Issued in Fort Worth, Texas, on November 5, 2007.

David A. Downey,

Manager, Rotorcraft Directorate, Aircraft Certification Service.

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DEPARTMENT OF THE INTERIOR

National Indian Gaming Commission

25 CFR Parts 502, 542, 543, 546, and 547

Notice of Extension of Comment Period

AGENCY: National Indian Gaming Commission, DOI.

SUMMARY: This notice extends the period for comments on the proposed definition for electronic or electromechanical facsimile (72 FR 60482), Class II game classification standards (72 FR 60483), Class II technical standards (72 FR 60495), and Class II minimum internal control standards (72 FR 60508) published in the **Federal Register** on October 24, 2007.

DATES: The comment period for the proposed definition for electronic or electromechanical facsimile, Class II game classification standards, Class II technical standards, and Class II minimum internal control standards regulations is extended from December 10, 2007, to January 24, 2008.

FOR FURTHER INFORMATION CONTACT: Penny Coleman, John Hay, or Michael Gross at 202/632–7003; fax 202/632–7066 (these are not toll-free numbers).

SUPPLEMENTARY INFORMATION: Congress established the National Indian Gaming Commission (NIGC or Commission) under the Indian Gaming Regulatory Act of 1988 (25 U.S.C. 2701 et seq.) (IGRA) to regulate gaming on Indian lands. On October 24, 2007, the proposed definition for electronic or electromechanical facsimile (72 FR 60482), Class II game classification standards (72 FR 60483), Class II technical standards (72 FR 60495), and Class II minimum internal control standards (72 FR 60508) regulations were published in the **Federal Register**.

Dated: November 5, 2007.

Philip N. Hogen,

Chairman, National Indian Gaming Commission.

Cloyce V. Choney,

Vice Chairman, National Indian Gaming Commission.

Norman H. DesRosiers,

Commissioner, National Indian Gaming Commission.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–151884–03]

RIN 1545–BD81

Update and Revision of Sections 1.381(c)(4)–1 and 1.381(c)(5)–1

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance under sections 381(c)(4) and (c)(5) of the Internal Revenue Code (Code) relating to the accounting method or combination of methods, including the inventory method, to use after certain corporate reorganizations and tax-free liquidations. These proposed regulations clarify and simplify the existing regulations under sections 381(c)(4) and (c)(5). The regulations affect corporations that acquire the assets of other corporations in transactions described in section 381(a).

DATES: Written or electronic comments and requests for a public hearing must be received by February 14, 2008.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–151884–03), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–151884–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov/* (IRS REG–151884–03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Cheryl Oseekey at (202) 622–4970; concerning submissions of comments and requests for a hearing, Kelly Banks at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Overview

Section 381 of the Code was enacted in 1954 to provide statutory authority for determining the carryover of certain tax attributes, including accounting methods, in certain corporate reorganizations and tax-free liquidations. Regulations implementing section 381(c)(4) were issued on August 5, 1964 (29 FR 11263). On August 23, 1972, the IRS proposed to revise these regulations (37 FR 16947). On December 23, 1998, the IRS withdrew the regulations that had been proposed in 1972 (63 FR 71047). Regulations implementing section 381(c)(5) were issued on January 15, 1975 (40 FR 2684).

Section 1.381(c)(4)–1 generally provides that after a section 381(a) transaction, the accounting method or combination of methods used by the parties to the section 381(a) transaction prior to the transaction will continue. However, when the accounting methods used prior to the section 381(a) transaction cannot continue to be used after the transaction, § 1.381(c)(4)–1 identifies the accounting method(s) to use after the transaction. Section 1.381(c)(5)–1 provides similar rules regarding inventory accounting methods.

The IRS and the Treasury Department are aware that the current regulations are inconsistent in the treatment of adjustments for inventory methods and for other accounting methods, and that there is confusion regarding the appropriate procedure for making accounting method changes required by section 381. In a notice of proposed rulemaking (68 FR 25310) issued on May 12, 2003, regarding sections 263A and 448, the IRS and the Treasury Department indicated that guidance regarding the accounting method(s) to be used after a section 381(a) transaction was contemplated. This notice of proposed rulemaking provides that guidance.

