

with reference only to the net dollar balances in that particular account.

(2) If a change in method of accounting is voluntary (i.e., initiated by the taxpayer), the entire amount of the adjustments required by section 481(a) is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income. See, however, §§ 1.446-1(e)(3) and 1.481-4 which provide that the Commissioner may prescribe the taxable year or years in which the adjustments are taken into account.

(3) If the change in method of accounting is involuntary (i.e., not initiated by the taxpayer), then only the amount of the adjustments required by section 481(a) that is attributable to taxable years beginning after December 31, 1953, and ending after August 16, 1954, (hereinafter referred to as post-1953 years) is taken into account. This amount is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income. See, however, §§ 1.446-1(e)(3) and 1.481-4 which provide that the Commissioner may prescribe the taxable year or years in which the adjustments are taken into account. See also § 1.481-3 for rules relating to adjustments attributable to pre-1954 years.

(4) For any adjustments attributable to post-1953 years that are taken into account entirely in the year of change and that increase taxable income by more than \$3,000, the limitations on tax provided in section 481(b) (1) or (2) apply. See § 1.481-2 for rules relating to the limitations on tax provided by sections 481(b) (1) and (2).

(5) A change in the method of accounting initiated by the taxpayer includes not only a change which he originates by securing the consent of the Commissioner, but also a change from one method of accounting to another made without the advance approval of the Commissioner. A change in the taxpayer's method of accounting required as a result of an examination of the taxpayer's income tax return will not be considered as initiated by the taxpayer. On the other hand, a taxpayer who, on his own initiative,

changes his method of accounting in order to conform to the requirements of any Federal income tax regulation or ruling shall not, merely because of such fact, be considered to have made an involuntary change.

(d) Any adjustments required under section 481(a) that are taken into account during a taxable year must be properly taken into account for purposes of computing gross income, adjusted gross income, or taxable income in determining the amount of any item of gain, loss, deduction, or credit that depends on gross income, adjusted gross income, or taxable income.

[T.D. 6500, 25 FR 11731, Nov. 26, 1960, as amended by T.D. 8608, 60 FR 40078, Aug. 7, 1995]

#### § 1.481-2 Limitation on tax.

(a) *Three-year allocation.* Section 481(b)(1) provides a limitation on the tax under chapter 1 of the Internal Revenue Code for the taxable year of change that is attributable to the adjustments required under section 481(a) and § 1.481-1 if the entire amount of the adjustments is taken into account in the year of change. If such adjustments increase the taxpayer's taxable income for the taxable year of the change by more than \$3,000, then the tax for such taxable year that is attributable to the adjustments shall not exceed the lesser of the tax attributable to taking such adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and § 1.481-1, or the aggregate of the increases in tax that would result if the adjustments were included ratably in the taxable year of the change and the two preceding taxable years. For the purpose of computing the limitation on tax under section 481(b)(1), the adjustments shall be allocated ratably to the taxable year of the change and the two preceding taxable years, whether or not the adjustments are in fact attributable in whole or in part to such years. The limitation on the tax provided in this paragraph shall be applicable only if the taxpayer used the method of accounting from which the change was made in computing taxable income for the two taxable years preceding the taxable year of the change.

(b) *Allocation under new method of accounting.* Section 481(b)(2) provides a second alternative limitation on the tax for the taxable year of change under chapter 1 of the Internal Revenue Code that is attributable to the adjustments required under section 481(a) and § 1.481-1 where such adjustments increase taxable income for the taxable year of change by more than \$3,000. If the taxpayer establishes from his books of account and other records what his taxable income would have been under the new method of accounting for one or more consecutive taxable years immediately preceding the taxable year of the change, and if the taxpayer in computing taxable income for such years used the method of accounting from which the change was made, then the tax attributable to the adjustments shall not exceed the smallest of the following amounts:

(1) The tax attributable to taking the adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and § 1.481-1;

(2) The tax attributable to such adjustments computed under the 3-year allocation provided in section 481(b)(1), if applicable; or

(3) The net increase in the taxes under chapter 1 (or under corresponding provisions of prior revenue laws) which would result from allocating that portion of the adjustments to the one or more consecutive preceding taxable years to which properly allocable under the new method of accounting and from allocating the balance thereof to the taxable year of the change.

