

Part III - Administrative, Procedural, and Miscellaneous

Nonaccrual Experience Method of Accounting



Notice 2003-12

SECTION 1. PURPOSE

The Internal Revenue Service is currently working on regulations under § 448(d)(5) of the Internal Revenue Code as amended by § 403 of the Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 403, 116 Stat. 21 (the Act), regarding the nonaccrual experience (“NAE”) method. Until such regulations are issued in final form, this notice provides interim guidance on which taxpayers may rely. The Service expects that the final regulations will incorporate the rules set forth in this Notice and will be effective for taxable years ending after March 9, 2002. This interim guidance includes: (1) for taxpayers who no longer qualify to use a NAE method, procedures to change their method of accounting; (2) for taxpayers who qualify to use a NAE method, two safe harbor NAE methods that will be presumed to clearly reflect the taxpayer’s NAE; (3) for taxpayers who qualify to use a NAE method but wish to compute their NAE using a formula other than the two safe harbors provided, the requirements that must be met in order to use an alternative formula to compute their NAE; and (4) for taxpayers who wish to change to a different NAE method, the procedures necessary to obtain automatic consent of the Commissioner to change to one of the safe harbor NAE methods or to an alternative NAE method that clearly reflects their experience.

SECTION 2. BACKGROUND

.01 Under § 448(d)(5), prior to its amendment by the Act, taxpayers using an accrual method of accounting and performing services were not required to accrue any portion of their service-related income that, on the basis of their experience, would not be collected. The Act modifies § 448(d)(5) to provide that a NAE method is now available only for taxpayers using an accrual method who either provide services in fields described in § 448(d)(2)(A) (*i.e.*, health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting), or who meet the \$5 million annual gross receipts test of § 448(c). As under prior law, a NAE method is available only to taxpayers not charging interest or penalties for failure to timely pay the amount charged.

.02 The Act also provides that the Service and the Treasury Department will issue regulations to permit taxpayers to determine the uncollectible amounts using alternative computations or formulas, including safe harbors, that, based on experience, accurately reflect the amount of income that the taxpayers will not collect. The amendments by the Act are effective for taxable years ending after March 9, 2002.

SECTION 3. NONACCRUAL EXPERIENCE METHODS

.01 *In General.* Pending the issuance of final regulations under § 448(d)(5), as amended, a taxpayer eligible to use a NAE method under § 448(d)(5), as amended, may use one of two safe harbor NAE methods of accounting provided in section 3.02 of this notice. Alternatively, a taxpayer eligible to use a NAE method under § 448(d)(5), as amended, may use any other NAE method (an “alternative NAE method”) that clearly

reflects the taxpayer's NAE, subject to the requirements of section 3.03 of this notice. See section 5 of this notice for procedures to obtain automatic consent to change to one of the safe harbor NAE methods or to an alternative NAE method.

.02 *Safe Harbor Methods*. The safe harbor NAE methods provided in this section 3.02 will be presumed to clearly reflect a taxpayer's NAE.

(1) *Section 1.448-2T(e)(2) method*. A taxpayer may use the NAE method provided in § 1.448-2T(e)(2) of the temporary income tax regulations.

(2) *Actual experience method*. (i) *Option A: Three-year moving average*. A taxpayer may use a NAE method under which the taxpayer determines the uncollectible amount ("actual NAE amount") by multiplying its year-end accounts receivable balance by a percentage ("three-year moving average NAE percentage") reflecting its actual NAE with respect to its accounts receivable balance at the beginning of the current taxable year and the two immediately preceding taxable years. Under the actual experience method, a taxpayer is allowed to increase its actual NAE amount by 5% ("adjusted NAE amount"). The taxpayer's three-year moving average NAE percentage, actual NAE amount, and adjusted NAE amount are determined according to the following steps:

STEP 1. Track the receivables in the taxpayer's accounts receivable balance at the beginning of the current year to determine the dollar amount of the accounts receivable actually determined to be uncollectible and charged off and not recovered or determined to be collectible by the date selected by the taxpayer (the "determination date") for the year. The determination date may not be later than the

earlier of the due date (including extensions) for filing the taxpayer's federal income tax return for that year or the date on which the taxpayer files such return for that year.