This notice of proposed rulemaking generally continues many of the provisions of the regulations originally issued in 1964 and 1975 regarding the accounting method or combination of methods to be used by the corporation that acquires the assets of another corporation in a section 381(a) transaction. However, the following changes to these regulations are proposed.

Consistency Between Sections 381(c)(4) and (c)(5)

Under the current regulations, there are several inconsistencies between the rules that apply to accounting method changes made pursuant to section 381(c)(4) and those made under section 381(c)(5). The proposed regulations generally make the rules that apply to accounting method changes made pursuant to section 381(c)(4) consistent with the rules that apply to changes made under section 381(c)(5).

Determining the Method To Be Used After the Section 381(a) Transaction

In general, the current regulations under both sections 381(c)(4) and (c)(5) provide that the accounting method to be used after a section 381(a) transaction by the party that survives the reorganization or liquidation (acquiring corporation) will depend on whether (1) The parties to the section 381(a) transaction used (or did not use) the same accounting method on the date of the section 381(a) transaction, and (2) The businesses of the parties to the section 381(a) transaction are combined after the transaction by the party that survives the transaction. If different methods are used and the combined corporations are operated as a single trade or business after the section 381(a) transaction, then the principal and special method (including the inventory method) rules apply.

The parties to the section 381(a) transaction determine the principal method by applying various tests under the regulations. The applicable test depends on whether the method under consideration is the overall accounting method, the method for a particular type of goods for which the Code or regulations provide a special method or methods, or an inventory method. The rules under the current regulations also address situations in which there is no principal method, or the principal method does not clearly reflect income. Currently, the regulations provide that if there is no principal method after applying the appropriate test or if that method is impermissible, the Commissioner shall select a suitable accounting method to use after the transaction.

The IRS and the Treasury Department believe that the various tests in the regulations and the need for the Commissioner in some situations to select a suitable accounting method to be used after the transaction have caused confusion and have led to controversies between taxpayers and the IRS. In order to eliminate the confusion and uncertainty and provide simplicity and uniformity, the IRS and the Treasury Department propose to provide rules that are similar to the current regulations but have a default rule to determine the principal method.

The proposed regulations generally provide under both sections 381(c)(4) and (c)(5) that the accounting method to be used after a section 381(a) transaction by the acquiring corporation will depend on whether (1) The businesses of the parties to the section 381(a) transaction are combined after the transaction by the acquiring corporation, and (2) The method is permissible. As under the current regulations, if the trades or businesses of the parties to the section 381(a) transaction are operated as separate trades or businesses after the section 381(a) transaction, an accounting method used by the parties prior to the section 381(a) transaction carries over and is used by the acquiring corporation provided the method is permissible (carryover method). If the trades or businesses of the parties to the section 381(a) transaction are not operated as separate trades or businesses after the section 381(a) transaction, then the acquiring corporation must determine and use the principal method.

The proposed regulations provide a general rule that the principal method generally is the accounting method used by the acquiring corporation prior to the section 381(a) transaction. However, there are two exceptions. First, if the acquiring corporation does not have an accounting method for a particular item or type of goods, the principal method is the accounting method for the item or type of goods used by the distributor or transferor corporation prior to the section 381(a) transaction. Second, if the distributor or transferor corporation is larger than the acquiring corporation, the principal methods for the overall accounting method and for the accounting method for a particular item or type of goods are the methods used by the distributor or transferor corporation prior to the section 381(a) transaction. The principal method continues to be determined separately for the overall accounting method and for any special accounting methods, such as an accounting method used for a long-term contract.

