

Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted. The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or by an adjustment under section 481(a) to be taken into account in the taxable year or years prescribed by the Commissioner.

(iii) This paragraph (e)(3) applies to Forms 3115 filed on or after December 31, 1997. For other Forms 3115, see § 1.446-1(e)(3) in effect prior to December 31, 1997 (§ 1.446-1(e)(3) as contained in the 26 CFR part 1 edition revised as of April 1, 1997).

(4) *Effective date.* [Reserved]. For further guidance, see § 1.446(e)-1T(e)(4)(i) and (ii).

[T.D. 6500, 25 FR 11708, Nov. 26, 1960, as amended by T.D. 7073, 35 FR 17710, Nov. 18, 1970; T.D. 7285, 38 FR 26184, Sept. 19, 1973; T.D. 8067, 51 FR 378, Jan. 6, 1986; T.D. 8131, 52 FR 10084, Mar. 30, 1987; T.D. 8408, 57 FR 12419, Apr. 10, 1992; T.D. 8482, 58 FR 42233, Aug. 9, 1993; T.D. 8608, 60 FR 40078, Aug. 7, 1995; T.D. 8719, 62 FR 26741, May 15, 1997; T.D. 8742, 62 FR 68169, Dec. 31, 1997; T.D. 8929, 66 FR 2223, Jan. 11, 2001; T.D. 9025, 67 FR 76985, Dec. 16, 2002; T.D. 9105, 69 FR 8, Jan. 2, 2004]

§ 1.446-1T General rule for methods of accounting (temporary).

(a) through (e)(2)(i) [Reserved]. For further guidance, see § 1.446-1(a) through (e)(2)(i).

(e)(2)(ii)(a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a de-

duction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations under sections 471 and 472), a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.460-4), certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations under the Code specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(b) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and of items that are deducted as business expenses, but which are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts. Although such adjustment may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustment in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve (for example, for banks under section 585 of the Internal Revenue Code), see the regulations under section 166 of the Internal Revenue Code. A change in the method of accounting also does not include a change in treatment resulting

from a change in underlying facts. For further guidance on changes involving depreciable or amortizable assets, see paragraph (e)(2)(ii)(d) of this section and § 1.1016-3T(h).

(c) [Reserved]. For further guidance, see § 1.446-1(e)(2)(ii)(c).

(d) *Changes involving depreciable or amortizable assets—(1) Scope.* This paragraph (e)(2)(ii)(d) applies to property subject to section 167, 168, 197, 1400I, 1400L(b), or 1400L(c), or to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168).

(2) *Changes in depreciation or amortization that are a change in method of accounting.* Except as provided in paragraph (e)(2)(ii)(d)(3) of this section, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in method of accounting. Additionally, a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting. Further, except as provided in paragraph (e)(2)(ii)(d)(3) of this section, the following changes in computing depreciation or amortization are a change in method of accounting:

(i) A change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset.

(ii) A change from not claiming to claiming the additional first year depreciation deduction provided by section 168(k) or 1400L(b) for, and the resulting change to the amount otherwise allowable as a depreciation deduction for the remaining adjusted depreciable basis (or similar basis) of, qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property, provided the taxpayer did not make the election out of the additional first year depreciation deduction (or did not make a deemed election out of the additional first year depreciation deduction; for further guidance, see Rev. Proc. 2002-33 (2002-1 C.B. 963), Rev. Proc. 2003-50 (2003-29 I.R.B. 119), and § 601.601(d)(2)(ii)(b) of this chapter) for

the class of property in which the qualified property, the 50-percent bonus depreciation property, or the qualified New York Liberty Zone property is included.

(iii) A change from claiming the 30-percent additional first year depreciation deduction to claiming the 50-percent additional first year depreciation deduction for 50-percent bonus depreciation property (provided the property is not included in any class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction) or a change from claiming the 50-percent additional first year depreciation deduction to claiming the 30-percent additional first year depreciation deduction for qualified property (including property that is included in a class of property for which the taxpayer elected the 30-percent, instead of the 50-percent, additional first year depreciation deduction) or qualified New York Liberty Zone property, and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's remaining adjusted depreciable basis (or similar basis). This paragraph (e)(2)(ii)(d)(2)(iii) does not apply if a taxpayer is making a late election or revoking a timely valid election under section 168(k) or 1400L(b) (see paragraph (e)(2)(ii)(d)(3)(iii) of this section).

