

safe harbors in such regulations that may be relied upon by taxpayers.

In accordance with the amendments to section 448(d)(5) in the 2002 Act, the IRS issued Notice 2003-12 (2003-6 I.R.B. 422) to provide interim guidance under section 448(d)(5), as amended, pending the issuance of new regulations. The interim guidance provided by Notice 2003-12 included: (1) For taxpayers that no longer qualified to use a nonaccrual-experience method, procedures to change their method of accounting; (2) for taxpayers that qualified to use a nonaccrual-experience method, two safe harbor nonaccrual-experience methods that were presumed to clearly reflect the taxpayer's nonaccrual-experience; (3) for taxpayers that qualified to use a nonaccrual-experience method but wished to compute their nonaccrual-experience using a formula other than the two safe harbors provided, the requirements necessary to use an alternative formula to compute their nonaccrual-experience; and (4) for taxpayers that wished to change to a different nonaccrual-experience method, the procedures necessary to obtain automatic consent of the Commissioner to change to one of the safe harbor nonaccrual-experience methods or to an alternative nonaccrual-experience method that clearly reflected their experience.

The guidance provided in Notice 2003-12 has, for the most part, been incorporated as part of these temporary regulations. However, certain provisions in the Notice have been modified to address certain concerns raised by the commentators.

Charging of Interest

Section 448(d)(5) and the former temporary regulations provide that a nonaccrual-experience method of accounting may not be used with respect to amounts due for which interest is required to be paid or for which there is any penalty for failure to timely pay any amounts due (other than, in certain circumstances, discounts offered for early payment of an amount due). One commentator suggested that a taxpayer should not be precluded from using a nonaccrual-experience method of accounting if the taxpayer's agreement contains a provision stating that interest is required to be paid but the taxpayer rarely enforces the provision. The IRS and Treasury Department continue to believe that if a taxpayer's agreement requires interest to be paid, or provides for any penalty for failure to timely pay any amounts due, such taxpayer is precluded from using the nonaccrual-experience method of

accounting, regardless of whether the taxpayer actually imposes such interest or penalty.

Safe Harbor Methods

The temporary regulations include the two safe harbor nonaccrual-experience methods that were included in Notice 2003-12. The first safe harbor method (safe harbor 1) is the method provided in former Temp. Reg. § 1.448-2T(e)(2). The second safe harbor method (safe harbor 2) is the actual experience method that may be computed using a three-year moving average beginning in the first taxable year this safe harbor method is used or, for taxpayers that do not have the information necessary to compute a three-year moving average in the first taxable year this method is used, the option of creating a three-year moving average beginning with the first taxable year that the taxpayer uses this safe harbor method. A newly formed taxpayer choosing the option of creating a three-year moving average that does not have any accounts receivable upon formation will not be able to exclude any portion of its year-end accounts receivable from income for its first taxable year because the taxpayer does not have any accounts receivable on the first day of the taxable year to track. Thus, a newly formed taxpayer that does not have any accounts receivable upon formation must begin creating its three-year moving average in its second taxable year.

Commentators requested that the IRS and Treasury Department consider other suggested alternative safe harbor methods for inclusion in the temporary regulations. The IRS and Treasury Department analyzed alternative methods and, based on this analysis, have determined that two other formulas will clearly reflect a taxpayer's nonaccrual-experience. As a result, the temporary regulations provide two additional safe harbor nonaccrual-experience methods that may be relied on by taxpayers as clearly reflecting their nonaccrual-experience.

The third safe harbor method (safe harbor 3) is a variation of the formula addressed in *Black Motor Co. v. Commissioner*, 41 B.T.A. 300 (1940), *aff'd*, 125 F.2d 977 (6th Cir. 1942). The nonaccrual-experience amount is computed by first determining the ratio of total bad debts charged off (adjusted for recoveries) for the current taxable year and the five preceding taxable years as compared to the total accounts receivable at the end of the current taxable year and the five preceding taxable years. This ratio is applied against the accounts receivable balance at the end of the current taxable year,

and the resulting amount is then reduced by the credit charges (accounts receivable) generated and written off during the current taxable year, which results in the nonaccrual-experience amount for the current taxable year.

The fourth safe harbor method (safe harbor 4) is computed by first determining the ratio of total bad debts charged off (adjusted for recoveries) for the current taxable year and the five preceding taxable years other than the credit charges (accounts receivable) that were charged off in the same taxable year they were generated as compared to the total accounts receivable at the end of the current taxable year and the five preceding taxable years. This ratio is then applied against the accounts receivable balance at the end of the current taxable year, which results in the nonaccrual-experience amount for the current taxable year.

Commentators suggested that the IRS and Treasury Department permit the formula addressed in *Black Motor* ("Black Motor formula") as an additional safe harbor formula in the temporary regulations. The IRS and Treasury Department have analyzed the Black Motor formula and have determined that the formula should not be provided as an additional safe harbor formula because the formula only produces an accurate reflection of a taxpayer's experience in limited circumstances. The IRS and Treasury Department believe that safe harbors 3 and 4 (discussed above), which are modifications of the Black Motor formula, remedy many of the shortcomings of the Black Motor formula and, as a result, safe harbors 3 and 4 have been included in the temporary regulations as additional safe harbor formulas.

The IRS and Treasury Department request comments on these safe-harbor nonaccrual-experience methods and suggestions on any additional safe harbor methods that will clearly reflect a taxpayer's experience. Specifically, the IRS and Treasury Department request comments on any additional modification to the Black Motor formula that will result in an accurate reflection of a taxpayer's experience.

Self-Testing of Any Alternative Method

Notice 2003-12 also allowed a taxpayer to use any alternative nonaccrual-experience method that clearly reflected the taxpayer's actual nonaccrual-experience, provided the taxpayer's alternative nonaccrual-experience method was "self-tested" in the first taxable year ending after March 9, 2002, in which the taxpayer uses the alternative nonaccrual-experience