26 CFR 601.204: Changes in accounting periods and in methods of accounting.

(Also Part I, §§ 1273; 1.1273–1, 1.1273–2.)

Rev. Proc. 97–39

SECTION 1. PURPOSE

.01 This revenue procedure allows a taxpayer to use the principal-reduction method of accounting — an aggregate method of accounting for de minimis original issue discount on certain loans originated by the taxpayer. The principal-reduction method is based on the rule that, if a taxpayer holds a debt instrument with de minimis original issue discount, the taxpayer must include that discount in income as stated principal payments are made. *See* § 1.1273–1(d)(5) of the Income Tax Regulations. A taxpayer may change to or adopt the principal-reduction method. The procedures for a taxpayer to change to the principal-reduction method are provided in Rev. Proc. 97–37, page 18, which provides simplified and uniform procedures to obtain automatic consent to make this and other changes in methods of accounting. This revenue procedure modifies and supersedes Rev. Proc. 94–29, 1994–1 C.B. 616.

.02 The principal-reduction method described in this revenue procedure is the same method of accounting that was described in Rev. Proc. 94–29. Accordingly, a taxpayer that properly changed to or adopted this method pursuant to Rev. Proc. 94–29 is not required to change its method of accounting to comply with this revenue procedure.

SECTION 2. BACKGROUND

.01 A debt instrument (loan) is issued with original issue discount (OID) if the loan's issue price is less than its stated redemption price at maturity. See § 1273(a)(1) of the Internal Revenue Code. In some cases, although a loan is issued with OID, the amount of OID is treated as zero. *See* § 1273(a)(3) and § 1.1273–1(d) (concerning de minimis OID).

.02 Points treated as paid when a loan is originated generally reduce the issue price of the loan. *See* § 1.1273–2(g) (concerning the effect of certain cash payments on the issue price of a loan). Thus, all points charged on a loan create or increase OID on the loan. As used in this revenue procedure, the term "points" refers only to amounts charged for the use or forbearance of money.

.03 Section 1.1272–3 allows a holder of a debt instrument to elect to use a constant yield method to account for all interest that accrues on the instrument. For purposes of this election, interest includes stated interest, acquisition discount, OID, de minimis OID, market discount, de minimis market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium. A holder may make the election only for a debt instrument acquired on or after April 4, 1994. Section 1.1272–3(d) provides rules for the time and manner of making the election under § 1.1272–3.

.04 Section 6001 and the regulations thereunder require taxpayers to keep permanent books of account or records to establish the amount of gross income for a taxable year.

SECTION 3. SCOPE

The principal-reduction method (described in section 5 of this revenue procedure) applies only to loans that—

(1) are acquired by the taxpayer at origination,

(2) do not have OID or, because the OID is de minimis under § 1.1273–1(d), are treated as not having OID,

(3) are not issued at a premium,

(4) are not subject to the election under § 1.1272–3, and

(5) produce ordinary gain or loss when sold or exchanged by the taxpayer.

SECTION 4. USE OF THE PRINCIPAL-REDUCTION METHOD

.01 *Permissibility.*

(1) *In general.* The principal-reduction method of accounting (described in section 5 of this revenue procedure) is a permissible method for use by taxpayers to account for de minimis OID (discount) on one or more categories of loans described in section 4.02 or 4.03 of this revenue procedure. If the principal-reduction method is used to account for any loans in a category of loans, the method must be used for the entire category of loans. As is more fully described in section 5 of this revenue procedure, if the method is used for more than one category, separate data for each category must be kept, and the computations must be made separately for each category.

(2) *Adopting principal-reduction method.* If a taxpayer does not already have a method of accounting for discount on one or more categories of loans, the taxpayer may adopt the principal-reduction method for discount on all or any of those categories of loans by using it on a federal income tax return. The taxpayer must attach to this return a statement identifying the categories of loans to which the new method will apply and describing any "additional categories" permitted under section 4.03 of this revenue procedure.

(3) *Changes to principal-reduction method.* A taxpayer wanting to change to the principal-reduction method must follow the provisions of Rev. Proc. 97–37.