(iv) A change from claiming to not claiming the additional first year depreciation deduction for an asset that is not qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property, and the resulting change to the amount otherwise allowable as a depreciation deduction for the property's depreciable basis.

(v) A change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Internal Revenue Code (for example, section 168(b)(4)), the regulations under the Code (for example, § 1.197-2(f)(1)(ii)), or other guidance published in the Internal Revenue Bulletin.

(vi) A change in the accounting for depreciable or amortizable assets from a single asset account to a multiple asset account (pooling), or vice versa,

or from one type of multiple asset account (pooling) to a different type of multiple asset account (pooling).

(vii) For depreciable or amortizable assets that are mass assets accounted for in multiple asset accounts or pools, a change in the method of identifying which assets have been disposed. For purposes of this paragraph (e)(2)(ii)(d)(2)(vii), the term *mass assets* means a mass or group of individual items of depreciable or amortizable assets that are not necessarily homogeneous, each of which is minor in value relative to the total value of the mass or group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, with respect to which separate identification is impracticable, and placed in service in the same taxable year.

(viii) Any other change in depreciation or amortization as the Secretary may designate by publication in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(3) *Changes in depreciation or amortization that are not a change in method of accounting—(i) Useful life.* An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168) is not a change in method of accounting. This adjustment in useful life is corrected by adjustments in the taxable year in which the conditions known to exist at the end of that taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)-1(b) (or if the period of limitation for assessment under section 6501(a) has expired for that taxable year, in the first succeeding taxable year open under the period of limitation for assessment), and in subsequent taxable years. In other situations, the adjustment in useful life may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the Internal Revenue Service (IRS) but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates

the correction in useful life, in lieu of filing amended Federal tax returns (for example, because the conditions known to exist at the end of a prior taxable year changed thereby resulting in a redetermination of the useful life under §1.167(a)-1(b)), the taxpayer may correct the adjustment in useful life by adjustments in the current and subsequent taxable years. This paragraph (e)(2)(ii)(d)(3)(i) does not apply if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Internal Revenue Code (for example, section 167(f)(1), section 168(c), section 197), the regulations under the Code, or other guidance published in the Internal Revenue Bulletin and, therefore, such change is a change in method of accounting (unless paragraph (e)(2)(ii)(d)(3)(v) of this section applies).

(ii) *Change in use.* A change in computing depreciation or amortization allowances in the taxable year in which the use of an asset changes in the hands of the same taxpayer is not a change in method of accounting.

(iii) *Elections.* Generally, the making of a late depreciation or amortization election or the revocation of a timely valid depreciation or amortization election is not a change in method of accounting, except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin. This paragraph (e)(2)(ii)(d)(3)(iii) also applies to making a late election or revoking a timely valid election made under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (107 Stat. 312, 540) (relating to amortizable section 197 intangibles). A taxpayer may request consent to make a late election or revoke a timely valid election by submitting a request for a private letter ruling.

(iv) *Salvage value.* Except as provided under paragraph (e)(2)(ii)(d)(2)(v) of this section, a change in salvage value of a depreciable or amortizable asset is not treated as a change in method of accounting.

(v) *Placed-in-service date.* Any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting. The change in placed-in-service date may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the change in placed-in-service date, in lieu of filing amended federal tax returns, the taxpayer may correct the placed-in-service date by adjustments in the current and subsequent taxable years.

(vi) Any other change in depreciation or amortization as the Secretary may designate by publication in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(4) *Item being changed.* For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies, the item being changed generally is the depreciation treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to a depreciable asset for which depreciation is determined under § 1.167(a)-11 (CLADR property). Further, a change in computing depreciation or amortization under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168) is permitted only with respect to all assets in a particular account (as defined in § 1.167(a)-7) or vintage account.

(5) *Special rules.* For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies—

(i) *Declining balance method to the straight line method for MACRS property.* For tangible, depreciable property subject to section 168 (MACRS property) that is depreciated using the 200-percent or 150-percent declining balance method of depreciation under section 168(b)(1) or (2), a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight

line method of depreciation in the first taxable year in which the use of the straight line method with respect to the adjusted depreciable basis of the MACRS property as of the beginning of that year will yield a depreciation allowance that is greater than the depreciation allowance yielded by the use of the declining balance method. When the change is made, the adjusted depreciable basis of the MACRS property as of the beginning of the taxable year is recovered through annual depreciation allowances over the remaining recovery period (for further guidance, see section 6.06 of Rev. Proc. 87-57 (1987-2 C.B. 687) and § 601.601(d)(2)(ii)(b) of this chapter).