Under the proposed regulations, whether the distributor or transferor corporation is larger than the acquiring corporation is determined using the test in § 1.381(c)(4)–1 of the current regulations for determining the overall principal method for methods other than inventory. Therefore, the parties to the section 381(a) transaction will compare their relative sizes in terms of total asset bases and gross receipts for both the overall accounting method and for special accounting methods. For inventory, whether the distributor or transferor corporation is larger than the acquiring corporation will be determined based on the value of the inventory using a test similar to the test in § 1.381(c)(5)–1 of the current regulations. The principal method is the inventory method used by the party with the largest fair market value of a particular type of goods. The regulations provide a simplified election that allows the acquiring corporation to apply the principal method test by comparing the value of the entire inventories of the parties to the section 381(a) transaction rather than the value of each particular type of goods.

Under the proposed regulations, if the carryover method or principal method is an impermissible method, the acquiring corporation generally must file a request to change to a permissible accounting method. However, if the carryover method is impermissible solely because only a single accounting method with respect to a particular item may be used by the acquiring corporation on the date of the section 381(a) transaction regardless of the number of separate and distinct trades or businesses operated on that date, the acquiring corporation must use the principal method as determined under § 1.381(c)(4)–1(c) of the proposed regulations.

All parties to a section 381(a) transaction may request permission to change their accounting methods for the taxable year in which the transaction occurs or is expected to occur under section 446(e). However, the acquiring corporation need not secure the Commissioner's consent to continue a carryover method or use the principal method.

Additionally, there is confusion under the current regulations as to whether an accounting method is established immediately upon use of a carryover method or principal method if the method is impermissible, and as to the appropriate remedy if an acquiring corporation discovers after the deadline for filing a request to change an accounting method for the year of the section 381(a) transaction that the carryover method or principal method is an impermissible method. The proposed regulations make it clear that every accounting method, whether it is a carryover method or a principal method, and whether the method is a permissible or impermissible method, is an established accounting method. Therefore, if an acquiring corporation discovers after the deadline for filing a request to change an accounting method for the year of the section 381(a) transaction that it is using an impermissible method, the acquiring corporation must file for an accounting method change to a permissible accounting method for the taxable year following the section 381(a) transaction.

Determining Adjustments Arising From a Change in an Accounting Method Under Sections 381(c)(4) and (c)(5)

Under the current regulations in § 1.381(c)(4)–1, once a principal method is determined, any party to the section 381(a) transaction that is required to change its accounting method to the principal method must compute the adjustment necessary to reflect the change by determining the difference between its tax liability as reflected on its actual return computed using its old accounting method, and the tax liability reflected on a hypothetical federal income tax return using the new accounting method. This adjustment is computed as if, on the date of the section 381(a) transaction, each changing corporation initiates an accounting method change. If there is an increase or decrease in tax liability, the acquiring corporation takes into account the hypothetical increase or decrease in tax in the taxable year that includes the date of the section 381(a) transaction.

The procedures are different for inventory under the current regulations in § 1.381(c)(5)–1. In lieu of the acquiring corporation taking into account the hypothetical increase or decrease in tax in the taxable year that includes the date of the section 381(a) transaction, the acquiring corporation takes the increase or decrease in income attributable to the accounting method change directly into account.

The IRS and the Treasury Department believe that the procedures for implementing changes to a principal method under the current regulations have been inconsistently applied and are another source of confusion. The proposed regulations modify § 1.381(c)(4)–1 and generally apply the adjustment methodology used under section 446(e) and § 1.381(c)(5)–1 of the current regulations. The proposed regulations generally make accounting method changes to a principal method and the resulting section 481(a) adjustment, if any, procedurally consistent with accounting method changes made pursuant to section 446(e). Accordingly, the acquiring corporation computes the section 481(a) adjustment necessary to reflect the accounting method change, if any, as if it had initiated an accounting method change for the trade or business required to implement the principal method. The acquiring corporation takes into account the appropriate amount of the section 481(a) adjustment, if any, computed as of the date of the section 381(a) transaction, from the accounting method change as an increase or decrease to its taxable income on the date of the section 381(a) transaction.