STEP 2. Repeat STEP 1 for the taxpayer's accounts receivable balance at the beginning of each of the two immediately preceding taxable years.

STEP 3. To determine the taxpayer's three-year moving average NAE percentage, (i) divide the sum of the net uncollectible amounts from STEP 1 and 2, by (ii) the sum of the accounts receivable balance at the beginning of the current taxable year and the accounts receivable balance at the beginning of each of the two preceding taxable years.

STEP 4. Multiply the percentage computed in STEP 3 by the taxpayer's accounts receivable balance at the end of the current taxable year. The product is the taxpayer's actual NAE amount for the current taxable year.

STEP 5. To determine the taxpayer's adjusted NAE amount, multiply the actual NAE amount from STEP 4 by 1.05. See *Example 1* in section 3.04 of this notice.

(ii) *Option B: Up to three-year moving average.* Alternatively, in computing its adjusted NAE amount, a taxpayer may use: its current year NAE percentage for the first year this method is used; a two-year moving average NAE percentage for the second year this method is used; and a three-year moving average NAE percentage for the third, and each succeeding, taxable year this method is used. See *Examples 2, 3 and 4* in section 3.04 of this notice.

(iii) A taxpayer that excludes an amount from income during a taxable year as a result of the taxpayer's use of the actual experience method cannot deduct in any subsequent taxable year the amount excluded from income. Thus, the taxpayer cannot deduct the excluded amount in the next taxable year, which is the taxable year in which the taxpayer actually determines that the amount is uncollectible and charges the amount off. If a taxpayer recovers an amount excluded from income, the taxpayer must include the recovered amount in income. If a calendar year taxpayer using the actual experience method determines that an amount that was not excluded from income is uncollectible and should be charged off (e.g., the taxpayer determines on November 1, 2002, that an account receivable that was originated on May 1, 2002, is uncollectible and should be charged off) the taxpayer may deduct the amount charged off when it is charged off, but must include any subsequent recoveries in income. The reasonableness of a taxpayer's determinations that amounts are uncollectible and should be charged off may be considered on examination. See §§ 1.448-2T(e)(3) and (e)(4) regarding the mechanics of the NAE method and related examples.

.03 *Alternative NAE Methods.* A taxpayer may use any alternative NAE method that clearly reflects the taxpayer's actual NAE, provided the taxpayer's alternative NAE method meets the self-test requirements as described in this section 3.03.

(1) *Self-testing.* A taxpayer using (or desiring to use) an alternative NAE method must "self-test" its alternative NAE method for its first taxable year ending after March 9, 2002, and every third taxable year thereafter by comparing the NAE amount under the taxpayer's alternative NAE method ("alternative NAE amount") with the

adjusted NAE amount that would have resulted from use of the actual experience method, as described in Section 3.02(2) of this Notice, for the test period. In no event will the test period include taxable years ending on or before March 9, 2002, or prior to the first year in which the taxpayer used its alternative NAE method.

(2) *Treated as clearly reflecting NAE.* If the total of the alternative NAE amounts for each year of the test period (“cumulative alternative NAE amount”) is less than or equal to the total of the adjusted NAE amount computed under STEP 5 of section 3.02(2)(i) of this revenue procedure for each year of the test period (“cumulative adjusted NAE amount”), then: (i) the taxpayer’s alternative NAE method will be treated as clearly reflecting its NAE for the test period; and (ii) the taxpayer may continue to use that alternative NAE method, subject to a requirement to self-test again in three taxable years. See *Example 6* in section 3.04 of this notice.

(3) *Treated as not clearly reflecting NAE.* If the cumulative alternative NAE amount is more than the cumulative adjusted NAE amount for the test period, then: (i) the taxpayer’s alternative NAE method will be treated as not clearly reflecting its NAE for the test period; and (ii) the taxpayer must change its NAE method of accounting to a method that will clearly reflect its NAE. See *Examples 7 and 8* in section 3.04 of this notice.