(ii) *Depreciation method changes for section 167 property.* For a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L, or former section 168), see § 1.167(e)-1T(b), (c), and (d) for the changes in depreciation method that are permitted to be made without the consent of the Commissioner. For CLADR property, see § 1.167(a)-11(c)(1)(iii) for the changes in depreciation method for CLADR property that are permitted to be made without the consent of the Commissioner. Further, see § 1.167(a)-11(b)(4)(iii)(c) for how to correct an incorrect classification or characterization of CLADR property.

(iii) *Section 481 adjustment.* Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin, no section 481 adjustment is required or permitted for a change from one permissible method of computing depreciation or amortization to another permissible method of computing depreciation or amortization for an asset because this change is implemented by either a cut-off method (for further guidance, see section 2.06 of Rev. Proc. 97-27 (1997-1 C.B. 680), section 2.06 of Rev. Proc. 2002-9 (2002-1 C.B. 327), and § 601.601(d)(2)(ii)(b) of this chapter) or a modified cut-off method (under which the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method of accounting), as appropriate. However, a

change from an impermissible method of computing depreciation or amortization to a permissible method of computing depreciation or amortization for an asset results in a section 481 adjustment. Similarly, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable (or vice versa) or a change in the treatment of an asset from expensing to depreciating (or vice versa) results in a section 481 adjustment.

(iii) *Examples.* The rules of this paragraph (e) are illustrated by the following examples:

Example 1. Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example 2. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example 3. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example 4. From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs in-

creases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.

Example 5. A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change in method of accounting for inventories.

Example 6. A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations under the Code. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example 7. A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a "reserve for price changes." Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations under the Code, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example 8. A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

Example 9. In 2000, A1, a calendar year taxpayer engaged in the trade or business of manufacturing knitted goods, purchased and placed in service a building and its components at a total cost of \$10,000,000 for use in its manufacturing operations. A1 classified the \$10,000,000 as nonresidential real property under section 168(e). A1 did not make any elections under section 168 on its 2000 Federal tax return. As a result, on its 2000, 2001, and 2002 federal tax returns, A1 depreciated the \$10,000,000 under the general depreciation

system of section 168(a), using the straight line method of depreciation, a 39-year recovery period, and the mid-month convention. In 2003, A1 completes a cost segregation study on the building and its components and identifies items that cost a total of \$1,500,000 as section 1245 property. As a result, the \$1,500,000 should have been classified in 2000 as 5-year property under section 168(e) and depreciated on A1's 2000, 2001, and 2002 Federal tax returns under the general depreciation system, using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, A1's change to this depreciation method, recovery period, and convention is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168.

Example 10. In 1996, B, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of \$1,000,000 for use in its plant located outside the United States. The equipment is 15-year property under section 168(e) with a class life of 20 years. The equipment is required to be depreciated under the alternative depreciation system of section 168(g). However, B incorrectly depreciated the equipment under the general depreciation system of section 168(a), using the 150-percent declining balance method, a 15-year recovery period, and the half-year convention. In 2003, the IRS examines B's 2000 Federal income tax return and changes the depreciation of the equipment to the alternative depreciation system, using the straight line method of depreciation, a 20-year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, this change in depreciation method and recovery period made by the IRS is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168.

Example 11. In May 2001, C, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. C never held this equipment for sale. However, C incorrectly treated the equipment as inventory on its 2001 and 2002 Federal tax returns. In 2003, C realizes that the equipment should have been treated as a depreciable asset. Pursuant to paragraph (e)(2)(ii)(d)(2) of this section, C's change in the treatment of the equipment from inventory to a depreciable asset is a change in method of accounting. This method change results in a section 481 adjustment.

