for the provisions of section 461(d) and this paragraph, would accelerate the time for accruing a tax is to be disregarded in determining the time for accruing such tax for purposes of the deduction allowed for such tax. Such action is to be disregarded not only with respect to a taxpayer (whose taxable income is computed under an accrual method of accounting) upon whom the tax is im-

posed at the time of the action, but also with respect to such a taxpayer upon whom the tax is imposed at any time subsequent to such action. Thus, in the case of a tax imposed on property, the acceleration of the time for accruing taxes is to be disregarded not only with respect to the taxpayer who owned the property at the time of such acceleration, but also with respect to any subsequent owner of the property whose taxable income is computed under an accrual method of accounting. Similarly, such action is to be disregarded with respect to all property subject to such tax, even if such property is acquired after the action. Whenever the time for accruing taxes is to be disregarded in accordance with the provisions of this paragraph, the taxpayer shall accrue the tax at the time (original accrual date) the tax would have accrued but for such action, and shall, in the absence of any action of the taxing jurisdiction placing the time for accruing such tax at a time subsequent to the original accrual date, continue to accrue the tax as of the original accrual date for all future taxable years.

(2) For purposes of this paragraph—

(i) The term “a taxpayer whose taxable income is computed under an accrual method of accounting” means a taxpayer who, for Federal income tax purposes, accounts for any tax which is the subject of “any action” (as defined in subdivision (iii) of this subparagraph) under an accrual method of accounting. See section 446 and the regulations thereunder. If a taxpayer uses an accrual method as his overall method of accounting, it shall be presumed that he is “a taxpayer whose taxable income is computed under an accrual method of accounting.” However, if the taxpayer establishes to the satisfaction of the district director that he has, for Federal income tax purposes, consistently accounted for such tax under the cash method of accounting, he shall be considered not to be “a taxpayer whose taxable income is computed under an accrual method of accounting.”

(ii) The time for accruing taxes shall be determined under section 461 and the regulations in this section.

(iii) The term “any action” includes the enactment or reenactment of legislation, the adoption of an ordinance, the exercise of any taxing or administrative authority, or the taking of any other step, the result of which is an acceleration of the accrual event of any tax. The term also applies to the substitution of a substantially similar tax by either the original taxing jurisdiction or a substitute jurisdiction. However, the term does not include either a judicial interpretation, or an administrative determination by the Internal Revenue Service, as to the event which fixes the accrual date for the tax.

(iv) The term “any taxing jurisdiction” includes the District of Columbia, any State, possession of the United States, city, county, municipality, school district, or other political subdivision or authority, other than the United States, which imposes, assesses, or collects a tax.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). State X imposes a tax on intangible and tangible personal property used in a trade or business conducted in the State. The tax is assessed as of July 1, and becomes a lien as of that date. As a result of administrative and judicial decisions, July 1 is recognized as the proper date on which accrual method taxpayers may accrue their personal property tax for Federal income tax purposes. In 1961 State X, by legislative action, changes the assessment and lien dates from July 1, 1962, to December 31, 1961, for the property tax year 1962. The action taken by State X is considered to be “any action” of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action. Therefore, for purposes of the deduction allowed for such tax, the personal property tax imposed by State X, for the property tax year 1962, shall be treated as though it accrued on July 1, 1962.

Example (2). Assume the same facts as in example (1) except that State X repeals the personal property tax and in lieu thereof enacts a franchise tax which is imposed on the privilege of conducting a trade or business within State X, and is based on the value of intangible and tangible personal property used in the trade or business. The franchise tax is to be assessed and will become a lien as of December 31, 1961, for the franchise tax year 1962, and on December 31 for all subsequent franchise tax years. Since the franchise tax is substantially similar to the former personal property tax and since the

enactment of the franchise tax has the effect of accelerating the accrual date of the personal property tax from July 1, 1962, to December 31, 1961, the action taken by State X is considered to be “any action” of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action. Therefore, for purposes of the deduction allowed for such tax, the franchise tax imposed by State X shall be treated as though it accrued on July 1, 1962, for the franchise tax year 1962, and on July 1 for all subsequent franchise tax years.