.02 *Standard categories of loans.* The

standard categories of loans are:

Category (1). Loans that are secured by 1- to 4-family residential real property and are not home equity lines of credit or construction loans.

Category (2). Construction loans with original terms not greater than three years.

Category (3). Loans that are secured by real property, are not contained in category (1) or (2), and are not home equity lines of credit.

Category (4). Loans that are consumer loans with original terms not greater than seven years, are not secured by real property, and are not revolving credit loans.

.03 *Additional categories of loans*. The principal-reduction method also may be used for discount on loans that are described in section 3 of this revenue procedure but are not in one of the standard categories described in section 4.02 of this revenue procedure. This use is permissible, however, only if the taxpayer defines one or more additional categories of loans that are sufficiently homogeneous so that use of the principal- reduction method for those additional categories clearly reflects the taxpayer's income. In particular, each additional category must consist solely of loans of comparable duration. For this purpose, duration means the weighted average time to expected payments of principal (including expected prepayments of principal). The weighted average is computed using the present value at issue of the expected payments and prepayments.

SECTION 5. PRINCIPAL-REDUCTION METHOD OF ACCOUNTING

Under the principal-reduction method of accounting for discount —

.01 As of the date each loan in a category is acquired, the taxpayer's basis in the loan is deemed to be the loan's stated principal amount. All the gain represented by the discount on the loan is recognized solely under the principal-reduction method described in this revenue procedure.

.02 The required computations must be made monthly. Thus, the computation period referred to in this revenue procedure is the month (or that portion of a month that falls within a short taxable year).

.03 At the start of each computation period, the taxpayer must record and retain the following information for each category of loans for which the taxpayer is using the principal-reduction method:

(1) Unpaid stated principal as of the end of the prior period of all loans in the category that were held at the end of the prior period (Starting Principal); and

(2) Unrecognized discount as of the end of the prior period (Starting Discount).

For the initial computation period, Starting Principal and Starting Discount are zero.

.04 During each computation period, the taxpayer must record and retain the following information for each category of loans for which the taxpayer is using the principal-reduction method:

(1) The stated principal amount at the time of acquisition of all loans in the category that were acquired at origination by the taxpayer at any time during the period, whether or not they are still held by the taxpayer at the end of the period (Current Principal). This amount includes loans in the category that are acquired as refinancings of, or in exchange for, loans previously held by the taxpayer. Thus, if a loan (whether or not in the category) is modified and the modification results under § 1001 in a deemed sale or exchange of the old loan for a new one that is in the category, the stated principal amount of the new loan is included in Current Principal.

(2) The aggregate discount (including discount attributable to points) at the time of acquisition on all loans described in section 5.04(1) of this revenue procedure (Current Discount).

(3) The unpaid stated principal amount of all loans in the category that are still held by the taxpayer at the end of the period (Ending Principal). Thus, Ending Principal does not include the stated principal amount of loans disposed of in refinancings or exchanges during the period. Ending Principal does not include rights (such as mortgage servicing rights) that are retained on the sale of a loan, except to the extent that those rights represent a participation interest in the stated principal amount of the original loan. Ending Principal does not include the stated principal amount of any loan to the extent charged off by the taxpayer during the period. Except as provided in the following sentence, if the taxpayer has foreclosed on the property securing a loan, neither the unpaid stated principal on the loan nor any remaining deficiency on the loan is counted as part of Ending Principal. If property securing a loan is acquired in a transaction governed by former § 595 and the property has not been disposed of before the end of the period, Ending Principal includes the unpaid stated principal of the loan immediately before the transaction in which the property was acquired.

.05 The discount taken into account as gain (Recognized Discount) during each computation period is the portion of total discount that corresponds to the portion of principal recovered during the period. For this purpose, Recognized Discount is the product of the sum of Starting Discount plus Current Discount times a fraction the denominator of which is the sum of Starting Principal plus Current Principal and the numerator of which is the excess of the denominator over Ending Principal. This can be restated as:

$$R = (D_{Start} + D_{Current}) \times ([P_{Start} + P_{Current} - P_{End}] / [P_{Start} + P_{Current}])$$

where —

P_{Start}	=	Starting Principal
D_{Start}	=	Starting Discount
$P_{Current}$	=	Current Principal
$D_{Current}$	=	Current Discount
P_{End}	=	Ending Principal
R	=	Recognized Discount

.06 The unrecognized discount at the end of the period (Ending Discount) is the excess of the sum of Starting Discount plus Current Discount over Recognized Discount. This amount must be used as Starting Discount for the next period. This can be restated as:

$$D_{End} = D_{Start} + D_{Current} - R$$

where —

D_{End} = Ending Discount

.07 Ending Principal for the current period must be used as Starting Principal for the following period.