Furthermore, to simplify the procedures under section 381(a) for accounting method changes, the proposed regulations provide that the rules governing accounting method changes under section 446(e) apply to determine (1) Whether the section 381(a) accounting method change is implemented with a section 481(a) adjustment or on a cut-off basis, (2) The computation of the section 481(a) adjustment, and (3) The appropriate period of taxable years over which the adjustment is included in taxable income. These rules are contained in applicable administrative published procedures that govern voluntary accounting method changes under section 446(e). (See, for example, Rev. Proc. 2002–9 (2002–1 CB 327) (see § 601.601(d)(2)(ii)(*b*) of this chapter), as modified and clarified by Announcement 2002–17 (2002–1 CB 561), modified and amplified by Rev. Proc. 2002–19 (2002–1 CB 696) (see § 601.601(d)(2)(ii)(*b*) of this chapter), and amplified, clarified and modified by Rev. Proc. 2002–54 (2002–2 CB 432), and Rev. Proc. 97–27 (1997–1 CB 680) (see § 601.601(d)(2)(ii)(*b*) of this chapter), as modified and amplified by Rev. Proc. 2002–19, as amplified and clarified by Rev. Proc. 2002–54). For example, if the current administrative procedures allow a section 481(a) adjustment to be taken into account over a period of four years for a particular accounting method change, an acquiring corporation will take into account one-fourth of the section 481(a) adjustment in the taxable year that includes the section 381(a) transaction, and one-fourth of the section 481(a) adjustment in each of the subsequent three years.

Time and Manner of Requesting Permission To Change an Accounting Method Under § 1.381(c)(4)–1 or § 1.381(c)(5)–1

Under the current regulations, if the acquiring corporation cannot use a principal method because it is impermissible, that is, it does not clearly reflect income or it conflicts with a closing agreement, or the acquiring corporation does not want to use the principal method even though it is permissible, there is confusion as to the manner in which a taxpayer requests the Commissioner's permission to use a different accounting method. Specifically, it is unclear whether an acquiring corporation may file a Form 3115, Application for Change in Accounting Method, to request the Commissioner's permission or whether the acquiring corporation must file a request for a private letter ruling. The proposed regulations make it clear that a taxpayer must request an accounting method change consistent with the manner in which accounting method changes are requested pursuant to section 446(e), that is, on a Form 3115.

The regulations under section 446(e) currently allow taxpayers to request an accounting method change at any time during the taxable year. See § 1.446–1(e)(3)(i). Under §§ 1.381(c)(4)–1(d) and 1.381(c)(5)–1(d) of the current regulations, the time for filing a request for an accounting method change is inconsistent with the section 446(e) regulations. Although the times for filing under these two regulations were consistent when the regulations were initially published, the section 446(e) regulations were subsequently amended without making conforming changes to §§ 1.381(c)(4)–1(d) and 1.381(c)(5)–1(d) of the current regulations. This inconsistency also has caused confusion. Rev. Proc. 2005–63 (2005–2 CB 491) (see § 601.601(d)(2)(ii)(*b*) of this chapter) was issued to address the problem. The revenue procedure extends the time to file a request to change an accounting method to the later of (1) The last day of the taxable year in which the distribution or transfer occurred, or (2) The earlier of (a) the day that is 180 days after the section 381(a) transaction date, or (b) the day on which the acquiring corporation files its tax return for the taxable year in which the distribution or transfer occurred.

The proposed regulations generally incorporate the time provided in Rev. Proc. 2005–63 for requesting the Commissioner's consent to change an accounting method. The IRS and the Treasury Department intend by this revision generally to conform the due dates for requesting an accounting method change under sections 381(c)(4) and (c)(5) to the due dates for requesting other accounting method changes under section 446(e), while providing sufficient time to request the Commissioner's consent if the section 381(a) transaction occurs at or near the end of a taxable year.