Example 12. Since 2001, D, a calendar year taxpayer, has used the distribution fee pe-

riod method to amortize distributor commissions and, under that method, established pools to account for the distributor commissions (for further guidance, see Rev. Proc. 2000-38 (2000-2 C.B. 310) and § 601.601(d)(2)(ii)(b) of this chapter). A change in the accounting of distributor commissions under the distribution fee period method from pooling to single asset accounting is a change in method of accounting pursuant to paragraph (e)(2)(ii)(d)(2)(vi) of this section. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 13. Since 2000, E, a calendar year taxpayer, has accounted for items of MACRS property that are mass assets in pools. Each pool includes only the mass assets that are placed in service by E in the same taxable year. E is able to identify the cost basis of each asset in each pool. None of the pools are general asset accounts under section 168(i)(4) and the regulations under section 168(i)(4). E identified any dispositions of these mass assets by specific identification. Because of changes in E's recordkeeping in 2003, it is impracticable for E to continue to identify disposed mass assets using specific identification. As a result, E wants to change to a first-in, first-out method under which the mass assets disposed of in a taxable year are deemed to be from the pool with the earliest placed-in-service year in existence as of the beginning of the taxable year of each disposition. Pursuant to paragraph (e)(2)(ii)(d)(2)(vii) of this section, this change is a change in method of accounting. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 14. In August 2001, F, a calendar taxpayer, purchased and placed in service a copier for use in its trade or business. F incorrectly classified the copier as 7-year property under section 168(e). F made no elections under section 168 on its 2001 Federal tax return. As a result, on its 2001 and 2002 Federal tax returns, F depreciated the copier under the general depreciation system of section 168(a), using the 200-percent declining balance method of depreciation, a 7-year recovery period, and the half-year convention. In 2003, F realizes that the copier is 5-year property and should have been depreciated on its 2001 and 2002 Federal tax returns under the general depreciation system using a 5-year recovery period rather than a 7-year recovery period. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, F's change in recovery period from 7 to 5 years is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply

because the copier is depreciated under section 168.

Example 15. In 1998, G, a calendar year taxpayer, purchased and placed in service an intangible asset that is not an amortizable section 197 intangible and that is not described in section 167(f). G amortized the cost of the intangible asset under section 167(a) using the straight line method of depreciation and a useful life of 13 years. In 2003, because of changing conditions, G changes the remaining useful life of the intangible asset to 2 years. Pursuant to paragraph (e)(2)(ii)(d)(3)(i) of this section, G's change in useful life is not a change in method of accounting because the intangible asset is depreciated under section 167 and G is not changing to or from a useful life that is specifically assigned by the Internal Revenue Code, the regulations under the Code, or other guidance published in the Internal Revenue Bulletin.

Example 16. In July 2001, H, a calendar year taxpayer, purchased and placed in service "off-the-shelf" computer software and a new computer. The cost of the new computer and computer software are separately stated. H incorrectly included the cost of this software as part of the cost of the computer, which is 5-year property under section 168(e). On its 2001 Federal tax return, H elected to depreciate its 5-year property placed in service in 2001 under the alternative depreciation system of section 168(g). The class life for a computer is 5 years. As a result, because H included the cost of the computer software as part of the cost of the computer hardware, H depreciated the cost of the software under the alternative depreciation system, using the straight line method of depreciation, a 5-year recovery period, and the half-year convention. In 2003, H realizes that the cost of the software should have been amortized under section 167(f)(1), using the straight line method of depreciation, a 36-month useful life, and a monthly convention. H's change from 5-years to 36-months is a change in method of accounting because H is changing to a useful life that is specifically assigned by section 167(f)(1). The change in convention from the half-year to the monthly convention also is a change in method of accounting. Both changes result in a section 481 adjustment.

Example 17. On September 15, 2001, I2, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of \$500,000 for use in its business. The equipment is 5-year property under section 168(e) with a class life of 9 years and is qualified property under section 168(k). I2 did not place in service any other depreciable property in 2001. Section 168(g)(1)(A) through (D) do not apply to the equipment. I2 intended to elect the alternative depreciation system under section 168(g) for 5-year property placed in service in 2001. However, I2 did not

make the election. Instead, I2 deducted on its 2001 Federal tax return the 30-percent additional first year depreciation attributable to the equipment and, on its 2001 and 2002 Federal tax returns, depreciated the remaining adjusted depreciable basis of the equipment under the general depreciation system under 168(a), using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. In 2003, I2 realizes its failure to make the alternative depreciation system election in 2001 and files a Form 3115 to change its method of depreciating the remaining adjusted depreciable basis of the 2001 equipment to the alternative depreciation system. Because this equipment is not required to be depreciated under the alternative depreciation system, I2 is attempting to make an election under section 168(g)(7). However, this election must be made in the taxable year in which the equipment is placed in service (2001) and, consequently, I2 is attempting to make a late election under section 168(g)(7). Accordingly, I2's change to the alternative depreciation system is not a change in accounting method pursuant to paragraph (e)(2)(ii)(d)(3)(iii) of this section. Instead, I2 must submit a request for a private letter ruling under §301.9100-3 of this chapter, requesting an extension of time to make the alternative depreciation system election on its 2001 Federal tax return.