(4) *Changes to or from alternative NAE methods.* A taxpayer that voluntarily changes its NAE method of accounting as a result of section 3.03(3) of this notice should follow the automatic change in method of accounting procedures described in Section 5.02 of this notice. A taxpayer that must change its NAE method

of accounting as a result of Section 3.03(3) of this Notice, but does not change, will be subject to being changed by the Service on examination to the actual experience method. A taxpayer that does not maintain records of the data necessary to determine its actual NAE (in accordance with section 3.02(2) of this notice) will be subject to being changed by the Service on examination to the specific charge-off method. A taxpayer described in this section that is required by the Service to change its NAE method of accounting on examination will be subject to such change in the earliest open taxable year under examination, and will be required to take into account any resulting § 481(a) adjustment entirely in the year of change, and may be subject to penalties. See § 446(f).

.04 *Examples*. In each example, the taxpayer: (1) uses a calendar year for federal income tax purposes and an accrual method of accounting; (2) is eligible to use a NAE method under § 448(d)(5), as amended by the Act; and (3) selects an appropriate determination date for each taxable year. In each of *Examples 1-5*, the taxpayer wants to use the actual experience method beginning in 2002.

Example 1. Taxpayer A has the data necessary to track the uncollectible amounts in its beginning-of-year accounts receivable for the current taxable year and the two immediately preceding taxable years. A determines that its actual accounts receivable collection experience is as follows:

Year	Total A/R Balance At Beginning of Year	Beginning A/R Amount Charged Off by Determination Date (adjusted for recoveries)
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2000	\$1,000,000	\$35,000
2001	760,000	75,000
2002	<u>1,975,000</u>	<u>65,000</u>
Total	\$3,735,000	\$175,000

A's ending A/R Balance on 12/31/2002 is \$880,000.

In 2002, A chooses to compute its NAE amount by using the three-year moving average under Option A in section 3.02(2)(i) of this notice. Thus, A's three-year moving average NAE percentage is 4.7%, determined by dividing the sum of the amount of A's receivables in its account on January 1st of 2000, 2001, and 2002, that were determined to be uncollectible and charged off (adjusted for recoveries) on or before the corresponding determination dates, by the sum of the balances of A's accounts receivable account on January 1st of 2000, 2001, and 2002 (*i.e.*, \$175,000/\$3,735,000 or 4.7%). Thus, A's actual NAE amount for 2002 is determined by multiplying this percentage by the balance of A's accounts receivable account on December 31, 2002 (*i.e.*, \$880,000 x 4.7% = \$41,360). A is permitted to exclude from gross income in 2002 an amount equal to 105% of A's actual NAE amount (\$41,360 x 105% = \$43,428). This is A's adjusted NAE amount for 2002.

Example 2. The facts are the same as *Example 1*, except A has not maintained the data necessary to use Option A in section 3.02(2)(i) of this notice. A determines that, of its 2002 beginning-of-year receivables of \$1,975,000, \$65,000 were determined to be uncollectible and charged off (adjusted for recoveries) on or before September 15, 2003, the date A timely files its federal income tax return for 2002 (the determination date). A chooses to use Option B in section 3.02(2)(ii) of this notice to compute its adjusted NAE amount for 2002. A's current year NAE percentage is 3.3%, determined

by dividing the amount of A's receivables in its account on January 1, 2002, that were charged off as uncollectible (adjusted for recoveries) on or before the determination date, by the balance of A's accounts receivable account on January 1, 2002 (*i.e.*, \$65,000/\$1,975,000 or 3.3%). Thus, A's actual NAE amount for 2002 is determined by multiplying this percentage by the balance of A's accounts receivable account on December 31, 2002 (*i.e.*, \$880,000 x 3.3% = \$29,040). A is permitted to exclude from gross income in 2002 an amount equal to 105% of A's actual NAE amount (\$29,040 x 105% = \$30,492). This is A's adjusted NAE amount for 2002.

Example 3. The facts are the same as *Example 2*. A determines that its accounts receivable collection experience for 2003 is as follows:

<u>Year</u>	<u>Total A/R Balance At Beginning of Year</u>	<u>Beginning A/R Amount Charged Off by Determination Date (adjusted for recoveries)</u>
2002	\$1,975,000	\$65,000
2003	<u>880,000</u>	<u>95,000</u>
Total	<u>\$2,855,000</u>	<u>\$160,000</u>

A's ending A/R Balance on 12/31/2003 is \$2,115,000.