(c) *Rules for computation of tax.* (1) The first step in determining whether either of the limitations described in section 481(b) (1) or (2) applies is to compute the increase in tax for the taxable year of the change that is attributable to the increase in taxable income for such year resulting solely from the adjustments required under section 481(a) and § 1.481-1. This increase in tax is the excess of the tax for the taxable year computed by taking into account such adjustments under section 481(a) over the tax computed for such year without taking the adjustments into account.

(2) The next step is to compute under section 481(b)(1) the tax attributable to the adjustments referred to in paragraph (c)(1) of this section for the taxable year of the change and the two preceding taxable years as if an amount equal to one-third of the net amount of such adjustments had been received or accrued in each of such taxable years. The increase in tax attributable to the adjustments for each such taxable year is the excess of the tax for such year computed with the allocation of one-third of the net adjustments to such taxable year over the tax computed without the allocation of any part of the adjustments to such year. For the purpose of computing the aggregate increase in taxes for such taxable years, there shall be taken into account the increase or decrease in tax for any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(1) but which is affected by a net operating loss under section 172 or by a capital loss carryback or carryover under section 1212, determined with reference to taxable years with respect to which adjustments under section 481(b)(1) are allocated.

(3) In the event that the taxpayer satisfies the conditions set forth in section 481(b)(2), the next step is to determine the amount of the net increase in tax attributable to the adjustments referred to in paragraph (c)(1) of this section for:

(i) The taxable year of the change,

(ii) The consecutive taxable year or years immediately preceding the taxable year of the change for which the taxpayer can establish his taxable income under the new method of accounting, and

(iii) Any taxable year preceding the taxable year of the change to which no adjustment is allocated under section 481(b)(2), but which is affected by a net operating loss or by a capital loss carryback or carryover determined with reference to taxable years with respect to which such adjustments are allocated.

The net increase in tax for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph shall be computed as if the amount of the adjustments for the prior taxable years

to which properly allocable in accordance with section 481(b)(2) had been received or accrued, or paid or incurred, as the case may be, in such prior years and the balance of the adjustments in the taxable year of the change. The amount of tax attributable to such adjustments for the taxable years specified in subdivisions (i), (ii), and (iii) of this subparagraph is the aggregate of the differences (increases and decreases) between the tax for each such year computed by taking into account the allocable portion of the adjustments in computing taxable income and the tax computed without taking into account any portion of the adjustments in computing taxable income. Generally, where there is an increase in taxable income for a preceding consecutive taxable year established under the new method of accounting, computed without regard to adjustments attributable to any preceding taxable year, the amount of the adjustments to be allocated to each such year shall be an amount equal to such increase. However, where the amount of the adjustments to be allocated to a prior taxable year is less than the increase in taxable income for such year established under the new method of accounting, the amount of the increase in such taxable income for purposes of determining the increase in tax under section 481(b)(2) for such year shall be considered to be the amount so allocated. For example, if the amount of the adjustments required by section 481(a) for 1958 (the taxable year of the change) is \$60,000, and the increase in taxable income is determined by the taxpayer to be \$40,000, \$5,000, and \$35,000, computed under the new method of accounting, for the taxable years 1957, 1956, and 1955, respectively, then the amount of the adjustments to be allocated to 1955 will be the balance of the adjustments, or \$15,000.

(4) The tax for the taxable year of the change shall be the tax for such year, computed without taking any of the adjustments referred to in paragraph (c)(1) of this section into account, increased by the smallest of the following amounts—

(i) The amount of tax for the taxable year of the change attributable solely to taking into account the entire

amount of the adjustments required by section 481(a) and § 1.481-1;

(ii) The sum of the increases in tax liability for the taxable year of the change and the two immediately preceding taxable years that would have resulted solely from taking into account one-third of the amount of such adjustments required for each of such years as though such amounts had been properly attributable to such years (computed in accordance with paragraph (c)(2) of this section); or

(iii) The net increase in tax attributable to allocating such adjustments under the new method of accounting (computed in accordance with paragraph (c)(3) of this section).