Example (3). Assume the same facts as in example (1) except that State X repealed the personal property tax and empowered the counties within the State to impose a personal property tax. Assuming the counties in State X subsequently imposed a personal property tax and chose December 31 of the preceding year as the assessment and lien date, the action of each of the counties would be considered to be “any action” of a taxing jurisdiction which results in the time for accruing taxes being earlier than it would have been but for that action since it is immaterial whether the original taxing jurisdiction or a substitute jurisdiction took the action.

(4) Section 461(d)(1) shall not be applicable to the extent that it would prevent the taxpayer and all other persons, including successors in interest, from ever taking into account, for Federal income tax purposes, any tax to which that section would otherwise apply. For example, assume that State Y imposes a personal property tax on tangible personal property used in a trade or business conducted in the State during a calendar year. The tax is assessed as of February 1 of the year following the personal property tax year, and becomes a lien as of that date. As a result of administrative and judicial decisions, February 1 of the following year is recognized as the proper date on which accrual method taxpayers may accrue the personal property tax for Federal income tax purposes. In 1962 State Y, by legislative action, changes the assessment and lien dates for the personal property tax year 1962 from February 1, 1963, to December 1, 1962, and to December 1 of the personal property tax year for all subsequent years. Corporation A, an accrual method taxpayer which uses the calendar year as its taxable year, pays the tax for 1962 on December 10, 1962. On December 15, 1962, the property

which was taxed is completely destroyed and, on December 20, 1962, corporation A transfers all of its remaining assets to its shareholders, and is dissolved. Since corporation A is not in existence in 1963, and therefore could not take the personal property tax into account in computing its 1963 Federal income tax if February 1, 1963, is considered to be the time for accruing the tax, and no other person could ever take such tax into account in computing his Federal income tax, such tax shall be treated as accruing as of December 1, 1962. To the extent that any person other than the taxpayer may at any time take such tax into account in computing his taxable income, the provisions of section 461(d)(1) shall apply. Thus, upon the dissolution of a corporation or the termination of a partnership between the time which, but for the provisions of section 461(d)(1) and this paragraph, would be the time for accruing any tax which was the subject of "any action" (as defined in subdivision (iii) of subparagraph (2)), and the original accrual date, the corporation or the partnership would be entitled to a deduction for only that portion, if any, of such tax with respect to which it can establish, to the satisfaction of the district director, that no other taxpayer can properly take into account in computing his taxable income. However, to the extent that the corporation or partnership cannot establish, at the time of its dissolution or termination, as the case may be, that no other taxpayer would be entitled to take such tax into account in computing his taxable income, and it is subsequently determined that no other taxpayer is entitled to take such tax into account in computing his taxable income, the corporation or partnership may file a claim for refund for the year of its dissolution or termination (subject to the limitations prescribed in section 6511) and claim as a deduction therein the portion of such tax determined to be not deductible by any other taxpayer.

(5) Section 461(d) and this paragraph shall apply to taxable years ending after December 31, 1960.

(e) *Dividends or interest paid by certain savings institutions on certain deposits or withdrawable accounts—(1) Deduction*

not allowable—(i) In general. Except as otherwise provided in this paragraph, pursuant to section 461(e) amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts (if such amounts paid or credited are withdrawable on demand subject only to customary notice to withdraw) by a mutual savings bank not having capital stock represented by shares, a domestic building and loan association, or a cooperative bank shall not be allowed as a deduction for the taxable year to the extent such amounts are paid or credited for periods representing more than 12 months. The provisions of section 461(e) are applicable with respect to taxable years ending after December 31, 1962. Whether amounts are paid or credited for periods representing more than 12 months depends upon all the facts and circumstances in each case. For example, payments or credits which under all the facts and circumstances are in the nature of bona fide bonus interest or dividends paid or credited because a shareholder or depositor maintained a certain balance for more than 12 months, will not be considered made for more than 12 months, providing the regular payments or credits represent a period of 12 months or less. The non-allowance of a deduction to the taxpayer under section 461(e) and this subparagraph has no effect either on the proper time for reporting dividends or interest by a depositor or holder of a withdrawable account, or on the obligation of the taxpayer to make a return setting forth, among other things, the aggregate amounts paid to a depositor or shareholder under section 6049 (relating to returns regarding payments of interest) and the regulations thereunder. With respect to a short period (a taxable year consisting of a period of less than 12 months), amounts of dividends or interest paid or credited shall not be allowed as a deduction to the extent that such amounts are paid or credited for a period representing more than the number of months in such short period. In such a case, the rules contained in section 461(e) and this paragraph apply to the short period in a manner consistent with the

