# Final(ly), Regulations Issued under Section 381

Tax Alert
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New final regulations under sections 381(c)(4) and (c)(5) were issued by the Treasury Department and IRS on August 1, 2011, in TD 9534. These new regulations pertain to the methods of accounting, including inventory methods, that may be used by corporations that acquire the assets of other corporations in certain corporate reorganizations and tax-free liquidations. Specifically, they address whether a post-acquisition trade or business should use a carryover method, principal method, or alternative permissible method.

As discussed more fully below, the methods of accounting to be used by the acquirer generally depend on whether the trades or business of the parties are integrated. If they are integrated, generally the acquirer must use the principal method of accounting, as determined under the regulations. Particular care and attention should be paid when determining whether to integrate the trades or businesses or to keep them separate, and if they are integrated, to determining the principal method. It is often the case that the principal method may be changed through adequate pre-transaction planning. Similarly, when integration is desired, a substantial amount of post-acquisition work will often be required to achieve that integration. Taxpayers should give attention before and after the acquisition to documenting their intent regarding separate or integrated trades or businesses in order to obtain the results they desire.

The newly published regulations are intended to clarify and simply the applicable rules. The final regulations are essentially the same as the proposed regulations that were published in November of 2007. Changes from the proposed regulations are non-substantive in nature.

As background, section 381 provides for the carryover of specified tax attributes after certain corporate reorganizations and tax-free liquidations. The focus of the final regulations is whether the acquiring corporation operates the trades or businesses of the parties to a section 381(a) transaction as separate and distinct trades or businesses following the date of distribution or transfer or as an integrated trade or business. Under the regulations, if the trades or business are operated separately, the carryover method will be used. In other words, the accounting methods used by the parties prior to the distribution or transfer will carry over and continue in use. However, if the trades or businesses are integrated, the acquiring corporation must determine and use the principal method.

In general, the principal method is the accounting method used by the acquiring corporation before the date of distribution or transfer; however, there are two exceptions where the distributing corporation's methods would be treated as the principal method. First, if the acquiring corporation does not have an accounting method for a particular item, the distributing corporation's method would become the principal method. Secondly, if the distributing corporation is larger than the acquiring company, all of the distributing corporation's non-inventory methods will become the principal methods.

To determine if a distributing corporation is larger than the acquiring corporation certain attributes, such as the adjusted bases of the assets and gross receipts under section 381(c)(4) and the fair market value of the inventory under section 381(c)(5), of only the trades or businesses that will be integrated after the date of distribution or transfer must be compared. In order for a distributing corporation's method to become the principal method under the first comparison, both the bases of the assets and the gross receipts of the distributing corporation must be larger. If they are not, the principal method will be that of the acquiring corporation. In respect to the fair market value of the inventory, a distributing corporation's method will be treated as the principal method when the distributing corporation holds more inventory of a particular type of goods than the acquiring corporation, based generally upon fair market value.

The final regulations also include rules for determining adjustments arising from a change in an accounting method under sections 381(c)(4) and (c)(5). As a matter of note, unlike changes in method of accounting under section 446(e), where a taxpayer must disclose its use of a method of accounting on a Form 3115, the final regulations do not provide audit protection when an acquiring corporation uses a principal method following a section 381(a) transaction.

Lastly, the final regulations include provisions concerning the time and manner for requesting permission to change an accounting method under the section 381 regulations, and for changing the accounting method in the tax year of the transfer or distribution. Regardless of whether the trades or businesses are operated separately, the regulations provide that an impermissible method may not be used. The acquiring corporation must secure IRS consent to change to a permissible method. The regulations provide that the general rules governing accounting method changes under section 446(e) should be used if the acquiring corporation chooses not to use the carryover method or principal method.

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