(5)(i) In the case of a change in method of accounting by a partnership, the adjustments required by section 481 shall be made with respect to the taxable income of the partnership but the limitations on tax under section 481(b) shall apply to the individual partners. Each partner shall take into account his distributive share of the partnership items, as so adjusted, for the taxable year of the change. Section 481(b) applies to a partner whose taxable income is so increased by more than \$3,000 as a result of such adjustments to the partnership taxable income. It is not necessary for the partner to have been a member of the partnership for the two taxable years immediately preceding the taxable year of the change of the partnership's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a partner may apply section 481(b)(2) even though he was not a member of the partnership for all the taxable years affected by the computation thereunder.

(ii) In the case of a change in method of accounting by an electing small business corporation under subchapter S, chapter 1 of the Code, the adjustments required by section 481 shall be made with respect to the taxable income of such electing corporation in the year of the change, but the limitations on tax under section 481(b) shall apply to the individual shareholders. Section 481(b) applies to a shareholder of an electing small business corporation whose taxable income is so increased by more than \$3,000 as a result

of such adjustments to such corporation's taxable income. It is not necessary for the shareholder to have been a member of the electing small business corporation, or for such corporation to have been an electing small business corporation, for the two taxable years immediately preceding the taxable year of the change of the corporation's accounting method in order to have the limitation provided by section 481(b)(1) apply. Further, a shareholder may apply section 481(b)(2), even though he was not a shareholder, or the corporation was not an electing small business corporation, for all the taxable years affected by the computation thereunder.

(6) For the purpose of the successive computations of the limitations on tax under section 481(b) (1) or (2), if the treatment of any item under the provisions of the Internal Revenue Code of 1986 (or corresponding provisions of prior internal revenue laws) depends upon the amount of gross income, adjusted gross income, or taxable income (for example, medical expenses, charitable contributions, or credits against the tax), such item shall be determined for the purpose of each such computation by taking into account the proper portion of the amount of any adjustments required to be taken into account under section 481 in each such computation.

(7) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning section 1314(a) for such year.

(8) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to tax on self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(d) *Examples.* The application of section 481(b) (1) and (2) may be illustrated by the following examples. Although the examples in this paragraph are based upon adjustments required in the case of a change in the over-all method of accounting, the principles illustrated would be equally applicable to

adjustments required in the case of a change in method of accounting for a particular material item, provided the treatment of such adjustments is not specifically subject to some other provision of the Internal Revenue Code of 1986.

*Example (1).* An unmarried individual taxpayer using the cash receipts and disbursements method of accounting for the calendar year is required by the Commissioner to change to an accrual method effective with the year 1958. As of January 1, 1958, he had an opening inventory of \$11,000. On December 31, 1958, he had a closing inventory of \$12,500. Merchandise purchases during the year amounted to \$22,500, and net sales were \$32,000. Total deductible business expenses were \$5,000. There were no receivables or payables at January 1, 1958. The computation of taxable income for 1958, assuming no other adjustments, using the new method of accounting follows:

Net sales .....		\$32,000
Opening inventory .....	\$11,000	
Purchases .....	22,500	
	<hr/>	
Total .....	33,500	
Less closing inventory .....	12,500	
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Cost of goods sold .....		21,000
		<hr/>
Gross profit .....		11,000
Business expenses .....		5,000
		<hr/>
Business income .....		6,000
Personal exemption and itemized deductions .....		1,600
		<hr/>
Taxable income .....		4,400