application of such rules to a 12-month taxable year. Subparagraph (2) of this paragraph provides rules for computing amounts not allowed in the taxable year and subparagraph (3) provides rules for determining when such amounts are allowed. See section 7701(a) (19) and (32) and the regulations thereunder for the definitions of domestic building and loan association and cooperative bank.

(ii) *Exceptions.* The rule of nonallowance set forth in subdivision (i) of this subparagraph is not applicable to a taxpayer in the year in which it liquidates (other than following, or as part of, an acquisition of its assets in which the acquiring corporation, pursuant to section 381(a), takes into account certain items of the taxpayer, which for purposes of this paragraph shall be referred to as an acquisition described in section 381(a)). In addition, such rule of nonallowance is not applicable to a taxpayer which pays or credits grace interest or dividends to terminating depositors or shareholders, provided the total amount of the grace interest or dividends paid or credited during the payment or crediting period (for example, a quarterly or semi-annual period) does not exceed 10 percent of the total amount of the interest or dividends paid or credited during such period, computed without regard to the grace interest or dividends. For example, providing the 10 percent limitation is met, the rule of nonallowance does not apply in a case in which a calendar year taxpayer, with regular interest payment dates of January 1, April 1, July 1, and October 1, pays grace interest for the period beginning October 1 to a depositor who terminates his account on December 10.

(2) *Computation of amounts not allowed as a deduction—(i) Method of computation.* The amount of the dividends or interest to which subparagraph (1) of this paragraph applies, which is not allowed as a deduction, shall be computed under the rules of this subparagraph. The amount which is not allowed as a deduction is the difference between the total amount of dividends or interest paid or credited to that class of accounts with respect to which a deduction is not allowed under subparagraph (1) of this paragraph during the taxable

year (or short period, if applicable) and an amount which bears the same ratio to such total as the number 12 (or number of months in the short period) bears to the number of months with respect to which such amounts of dividends or interest are paid or credited.

(ii) *Examples.* The provisions of subdivision (i) of this subparagraph may be illustrated by the following examples:

Example (1). X Association, a domestic building and loan association filing its return on the basis of a calendar year, regularly credits dividends on its withdrawable accounts quarterly on the first day of the quarter following the quarter with respect to which they are earned. X changes the time of crediting dividends commencing with the credit for the fourth quarter of 1964. Such credit and all subsequent credits are made on the last day of the quarter with respect to which they are earned. As a result of this change X's credits for the year 1964 are as follows:

Period with respect to which earned	Date credited in 1964	Amt.
4th quarter, 1963	Jan. 1	\$250,000
1st quarter, 1964	Apr. 1	300,000
2d quarter, 1964	July 1	300,000
3d quarter, 1964	Oct. 1	300,000
4th quarter, 1964	Dec. 31	350,000
Total dividends credited		1,500,000

Since the change in the time of crediting dividends results in the crediting in 1964 of amounts of dividends representing periods totaling 15 months (October 1963 through December 1964), amounts shall not be allowed as a deduction in 1964 which are in excess of \$1,200,000, which is the amount which bears the same ratio to the amounts of dividends credited during the year (\$1,500,000) as the number 12 bears to the number of months (15) with respect to which such dividends are credited. Thus, \$300,000 (\$1,500,000 minus \$1,200,000) is not allowed as a deduction in 1964.