(3) [Reserved]. For further guidance, see §1.446-1(e)(3).

(4) *Effective date*—(i) *In general.* Except as provided in paragraphs (e)(3)(iii) and (e)(4)(ii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.446-1(e) in effect prior to December 30, 2003 (§1.446-1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(ii) *Changes involving depreciable or amortizable assets.* With respect to paragraph (e)(2)(ii)(d) of this section, paragraph (e)(2)(iii) *Examples 9 through 17* of this section, the addition of the language "certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section)" to the last sentence of paragraph (e)(2)(ii)(a) of this section, and the removal of all language regarding useful life and the sentence "On the other hand, a correction to require depreciation in lieu of a deduction for the cost of a class of depreciable assets which had been consistently treated as an expense in the year of purchase involves

the question of the proper timing of an item, and is to be treated as a change in method of accounting'' from paragraph (e)(2)(ii)(b) of this section—

(A) For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made for taxable years ending on or after December 30, 2003; and

(B) For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made for taxable years ending on or after December 30, 2003.

(iii) The applicability of paragraph (e) of this section expires on or before December 29, 2006.

[T.D. 9105, 69 FR 8, Jan. 2, 2004; 69 FR 5273, Feb. 4, 2004]

§ 1.446-2 Method of accounting for interest.

(a) *Applicability*—(1) *In general.* This section provides rules for determining the amount of interest that accrues during an accrual period (other than interest described in paragraph (a)(2) of this section) and for determining the portion of a payment that consists of accrued interest. For purposes of this section, interest includes original issue discount and amounts treated as interest (whether stated or unstated) in any lending or deferred payment transaction. Accrued interest determined under this section is taken into account by a taxpayer under the taxpayer's regular method of accounting (e.g., an accrual method or the cash receipts and disbursements method). Application of an exception described in paragraph (a)(2) of this section to one party to a transaction does not affect the application of this section to any other party to the transaction.

(2) *Exceptions*—(i) *Interest included or deducted under certain other provisions.* This section does not apply to interest that is taken into account under—

(A) Sections 1272(a), 1275, and 163(e) (income and deductions relating to original issue discount);

(B) Section 467(a)(2) (certain payments for the use of property or services);

(C) Sections 1276 through 1278 (market discount);

(D) Sections 1281 through 1283 (discount on certain short-term obligations);

(E) Section 7872(a) (certain loans with below-market interest rates); or

(F) Section 1.1272-3 (an election by a holder to treat all interest on a debt instrument as original issue discount).

(ii) *De minimis original issue discount.* This section does not apply to de minimis original issue discount (other than de minimis original issue discount treated as qualified stated interest) as determined under §1.1273-1(d). See §1.163-7 for the treatment of de minimis original issue discount by the issuer and §§1.1273-1(d) and 1.1272-3 for the treatment of de minimis original issue discount by the holder.

(b) *Accrual of qualified stated interest.* Qualified stated interest (as defined in §1.1273-1(c)) accrues ratably over the accrual period (or periods) to which it is attributable and accrues at the stated rate for the period (or periods).

(c) *Accrual of interest other than qualified stated interest.* Subject to the modifications in paragraph (d) of this section, the amount of interest (other than qualified stated interest) that accrues for any accrual period is determined under rules similar to those in the regulations under sections 1272 and 1275 for the accrual of original issue discount. The preceding sentence applies regardless of any contrary formula agreed to by the parties.

(d) *Modifications*—(1) *Issue price.* The issue price of the loan or contract is equal to—

(i) In the case of a contract for the sale or exchange of property to which section 483 applies, the amount described in §1.483-2(a)(1)(i) or (ii), whichever is applicable;

(ii) In the case of a contract for the sale or exchange of property to which section 483 does not apply, the stated principal amount; or

(iii) In any other case, the amount loaned.

(2) *Principal payments that are not deferred payments.* In the case of a contract to which section 483 applies, principal payments that are not deferred payments are ignored for purposes of determining yield and adjusted issue price.