Under the cash receipts and disbursements method of accounting, only \$9,000 of the \$11,000 opening inventory had been included in the cost of goods sold and claimed as a deduction for the taxable years 1954 through 1957; the remaining \$2,000 had been so accounted for in pre-1954 years. In order to prevent the same item from reducing taxable income twice, an adjustment of \$9,000 must be made to the taxable income of 1958 under the provisions of section 481(a) and § 1.481-1. Since the change in method of accounting was not initiated by the taxpayer, the \$2,000 of opening inventory which had been included in cost of goods sold in pre-1954 years is not taken into account. Taxable income for 1958 is accordingly increased by \$9,000 under section 481(a) to \$13,400. Assuming that the tax on \$13,400 is \$4,002 and that the tax on \$4,400 (income without the adjustment) is \$944, the increase in tax attributable to the adjustment, if taken into account for the taxable year of the change, would be the difference between the two, or \$3,058. Since the adjustment required by section 481(a) and § 1.481-1 (\$9,000) increases taxable income by more than \$3,000, the increase in tax for the

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taxable year 1958 attributable to the adjustment of \$9,000 (i.e., \$3,058) may be limited under the provisions of section 481(b) (1) or (2). See examples (2) and (3).

*Example (2).* Assume that the taxpayer in example (1) used the cash receipts and disbursements method of accounting in com-

puting taxable income for the years 1956 and 1957 and that the taxable income for these years determined under such method was \$4,000 and \$6,000, respectively. The section 481(b)(1) limitation on tax with a pro rata three-year allocation of the \$9,000 adjustment is computed as follows:

Taxable year	Taxable income before adjustment	Taxable income with adjustment	Assume total tax	Assumed tax before adjustment	Increase in tax attributable to adjustment
1956 .....	\$4,000	\$7,000	\$1,660	\$840	\$820
1957 .....	6,000	9,000	2,300	1,360	940
1958 .....	4,400	7,400	1,780	944	836
<b>Total .....</b>					<b>2,596</b>

Since this increase in tax of \$2,596 is less than the increase in tax attributable to the inclusion of the entire adjustment in the income for the taxable year of the change (\$3,058), the limitation provided by section 481(b)(1) applies, and the total tax for 1958, the taxable year of the change, if section 481(b)(2) does not apply, is determined as follows:

Tax without any portion of adjustment .....	\$944
Increase in tax attributable to adjustment computed under section 481(b)(1) .....	2,596
<b>Total tax for taxable year of the change .....</b>	<b>3,540</b>

*Example (3).* (i) Assume the same facts as in example (1) and, in addition, assume that the taxpayer used the cash receipts and disbursements method of accounting in computing taxable income for the years 1953 through 1957; that he established his taxable income under the new method for the taxable years 1953, 1954, and 1957, but did not have sufficient records to establish his taxable income under such method for the taxable years 1955 and 1956. The original taxable income and taxable income as redetermined are as follows:

Taxable year	Taxable income		Increase or (decrease) in taxable income
	Determined under cash receipts and disbursements method	Established under new method	
1953 .....	\$5,000	\$7,000	\$2,000
1954 .....	6,000	7,000	1,000
1955 .....	5,500	( <sup>1</sup> )	
1956 .....	4,000	( <sup>1</sup> )	
1957 .....	6,000	10,000	4,000

<sup>1</sup> Undetermined.

As in examples (1) and (2), the total adjustment under section 481(a) is \$9,000. Of the \$9,000 adjustment, \$4,000 may be allocated to 1957, which is the only year consecutively preceding the taxable year of the change for

which the taxpayer was able to establish his income under the new method. Since the income cannot be established under the new method for 1956 and 1955, no allocation may be made to 1954 or 1953, even though the taxpayer has established his income for those years under the new method of accounting. The balance of \$5,000 (\$9,000 minus \$4,000) must be allocated to 1958.

(ii) The limitation provided by section 481(b)(2) is computed as follows: The tax for 1957, based on taxable income of \$6,000, is assumed to be \$1,360. Under the new method, based on taxable income of \$10,000, the tax for 1957 is assumed to be \$2,640, the increase attributable to \$4,000 of the \$9,000 section 481(a) adjustment being \$1,280, (\$2,640 minus \$1,360). The tax for 1958, computed on the basis of taxable income of \$4,400 (determined under the new method), is assumed to be \$944. The tax computed for 1958 on taxable income of \$9,400 (\$4,400 plus the \$5,000 adjustment allocated to 1958) is assumed to be \$2,436, leaving a difference of \$1,492 (\$2,436 minus \$944) attributable to the inclusion in 1958 of the portion of the total adjustment to be taken into account which could not be properly allocated to the taxable year or years consecutively preceding 1958.