Example (2). Y Association, a domestic building and loan association filing its return on the basis of a calendar year, regularly credits dividends on its withdrawable accounts on the basis of a semiannual period on March 31 and September 30 of each year. Y changes the period with respect to which credits are made from the semiannual period to the quarterly basis, commencing with the last quarter in 1964. The credit for this last quarter and all subsequent credits are made on the last day of the quarter with respect to which they are earned. As a result of this change, Y's credits for the year 1964 are as follows:

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Period with respect to which earned	Date credited in 1964	Amt.
6-month period ending Mar. 31, 1964.	Mar. 31	\$300,000
6-month period ending Sept. 30, 1964.	Sept. 30	400,000
4th quarter, 1964	Dec. 31	200,000
Total dividends credited		900,000

Since the change in the basis of crediting dividends results in a crediting in 1964 of dividends representing periods totaling 15 months (October 1963 through December 1964), amounts shall not be allowed as a deduction in 1964 which are in excess of \$720,000, which is the amount which bears the same ratio to the amounts of dividends credited during the year (\$900,000) as the number 12 bears to the number of months (15) with respect to which such dividends are credited. Thus, \$180,000 (\$900,000 minus \$720,000) is not allowed as a deduction in 1964.

Example (3). Z Association, a domestic building and loan association regularly files its return on the basis of a fiscal year ending on the last day of February and regularly credits dividends on its withdrawable accounts quarterly on the last day of the quarter with respect to which they are earned. Z receives approval from the Commissioner of Internal Revenue to change its accounting period to a calendar year and effects the change by filing a return for a short period ending on December 31, 1964. Dividend credits for the short period beginning on March 1 and ending on December 31, 1964, are as follows:

Period with respect to which earned	Date credited in 1964	Amt.
January-March 1964	Mar. 31	\$250,000
April-June 1964	June 30	300,000
July-September 1964	Sept. 30	300,000
October-December 1964	Dec. 31	350,000
Total dividends credited		1,200,000

Since the change of accounting period results in amounts of dividends credited (\$1,200,000) representing periods totaling 12 months (January through December 1964), and such periods represent more than the number of months (10) in the short period, an amount shall not be allowed as a deduction in such short period which is in excess of \$1,000,000, which is the amount which bears the same ratio to the amount of dividends credited in the short period (\$1,200,000) as the number of months (10) in the short period bears to the number of months (12) with respect to which such dividends are credited. Thus, \$200,000 (\$1,200,000 minus \$1,000,000) is not allowed as a deduction in the short period.

(3) *When amounts allowable.* The amount of dividends or interest not allowed as a deduction under subpara-

graph (1) of this paragraph shall be allowed as follows (subject to the limitation that the total of the amounts so allowed shall not exceed the amount not allowed under subparagraph (1)):

(i) Such amount shall be allowed as a deduction in a later taxable year or years subject to the limitation that, when taken together with the deductions otherwise allowable in the later taxable year or years, it does not bring the deductions for any later taxable year to a total representing a period of more than 12 months (or number of months in the short period, if applicable). However, in any event, an amount otherwise allowable under subdivision (ii) of this subparagraph shall be allowed notwithstanding the fact that it may bring the deductions allowable to a total representing a period of more than 12 months (or number of months in the short period, if applicable).

(ii) In any case in which it is established to the satisfaction of the Commissioner that the taxpayer does not intend to avoid taxes, one-tenth of such amount shall be allowed as a deduction in each of the 10 succeeding taxable years—

(a) Commencing with the taxable year for which such amount is not allowed as a deduction under subparagraph (1), or

(b) In the case of such amount not allowed for a taxable year ending before July 1, 1964, commencing with either the first or second taxable year after the taxable year for which such amount is not allowed as a deduction under subparagraph (1) if the taxpayer has not taken a deduction on his return, or filed a claim for credit or refund, in respect of such amount under (a).

Normally, if the deduction not allowed under subparagraph (1) is a result of a change, not requested by the taxpayer, in the taxpayer's annual accounting period or dividend or interest payment or crediting dates solely as a consequence of a requirement of a Federal or State regulatory authority, or if the deduction is not allowed solely as a result of the taxpayer being a party to an acquisition to which section 381(a) applies, the Commissioner will permit the allowance of the amount not allowed in the manner provided in this

subdivision. Nothing set forth in this subdivision shall be construed as permitting the allowance of a credit or refund for any year which is barred by the limitations on credit or refund provided by section 6511.

