

method and every three taxable years thereafter. The Notice provided that if the taxpayer's total alternative nonaccrual-experience amount for the test period was less than or equal to the total adjusted nonaccrual-experience amount (actual nonaccrual-experience amount multiplied by 105%) for the test period, then the taxpayer's alternative nonaccrual-experience method would be treated as clearly reflecting its nonaccrual-experience for the test period and the taxpayer would be permitted to continue using the alternative nonaccrual-experience method, subject to self-testing again in three taxable years. However, if the taxpayer's total alternative nonaccrual-experience amount for the test period was greater than the total adjusted nonaccrual-experience amount for the test period, the Notice stated that the taxpayer's alternative nonaccrual-experience method would be treated as not clearly reflecting its nonaccrual-experience for the test period and the taxpayer was required to change its nonaccrual-experience method of accounting to a method that would clearly reflect its nonaccrual experience.

Some commentators suggested that the self-testing requirement in Notice 2003-12 should not be included in the regulations. They suggested that the self-testing requirement is inconsistent with the language and purpose of the amendments made by the 2002 Act. The commentators also suggested that it would be burdensome and impractical for many taxpayers using an alternative nonaccrual-experience method to conduct the self-test due to the limitations of their existing automated record keeping systems. Finally, one commentator suggested that if a taxpayer's alternative nonaccrual-experience method fails the self-testing requirements, then the temporary regulations should limit the taxpayer's exclusion under section 448(d)(5) to the taxpayer's adjusted nonaccrual-experience amount, rather than require the taxpayer to change its method of accounting.

The IRS and Treasury Department believe that the self-testing requirement is consistent with the 2002 Act, which provides that "[a] taxpayer may adopt, or * * * change to, a computation or formula that clearly reflects the taxpayer's experience," and that "[a] request [to change] shall be approved if such computation or formula clearly reflects the taxpayer's experience." Public Law 107-147, § 403(a). The IRS and Treasury Department believe that self-testing is necessary for taxpayers that do not use one of the four safe harbor methods provided to ensure that

the statutory requirement that the taxpayer's formula or computation accurately reflect the taxpayer's nonaccrual experience is met. Therefore, the temporary regulations continue to permit a taxpayer to use any alternative nonaccrual-experience method, provided such method meets the self-testing requirements described in the temporary regulations. The IRS and Treasury Department welcome comments from taxpayers and practitioners specifically addressing the limitations of their record keeping systems that affect conducting self-testing, and ways in which the burden on taxpayers of self-testing might be reduced without compromising the statute's requirement that the taxpayer's method clearly reflect the taxpayer's experience.

Under the temporary regulations, taxpayers using (or desiring to use) an alternative nonaccrual-experience method must self-test the method in the first taxable year ending after March 9, 2002, that the taxpayer uses, or desires to use, the method (first-year self-test), and every three taxable years thereafter (three-year self-test). When conducting the first-year self-test, a taxpayer is permitted to test its alternative nonaccrual-experience method against any of the four safe harbor methods. If a taxpayer is permitted to use its alternative nonaccrual-experience method as a result of satisfying the first year self-test, the temporary regulations require the taxpayer to include contemporaneous documentation in its books and records stating which safe harbor method was used during the self-test that permitted the taxpayer to use its alternative nonaccrual-experience method. When conducting any three-year self-test, the taxpayer must self-test its alternative nonaccrual-experience method against the same safe harbor method used during the immediately preceding self-test. The temporary regulations also provide rules for taxpayers that want to change the safe harbor method used to test their alternative nonaccrual-experience method.

For purposes of the first-year self-test, if the alternative nonaccrual-experience amount for the first-year self-test is less than or equal to the nonaccrual-experience amount computed under the safe harbor formula selected by the taxpayer for the first-year self-test, then the taxpayer's alternative nonaccrual-experience method will be treated as clearly reflecting its nonaccrual-experience for the test period and the taxpayer may continue to use that alternative nonaccrual-experience method, subject to a requirement to self-

test again after three taxable years. If the alternative nonaccrual-experience amount is greater than the nonaccrual-experience amount of the safe harbor method selected by the taxpayer for its self-test method, then the taxpayer's alternative nonaccrual-experience method will be treated as not clearly reflecting its nonaccrual-experience for such taxable year and the taxpayer will not be permitted to use that alternative nonaccrual-experience method for such taxable year. The taxpayer is permitted, however, to adopt (or change to) a safe harbor nonaccrual-experience method provided in the regulations or another alternative nonaccrual-experience method, subject to the first-year self-test requirement.

For purposes of the three-year self-test requirement, if the cumulative alternative nonaccrual-experience amount for the test period is less than or equal to the cumulative nonaccrual-experience amount (computed by using for each taxable year of the test period the safe harbor formula used, and contemporaneously documented, during the immediately preceding self-test) (cumulative safe harbor nonaccrual-experience amount), then the taxpayer's alternative nonaccrual-experience method will be treated as clearly reflecting its nonaccrual experience for the test period and the taxpayer may continue to use that alternative nonaccrual-experience method, subject to a requirement to self-test again in three taxable years. If the cumulative alternative nonaccrual-experience amount for the test period is greater than the cumulative safe harbor nonaccrual-experience amount, then the taxpayer's alternative nonaccrual-experience amount will be limited to the cumulative safe harbor nonaccrual-experience amount for the test period. Any excess of the taxpayer's cumulative alternative nonaccrual-experience amount excluded from income during the test period over the taxpayer's cumulative safe harbor nonaccrual-experience amount must be recaptured into income in the third taxable year of the three-year self-test. The taxpayer may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement.

The IRS and Treasury Department request comments on the first-year self-test, three-year self-test, and recapture provisions of the temporary regulations.

Special Rules

Notice 2003-12 provided that a taxpayer that did not maintain records of the data necessary to determine its actual nonaccrual-experience would be subject to being changed by the IRS on