Changing Accounting Methods in the Taxable Year of the Section 381(a) Transaction

The existing regulations under sections 381(c)(4) and (c)(5) require certain adjustments attributable to an accounting method change to be taken into account entirely in one taxable year. The adjustment required of the acquiring corporation under the existing section 381(c)(4) regulations is to take into account the hypothetical tax increase due to the accounting method change rather than a section 481(a) adjustment. The administrative procedures applicable to voluntary accounting method changes historically have required a section 481(a) adjustment to be taken into account over a period of taxable years. This discrepancy in when the adjustments are taken into account produced an incentive for taxpayers to request a voluntary accounting method change in the year in which the section 381(a) transaction occurred for changes that would result in a positive adjustment while making changes that would result in a negative adjustment under the rules in § 1.381(c)(4)–1 or § 1.381(c)(5)–1 of the current regulations. The IRS generally declined to entertain requests for an accounting method change that otherwise would be effected pursuant to sections 381(c)(4) and (c)(5). More recently, however, the administrative procedures that apply to voluntary accounting method changes have provided for taking positive section 481(a) adjustments into account over a period of taxable years while allowing negative section 481(a) adjustments to be taken into account in the year in which the method change is effected, which lessens the incentive to make an accounting method change under section 446(e) in lieu of section 381(a).

Generally, the proposed regulations provide that the acquiring corporation will be permitted to request an accounting method change for the taxable year in which the section 381(a) transaction occurs. The proposed regulations also provide that the other parties to a section 381(a) transaction will be allowed to request accounting method changes for the taxable year that ends with the section 381(a) transaction. For trades or businesses that will not operate as separate trades or businesses after the section 381(a) transaction, an accounting method change will be granted only if the requested method is the method that will continue to be used after the section 381(a) transaction. For example, an acquiring corporation will be granted permission to change an accounting method only if the proposed method will be the principal method on the date of the section 381(a) transaction. The IRS generally will not grant an accounting method change to a distributor or transferor corporation for the taxable year that ends with the section 381(a) transaction if that method must change to a different method under the principal method rules of §§ 1.381(c)(4)–1(c) and 1.381(c)(5)–1(c) of the proposed regulations. Similarly, the IRS generally will not grant an accounting method change to an acquiring corporation in the taxable year that includes the section 381(a) transaction if that method must change to a different method under the principal method rules of §§ 1.381(c)(4)–1(c) and 1.381(c)(5)–1(c) of the proposed regulations. If and when the proposed regulations are finalized, the IRS and the Treasury Department intend to make changes to the administrative procedures applicable to voluntary accounting methods to generally allow changes during the year of a section 381(a) transaction as previously described and will change relevant terms and conditions, as needed, particularly for taxpayers who are under exam or in appeals.

Audit Protection

Changes to the principal method under §§ 1.381(c)(4)–1 and 1.381(c)(5)–1 of the current regulations are made without audit protection. The IRS and the Treasury Department believe that audit protection is not warranted when either the carryover method or principal method, as applicable, is used in the context of voluntary compliance under sections 381(c)(4) and (c)(5). Unlike accounting method changes under section 446(e) for which a taxpayer must disclose its use of an improper accounting method as part of the accounting method change process, changes to a principal method pursuant to §§ 1.381(c)(4)–1 and 1.381(c)(5)–1 of the current regulations are made by the taxpayer on the tax return without disclosing the change on a Form 3115, Application for Change in Accounting Method.

The IRS and the Treasury Department, however, believe that audit protection is warranted when an accounting method other than the carryover method or principal method is used in the context of voluntary compliance under sections 381(c)(4) and (c)(5). Under the proposed regulations, a taxpayer using an improper accounting method may request permission to change the method at any time before the end of its taxable year. Thus, if the acquiring corporation is using an improper accounting method or would be required to use an improper accounting method because of the application of § 1.381(c)(4)–1 or § 1.381(c)(5)–1 of the proposed regulations, it can request consent to change to a proper accounting method. That change will be accorded the usual audit protection procedures provided in guidance issued under section 446(e) for the requested change. Similarly, if another party to the section 381(a) transaction is using an improper accounting method, it may request consent to change to a proper accounting method at any time prior to the section 381(a) transaction. That change also will be accorded the usual audit protection procedures provided in guidance issued under section 446(e) for the requested change.