(iii) The tax attributable to the adjustment is determined by selecting the smallest of the three following amounts:

Increase in tax attributable to adjustment computed under section 481(b)(2) (\$1,280+\$1,492) .....	\$2,772
Increase in tax attributable to adjustment computed under section 481(b)(1) (example (2)) .....	2,596
Increase in tax if the entire adjustment is taken into account in the taxable year of the change (example (1)) .....	3,058

The final tax for 1958 is then \$3,540 computed as follows:

Tax before inclusion of any adjustment .....	\$944
Increase in tax attributable to adjustments (smallest of \$2,772, \$2,596 or \$3,058) .....	2,596
<b>Total tax for 1958 (limited in accordance with section 481(b)(1)) .....</b>	<b>3,540</b>

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*Example (4).* Assume that X Corporation has maintained its books of account and filed its income tax returns using the cash receipts and disbursements method of accounting for the years 1953 through 1957. The

corporation secures permission to change to an accrual method of accounting for the calendar year 1958. The following tabulation presents the data with respect to the taxpayer's income for the years involved:

Year	Taxable income under the cash receipts and disbursements method		Taxable income established under accrual method	Increase or (decrease) attributable to change	Changes in taxable income due to changes in net loss carryback
	Before application of net operating loss carryback	After application of net operating loss carryback			
1953 .....	\$2,000	0	( <sup>1</sup> )	.....	\$2,000
1954 .....	4,000	\$1,000	( <sup>1</sup> )	.....	3,000
1955 .....	(5,000)	.....	\$1,000	\$6,000	.....
1956 .....	80,000	80,000	77,000	(3,000)	.....
1957 .....	90,000	90,000	96,000	6,000	.....
1958 .....	.....	.....	100,000	.....	.....

<sup>1</sup> Not established.

As indicated above, taxable income for 1953 and 1954, as determined under the cash receipts and disbursements method of accounting, was \$2,000 and \$4,000, respectively, and after application of the net operating loss carryback from 1955, the taxable income was reduced to zero in 1953 and to \$1,000 in 1954. The taxpayer was unable to establish taxable income for these years under an accrual method of accounting; however, under section 481(b)(3)(A), increases or decreases in the tax for taxable years to which no adjustment is allocated must, nevertheless, be taken into account to the extent the tax for such years would be affected by a net operating loss determined with reference to taxable years to which adjustments are allocated. The total amount of the adjustments required under section 481(a) and attributable to the taxable years 1953 through 1957 in this example is assumed to be \$10,000. The redetermination of taxable income established by the taxpayer for the taxable years 1955, 1956, and 1957 appears under the heading

“Taxable income established under accrual method” in the above tabulation. The tabulation assumes that the taxpayer has been able to recompute the income for those years so as to establish a net adjustment of \$9,000, which leaves a balance of \$1,000 unaccounted for. In accordance with the requirements of section 481(b)(2), the \$1,000 amount is allocated to 1958, the taxable year of the change. The following computations are necessary in order to determine the tax attributable to the adjustments under section 481(a):

**INCREASE IN TAX ATTRIBUTABLE TO INCLUSION IN 1958 OF THE ENTIRE \$10,000 ADJUSTMENT**

Tax on income of 1958 increased by entire amount of adjustment (\$100,000+\$10,000) .....	\$51,700
Tax on income of 1958 without adjustment (\$100,000) .....	46,500
Increase in tax attributable to inclusion of entire adjustment in year of the change .....	5,200

Increase in tax attributed to adjustment computed under section 481(b)(1)

Year	Amount of adjustment	Tax before adjustment	Tax after adjustment	Increase in tax liability attributable to adjustment
1958 .....	\$3,334	\$46,500	\$48,234	\$1,734
1957 .....	3,333	41,300	43,033	1,733
1956 .....	3,333	36,100	37,833	1,733
Increase in tax attributable to adjustment computed under section 481(b)(1) .....	.....	.....	.....	5,200