In 2003, A must compute its NAE amount using an average of its actual NAE for 2002 and 2003 (in accordance with Option B in section 3.02(2)(ii) of this notice). Thus, A's two-year moving average NAE percentage is 5.6%, determined by dividing the sum of the amount of A's receivables in its accounts on January 1st of 2002 and 2003, that were determined to be uncollectible and charged off (adjusted for recoveries) on or before the corresponding determination dates, by the sum of the balances of A's accounts receivable account on January 1st of 2002 and 2003 (*i.e.*,

\$160,000/\$2,855,000 or 5.6%). Thus, A's actual NAE amount for 2003 is determined by multiplying this percentage by the balance of A's accounts receivable account on December 31, 2003 (*i.e.*, \$2,115,000 x 5.6% = \$118,440). A is permitted to exclude from gross income in 2003 an amount equal to 105% of A's actual NAE amount (\$118,440 x 105% = \$124,362). This is A's adjusted NAE amount for 2003.

Example 4. The facts are the same as *Example 3*. A determines that its accounts receivable collection experience for 2004 is as follows:

<u>Year</u>	<u>Total A/R Balance At Beginning of Year</u>	<u>Beginning A/R Amount Charged Off by Determination Date (adjusted for recoveries)</u>
2002	\$1,975,000	\$65,000
2003	880,000	95,000
2004	<u>2,115,000</u>	<u>105,000</u>
Total	\$4,970,000	\$265,000

A's ending A/R Balance on 12/31/2004 is \$1,600,000.

In 2004, A must compute its NAE amount using an average of its actual NAE for 2002, 2003, and 2004 (in accordance with Option B in section 3.02(2)(ii) of this notice). Thus, A's actual three-year moving average NAE percentage is 5.3%, determined by dividing the sum of the amount of A's receivables in its account on January 1st of 2002, 2003, and 2004, that were determined to be uncollectible and charged off (adjusted for recoveries) on or before the corresponding determination dates, by the sum of the balances of A's accounts receivable account on January 1st of 2002, 2003, and 2004 (*i.e.*, \$265,000/\$4,970,000 or 5.3%). Thus, A's actual NAE amount for 2004 is determined by multiplying this percentage by the balance of A's accounts receivable account on December 31, 2004 (*i.e.*, \$1,600,000 x 5.3% = \$84,800). A is permitted to

exclude from gross income in 2004 an amount equal to 105% of A’s actual NAE amount (\$84,800 x 105% = \$89,040). This is A’s adjusted NAE amount for 2004. Thereafter, A must continue to use a 3-year moving average to compute its actual NAE, or obtain approval of the Commissioner to change its method of accounting.

Example 5. Taxpayer B has not tracked its 2002 beginning-of-year accounts receivable. Therefore, B may not use the actual experience method for 2002. B may use this method for 2003 if B tracks its 2003 beginning-of-year receivables.

Example 6. Beginning in 2002, taxpayer C uses an alternative NAE method similar to the method described in *Black Motor Co. v. Comm’r*, 41 B.T.A. 300 (1940), *aff’d*, 125 F.2d 977 (6th Cir. 1942). C must self-test its alternative NAE method for the first year it is used (2002), and then every three taxable years after 2002 for which C uses its alternative NAE method. Thus, beginning in 2002, C must begin tracking its beginning-of-year accounts receivable and computing its actual NAE as provided in section 3.02(2) of this notice. C’s actual NAE amount and alternative NAE amount for 2002 are set forth below:

<u>Year</u>	<u>Total A/R Balance At Beginning of Year</u>	<u>Beginning A/R Amount Charged Off by Determination Date (adjusted for recoveries)</u>	<u>Alternative NAE Amount</u>
2002	\$350,000	\$14,000	\$20,700

C’s ending A/R Balance on 12/31/2002 is \$500,000.