(iii) If the total of the amounts, if any, allowed under subdivisions (i) and (ii) of this subparagraph before the taxable year in which the taxpayer liquidates or otherwise ceases to engage in trade or business is less than the amount not allowed under subparagraph (1), there shall be allowed a deduction in such taxable year for the difference between the amount not allowed under subparagraph (1) and the amounts allowed, if any, as deductions under subdivisions (i) and (ii) unless the circumstances under which the taxpayer ceased to do business constitute an acquisition described in section 381(a) (relating to carryovers in certain corporate acquisitions). If the circumstances under which the taxpayer ceased to do business constitute an acquisition described in section 381(a), the acquiring corporation shall succeed to and take into account the balance of the amounts not allowed on the same basis as the taxpayer, had it not ceased to engage in business.

[T.D. 6500, 25 FR 11720, Nov. 26, 1960, as amended by T.D. 6520, 25 FR 13692, Dec. 24, 1960; T.D. 6710, 29 FR 3473, Mar. 18, 1964; T.D. 6735, 29 FR 6494, May 19, 1964; T.D. 6772, 29 FR 15753, Nov. 24, 1964; T.D. 6917, 32 FR 6682, May 2, 1967; T.D. 8408, 57 FR 12420, Apr. 10, 1992; T.D. 8482, 58 FR 42233, Aug. 9, 1993; T.D. 8554, 59 FR 36360, July 18, 1994; T.D. 8820, 64 FR 26851, May 18, 1999]

§ 1.461-2 Contested liabilities.

(a) *General rule*—(1) *Taxable year of deduction.* If—

(i) The taxpayer contests an asserted liability,

(ii) The taxpayer transfers money or other property to provide for the satisfaction of the asserted liability,

(iii) The contest with respect to the asserted liability exists after the time of the transfer, and

(iv) But for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or, in the case of an accrual method taxpayer, for an earlier

taxable year for which such amount would be accruable),

then the deduction with respect to the contested amount shall be allowed for the taxable year of the transfer.

(2) *Exception.* Subparagraph (1) of this paragraph shall not apply in respect of the deduction for income, war profits, and excess profits taxes imposed by the authority of any foreign country or possession of the United States, including a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

(3) *Refunds includible in gross income.* If any portion of the contested amount which is deducted under subparagraph (1) of this paragraph for the taxable year of transfer is refunded when the contest is settled, such portion is includible in gross income except as provided in § 1.111-1, relating to recovery of certain items previously deducted or credited. Such refunded amount is includible in gross income for the taxable year of receipt, or for an earlier taxable year if properly accruable for such earlier year.

(4) *Examples.* The provisions of this paragraph are illustrated by the following examples:

Example (1). X Corporation, which uses an accrual method of accounting, in 1964 contests \$20 of a \$100 asserted real property tax liability but pays the entire \$100 to the taxing authority. In 1968, the contest is settled and X receives a refund of \$5. X deducts \$100 for the taxable year 1964, and includes \$5 in gross income for the taxable year 1968 (assuming § 1.111-1 does not apply to such amount). If in 1964 X pays only \$80 to the taxing authority, X deducts only \$80 for 1964. The result would be the same if X Corporation used the cash method of accounting.

Example (2). Y Corporation makes its return on the basis of a calendar year and uses an accrual method of accounting. Y's real property taxes are assessed and become a lien on December 1, but are not payable until March 1 of the following year. On December 10, 1964, Y contests \$20 of the \$100 asserted real property tax which was assessed and became a lien on December 1, 1964. On March 1, 1965, Y pays the entire \$100 to the taxing authority. In 1968, the contest is settled and Y receives a refund of \$5. Y deducts \$80 for the taxable year 1964, deducts \$20 for the taxable year 1965, and includes \$5 in gross income for the taxable year 1968 (assuming § 1.111-1 does not apply to such amount).