.08 The discount recognized as gain during a taxable year is the sum of the Recognized Discount for all computation periods comprising the year.

.09 For each period, the amounts referred to above must be recorded and separately retained as part of the taxpayer's tax books and records. *See* § 6001 and the regulations thereunder. These records must be maintained as separate tax records and not merely as a set of adjustments to book figures. These records must affirmatively demonstrate the period-to-period consistency required by sections 5.06 and 5.07 of this revenue procedure.

SECTION 6. EXAMPLE

.01 *T* properly adopts the method described in section 5 of this revenue procedure for all the loans that it acquires that are described in Category (1) in section 4.02 of this revenue procedure.

.02 For *T*'s first month in operation, it acquired at origination loans in Category (1) with an aggregate stated principal amount of $10,000,000 at the time of acquisition. The sum of the discount with which these loans were acquired is $400,000. At the end of the month, $9,000,000 was the outstanding stated principal amount on the Category (1) loans still held by *T*. Thus, the discount recognized during the month is $40,000. That figure is derived as follows:

$R = (D_{Start} + D_{Current}) \times ([P_{Start} + P_{Current} - P_{End}] / [P_{Start} + P_{Current}])$

= ($0 + $400,000) x ([$0 + $10,000,000 - $9,000,000] / [$0 + $10,000,000])

= ($400,000) x ($1,000,000 / $10,000,000)

= $400,000 x 0.1

= $40,000

The amount of unrecognized discount at the end of the month is $360,000. This figure is derived as follows:

$D_{End} = D_{Start} + D_{Current} - R$

= $0 + $400,000 – $40,000

= $360,000

.03 In the second month of operation, T acquired at origination $23,000,000 in Category (1) loans with a total of $760,000 in discount at the time of acquisition. At the end of the month, $28,000,000 was the outstanding stated principal amount on Category (1) loans still held by T. Thus, the discount recognized during the second month is $140,000. This figure is derived as follows:

$R = (D_{Start} + D_{Current}) \times ([P_{Start} + P_{Current} - P_{End}] / [P_{Start} + P_{Current}])$

= ($360,000 + $760,000) x ($9,000,000 + $23,000,000 – $28,000,000) / ($9,000,000 + $23,000,000)

= $1,120,000 x ($4,000,000 / $32,000,000)

= $1,120,000 x 0.125

= $140,000

The amount of unrecognized discount at the end of the month is $980,000 of discount. This figure is derived as follows:

$D_{End} = D_{Start} + D_{Current} - R$

= $360,000 + $760,000 – $140,000

= $980,000

SECTION 7. INTERACTION WITH § 475

If a loan is subject to both the mark-to-market rules under § 475 and the principal-reduction method, see Notice 96–23, 1996–1 C.B. 374.

SECTION 8. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:FI&P, 1111 Constitution Avenue, NW, Washington, DC 20224.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 94–29, 1994–1 C.B. 616, is modified, and as modified, is superseded. However, see the transition rules in section 13.02 of Rev. Proc. 97–37.

SECTION 10. EFFECTIVE DATE

This revenue procedure is effective on August 18, 1997.

SECTION 11. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1551.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are in sections 4 and 5. This information is necessary and will be used to determine whether the taxpayer properly has adopted the principal-reduction method of accounting. The collections of information are required for the taxpayer to use the principal-reduction method of accounting. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 3,650 hours.

The estimated annual burden per respondent/record keeper varies from 12 hours to 14 hours depending on individual circumstances, with an estimated average of 12 hours. The estimated number of respondents and/or recordkeepers is 350.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

This revenue procedure was drafted in the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure, contact

William E. Blanchard on (202) 622-3950 (not a toll free call).