C’s actual NAE percentage is 4%, determined by dividing the amount of C’s receivables in its account on January 1, 2002, that were charged off as uncollectible (adjusted for recoveries) on or before the determination date, by the balance of C’s accounts

receivable account on January 1, 2002 (*i.e.*, \$14,000/\$350,000 or 4%). Thus, C's actual NAE amount for 2002 is determined by multiplying this percentage by the balance of C's accounts receivable account on December 31, 2002 (*i.e.*, \$500,000 x 4% = \$20,000). Because C's alternative NAE amount for 2002 (\$20,700) is not greater than 105% of its actual NAE amount for 2002 (*i.e.*, \$20,000 x 1.05 = \$21,000), C's alternative NAE method will be treated as clearly reflecting its actual NAE for the test period 2002. C's next test period would be taxable years 2003 through 2005. C's actual NAE amounts (computed under Option B of section 3.02(2) of this revenue procedure, because C lacked the data to use Option A) and alternative NAE amounts for those years are set forth below:

Year	Total A/R Balance At Beginning of Year	Beginning A/R Amount Charged Off by Determination Date adjusted for recoveries)	Actual NAE Amount	Alternative NAE Amount
2003	\$440,000	\$30,000	\$42,329	\$43,050
2004	760,000	65,000	138,183	140,200
2005	<u>1,965,000</u>	<u>65,000</u>	<u>101,106</u>	<u>110,550</u>
Total	\$3,165,000	\$160,000	\$281,618	\$293,800

Assume that C's ending A/R balance on 12/31/05 is \$2,000,000.

Because C's cumulative alternative NAE amount for this period (\$293,800) is not greater than 105% of its cumulative actual NAE amount for the same period (*i.e.*, \$281,618 x 1.05 = \$295,699), C's alternative NAE method will be treated as clearly reflecting its actual NAE for the test period. Accordingly, C may continue to use its alternative NAE method, subject to the requirement that C self-test again after the next three taxable years.

Example 7. The facts are the same as *Example 6*, except that C's alternative

NAE amount for 2002 is \$21,700. Because C's alternative NAE amount for 2002 is more than 105% of its actual NAE amount for 2002 (*i.e.*, $\$20,000 \times 1.05 = \$21,000$), C's alternative NAE method will be treated as not clearly reflecting its NAE for the test period. As a result, C cannot use its alternative NAE method of accounting, but must use a method that will clearly reflect its NAE for 2002.

Example 8. The facts are the same as *Example 7*, except that C used its alternative NAE method in taxable years prior to 2002. Because C's alternative NAE method will be treated as not clearly reflecting its NAE for the test period, C will be required to change its NAE method of accounting to a method that will clearly reflect its NAE for 2002.

SECTION 4. AUDIT PROTECTION FOR TAXPAYERS CURRENTLY USING THE ACTUAL EXPERIENCE METHOD

If a taxpayer uses the actual experience method described in section 3.02(2) of this notice to determine its NAE amount, the taxpayer's use of that method will not be raised as an issue by the Service in a taxable year that ends before January 22, 2003. If the taxpayer uses the actual experience method described in section 3.02(2) of this notice, and its use of that method is an issue under consideration (within the meaning of section 3.09 of Rev. Proc. 2002-9) in examination, in appeals, or before the U.S. Tax Court in a taxable year that ends before January 22, 2003, that issue will not be further pursued by the Service.

SECTION 5. APPLICATION.

.01 *Taxpayers No Longer Qualified Under § 448 to Use a NAE Method.* In the

case of a taxpayer that is no longer qualified under § 448(d)(5), as amended by the Act, to use a NAE method for its first taxable year ending after March 9, 2002, the change from the taxpayer's NAE method is treated as initiated by the taxpayer, made with the consent of the Commissioner, and the net amount of the required § 481(a) adjustment is to be taken into account over a period of 4 taxable years (or, if less, the number of taxable years that the taxpayer has used the NAE method). Such a taxpayer is not required to file Form 3115, *Application for Change in Accounting Method*, with the national office, or pay any associated user fee. However, to assist the Service in processing the taxpayer's change in method of accounting, the taxpayer should attach Form 3115 to its income tax return for the year of change, and write "Change off of the nonaccrual experience method under Notice 2003-12" at the top of the form.