Proposed Effective/Applicability Date

These regulations are proposed to apply to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after the date these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Although there is a lack of available data regarding the extent to which small entities engage in the corporate reorganizations and tax-free liquidations described in section 381(a), this certification is based on the belief of the IRS and the Treasury Department that these transactions generally involve larger entities. Notwithstanding this certification that only large entities are affected, these proposed regulations will not have a significant economic impact on large or small taxpayers. These proposed regulations will reduce burden on taxpayers by clarifying existing rules and simplifying the procedures for requesting changes in accounting methods to methods other than the carryover or principal methods. Additionally, these proposed regulations make the implementation rules more consistent with the general rules for changes in accounting methods. Therefore, because these proposed regulations would generally clarify and simplify existing rules, these regulations will not have a significant economic impact on a substantial number of small entities. The IRS and the Treasury Department specifically solicit comment from any party, particularly affected small entities, on the accuracy of this certification. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department want to provide clear, consistent, and administrable rules that will reduce the uncertainty and controversy in this area. Thus, the IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. Topics on which comments are requested include: (1) In determining the relative sizes of the parties to a section 381(a) transaction, is it appropriate to calculate the gross receipts for a representative period by examining the gross receipts that are properly recognized under the acquiring corporation's and the distributor or transferor corporation's accounting method used for that period for federal income tax purposes, and (2) For a taxpayer using the last-in, first-out (LIFO) inventory method, should the principal method be applied at the level of each particular type of goods, or to pools of goods? All comments will be made available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Cheryl Oseekey, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.381(c)(4)–1 also issued under 26 U.S.C. 381(c)(4). * * *

Section 1.381(c)(5)–1 also issued under 26 U.S.C. 381(c)(5). * * *

Par. 2. In § 1.381(a)–1, paragraph (b)(1)(i) is revised and paragraph (e) is added to read as follows:

§ 1.381(a)–1 General rule relating to carryovers in certain corporate acquisitions.

* * * * *

(b) * * *

(1) * * * (i) The complete liquidation of a subsidiary corporation upon which no gain or loss is recognized in accordance with the provisions of section 332;

* * * * *

(e) *Effective/applicability date.* The rules of paragraph (b)(1)(i) of this section apply to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 3. Section1.381(c)(4)–1 is revised to read as follows:

§ 1.381(c)(4)–1 Accounting method.

(a) *Introduction*—(1) *Purpose.* This section provides guidance regarding the accounting method or combination of methods (other than inventory and depreciation accounting methods) an acquiring corporation must use following a distribution or transfer to which sections 381(a) and (c)(4) apply and how to implement any associated accounting method changes. See § 1.381(c)(5)–1 for guidance regarding the inventory accounting methods an acquiring corporation must use following a distribution or transfer to which sections 381(a) and (c)(5) apply. See § 1.381(c)(6)–1 for guidance regarding the depreciation accounting methods an acquiring corporation must use following a distribution or transfer to which sections 381(a) and (c)(6) apply.

(2) *Carryover requirement*—(i) *In general.* In a transaction to which section 381(a) applies, if an acquiring corporation operates the trades or businesses of the parties to the section 381(a) transaction as separate and distinct trades or businesses after the date of distribution or transfer, then the acquiring corporation generally must use the same accounting method(s) used by the distributor or transferor corporation(s) on the date of distribution or transfer for the acquired trade or business (carryover method). If an acquiring corporation does not operate the trades or businesses of the parties to the section 381(a) transaction as separate and distinct trades or businesses after the date of distribution or transfer, then the acquiring corporation must use a principal method as determined under paragraph (c) of this section and must take into account any section 481(a) adjustment, if applicable, as required under paragraph (d)(1) of this section. The acquiring corporation need not secure the Commissioner's consent to continue or to use a permissible carryover method or principal method.