Increase in tax attributed to adjustment computed under section 481(b)(2)

1953 .....	<sup>1</sup> \$2,000	0	<sup>1</sup> \$600	\$600
1954 .....	<sup>1</sup> 3,000	\$300	<sup>1</sup> 1,200	900
1955 .....	6,000	0	300	300
1956 .....	(3,000)	36,100	34,540	(1,560)
1957 .....	96,000	41,300	44,420	3,120

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Increase in tax attributed to adjustment computed under section 481(b)(1)

Year	Amount of adjustment	Tax before adjustment	Tax after adjustment	Increase in tax liability attributable to adjustment
1958 .....	<sup>2</sup> 1,000	46,500	<sup>2</sup> 47,020	520
Increase in tax attributable to the adjustment computed under section 481(b)(2) .....				3,880

<sup>1</sup> Attributable to recomputations of net operating loss carrybacks determined with reference to net operating loss in 1955.  
<sup>2</sup> Attributable to the inclusion of \$1,000 in the year of the change which represents the portion of the \$10,000 adjustment not allocated to taxable years prior to the year of the change for which taxable income is established under the new method.

Since the limitation under section 481(b)(2) (\$3,880) on the amount of tax attributable to the adjustments is applicable, the final tax for the taxable year of the change is computed by adding such amount to the tax for that year computed without the inclusion of any amount attributable to the adjustments, that is, \$46,500 plus \$3,880, or \$50,380.

[T.D. 6500, 25 FR 11732, Nov. 26, 1960, as amended by T.D. 6490, 25 FR 8374, Sept. 1, 1960; T.D. 7301, 39 FR 963, Jan. 4, 1974; T.D. 8608, 60 FR 40078, Aug. 7, 1995]

**§ 1.481-3 Adjustments attributable to pre-1954 years where change was not initiated by taxpayer.**

If the adjustments required by section 481(a) and § 1.481-1 are attributable to a change in method of accounting which was not initiated by the taxpayer, no portion of any adjustments which is attributable to pre-1954 years shall be taken into account in computing taxable income. For example, if the total adjustments in the case of a change in method of accounting which is not initiated by the taxpayer amount to \$10,000, of which \$4,000 is attributable to pre-1954 years, only \$6,000 of the \$10,000 total adjustments is required to be taken into account under section 481 in computing taxable income. The portion of the adjustments which is attributable to pre-1954 years is the net amount of the adjustments which would have been required if the taxpayer had changed his method of accounting in his first taxable year which began after December 31, 1953, and ended after August 16, 1954.

[T.D. 6500, 25 FR 11735, Nov. 26, 1960, as amended by T.D. 8608, 60 FR 40079, Aug. 7, 1995]

**§ 1.481-4 Adjustments taken into account with consent.**

(a) In addition to the terms and conditions prescribed by the Commissioner under § 1.446-1(e)(3) for effecting a change in method of accounting, including the taxable year or years in which the amount of the adjustments required by section 481(a) is to be taken into account, or the methods of allocation described in section 481(b), a taxpayer may request approval of an alternative method of allocating the amount of the adjustments under section 481. See section 481(c). Requests for approval of an alternative method of allocation shall set forth in detail the facts and circumstances upon which the taxpayer bases its request. Permission will be granted only if the taxpayer and the Commissioner agree to the terms and conditions under which the allocation is to be effected. See § 1.446-1(e) for the rules regarding how to secure the Commissioner's consent to a change in method of accounting.

(b) An agreement to the terms and conditions of a change in method of accounting under § 1.446-1(e)(3), including the taxable year or years prescribed by the Commissioner under that section (or an alternative method described in paragraph (a) of this section) for taking the amount of the adjustments under section 481(a) into account, shall be in writing and shall be signed by the Commissioner and the taxpayer. It shall set forth the items to be adjusted, the amount of the adjustments, the taxable year or years for which the adjustments are to be taken into account, and the amount of the adjustments allocable to each year. The