.02 *Taxpayers Permitted to Use a NAE Method.* A change to a NAE method, or a change from one NAE method to another NAE method, is a change in method of accounting to which the provisions of §§ 446 and 481, and the regulations thereunder, apply. Therefore, a taxpayer that wants to use one of the NAE methods provided in this notice, and that does not currently use that method, must follow the automatic change in method of accounting procedures in Rev. Proc. 2002-9, 2002-3 I.R.B. 327 (as modified and amplified by Rev. Proc. 2002-19, 2002-13 I.R.B. 696, modified and clarified by Announcement 2002-17, 2002-8 I.R.B. 561, and amplified, clarified, and modified by Rev. Proc. 2002-54, 2002-35 I.R.B. 432) (or successors), with the following modifications:

- (1) The scope limitations in section 4.02 of Rev. Proc. 2002-9 do not apply

to a taxpayer that wants to change to a NAE method provided in this Notice for either its first or second taxable year ending after March 9, 2002, provided the taxpayer's NAE method is not an issue under consideration for taxable years under examination, within the meaning of section 3.09 of Rev. Proc. 2002-9, at the time the Form 3115 is filed with the national office (subject to the exception in Section 4 of this Notice);

(2) A taxpayer that wants to change to a NAE method provided in this Notice for its first taxable year ending after March 9, 2002, that on or before March 12, 2003, files its original federal income tax return for that year is not required to comply with the filing requirement in section 6.02(3)(a) of Rev. Proc. 2002-9, provided the taxpayer complies with the following filing requirements. The taxpayer must complete and file the Form 3115 in duplicate. The original Form 3115 must be attached to an amended federal income tax return for the taxpayer's first taxable year ending after March 9, 2002. This amended return must be filed no later than August 11, 2003. The copy of the Form 3115 must be filed with the national office (see section 6.02(6) of Rev. Proc. 2002-9 for the address) no later than when the taxpayer's amended return is filed; and

(3) When filing the Form 3115, the taxpayer must complete all applicable parts of the form and, in lieu of the label required by section 6.02(4) of Rev. Proc. 2002-9, are instructed to write "Change to [identify the requested NAE method] under Notice 2003-12" at the top of the form.

.03 Taxpayers That Must Change After Self-Testing. If a taxpayer required to change its method of accounting as a result of section 3.03 of this Notice properly

applied its alternative NAE method during the test period and the taxpayer makes the change for its first taxable year following the last taxable year of the test period, the taxpayer must follow the automatic change in method of accounting procedures in Rev. Proc. 2002-9 (or successors) and the scope limitations of section 4.02 of Rev. Proc. 2002-9 will not apply.

SECTION 6. EFFECTIVE DATE AND TRANSITION RULE

.01 *In General.* This notice is effective for taxable years ending after March 9, 2002.

.02 *Transition Rule.* If a taxpayer filed an application or ruling request under the procedures prescribed in Rev. Proc. 97-27, 1997-1 C.B. 680, with the national office to make a change in its method of accounting under § 448(d)(5), as amended, for a year of change for which this notice is effective and the application or ruling request is pending with the national office on January 22, 2003, the taxpayer must notify the national office in writing (see section 8.06 of Rev. Proc. 97-27 for the address) prior to March 24, 2003, if the taxpayer wants the national office to continue processing its application or ruling request under the procedures prescribed in Rev. Proc. 97-27. If the taxpayer does not notify the national office within the time provided in this section, the taxpayer's Form 3115, and any user fee that was submitted with the Form 3115, will be returned to the taxpayer. A taxpayer whose Form 3115 is returned under this section may file a new Form 3115 under the procedures prescribed in section 5.02 of this notice.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002-9 is modified to include the changes in method of accounting provided in this notice in section 5.06 of the Appendix.

REQUEST FOR COMMENTS

The Service and the Treasury Department invite comments on the safe harbor NAE methods described in this notice, suggestions for additional safe harbor NAE methods, the use of a "self-test" for alternative NAE methods, as well as any other issues that should be addressed in the forthcoming regulations. Written comments may be submitted on or before April 23, 2003, to

Internal Revenue Service
P.O. Box 7604
Benjamin Franklin Station
Washington, DC 20224
Attn: CC:ITA:RU (Notice 2002-12), Room 5226

Submissions also may be sent electronically via the Internet to the following e-mail address: notice.comments@m1.irs.counsel.treas.gov. Comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Terrance McWhorter of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this notice, contact Mr. McWhorter at 202-622-4970 (not a toll-free call).