(ii) *Carryover method or principal method not permissible.* In general, if a carryover method or principal method is an impermissible accounting method, the acquiring corporation must secure the Commissioner's consent to change to a different accounting method as provided in paragraph (d)(2) of this section. If, however, a carryover method is impermissible solely because only a single accounting method with respect to a particular item may be used by the acquiring corporation after the date of the section 381(a) transaction regardless of the number of separate and distinct trades or businesses operated on that date, the acquiring corporation must use a principal method as determined under paragraph (c) of this section.

(iii) *Voluntary change.* All parties to a section 381(a) transaction may request permission under section 446(e) to change an accounting method for the taxable year in which the transaction occurs or is expected to occur. For trades or businesses that will not operate as separate trades or businesses after the section 381(a) transaction, an accounting method change will be granted only if the requested method is the method that the acquiring corporation must use after the date of the distribution or transfer in the taxable year that includes the section 381(a) transaction. The time and manner of obtaining the Commissioner's consent to change to a different accounting method is described in paragraph (d)(2) of this section.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (a):

Example 1. Separate and distinct trades or businesses after the date of the distribution *or transfer*—(i) *Facts.* X Corporation operates an employment agency that uses the overall cash receipts and disbursements accounting method. T Corporation operates an educational institution that uses an overall accrual method. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. X Corporation operates the employment agency and educational institution as separate and distinct trades or businesses after the date of the section 381(a) transaction.

(ii) *Conclusion.* After the section 381(a) transaction, X Corporation will use the cash receipts and disbursements method for the employment agency and an accrual method for the educational institution. X Corporation need not secure the Commissioner's consent to continue either accounting method.

Example 2. Carryover of special accounting method—(i) *Facts.* X Corporation provides personal grooming consulting and T Corporation provides weight management consulting. Both X Corporation and T Corporation use an overall accrual method. X Corporation acquires all of the assets of T Corporation in a transaction to which section 381(a) applies. X Corporation operates the personal grooming and weight management consulting businesses as separate and distinct trades or businesses after the date of the section 381(a) transaction. X Corporation has made an election to use the recurring item exception under § 1.461–4(h). T Corporation has not.

(ii) *Conclusion.* After the section 381(a) transaction, X Corporation will use an overall accrual method for both the personal grooming consulting business and the weight management consulting business. X Corporation must continue to use the recurring item exception under § 1.461–4(h) for the personal grooming consulting business. X Corporation need not secure the Commissioner's consent to continue its overall accrual method and the recurring item exception under § 1.461–4(h) for the personal grooming consulting business.

Example 3. One accounting method allowed—(i) *Facts.* X Corporation is an engineering firm that uses the overall cash receipts and disbursements accounting method and has elected under section 171 to amortize bond premium with respect to its taxable bonds acquired at a premium. T Corporation is a manufacturer that uses an overall accrual accounting method and has not made a section 171 election to amortize bond premium with respect to its taxable bonds acquired at a premium. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. X Corporation operates the engineering firm and manufacturing operations as separate and distinct trades or businesses after the date of the section 381(a) transaction.

(ii) *Conclusion.* After the section 381(a) transaction, X Corporation will use the cash receipts and disbursements method for the engineering firm and an overall accrual method for the manufacturing operations. X Corporation may not continue separate accounting methods for amortizable bond premium, notwithstanding that it has two separate and distinct trades or businesses, because a taxpayer is permitted only one accounting method for amortizable bond premium. For both trades or businesses, X Corporation must use the principal method for bond premium as determined under paragraph (c) of this section. X Corporation will make the necessary changes to this principal method using the procedures described in paragraph (d)(1) of this section. Further, if the principal method is not to amortize bond premium, X Corporation may make an election to amortize bond premium to the extent permitted by section 171. See paragraph (e)(2) of this section.

Example 4. Voluntary change—(i) *Facts.* The facts are the same as in *Example 1* except that X Corporation wants to cease using an overall accrual method for the educational institution and change to the cash receipts and disbursements method.

(ii) *Conclusion.* X Corporation must secure the Commissioner's consent to use the cash receipts and disbursements method for the educational institution by filing a Form 3115, Application for Change in Accounting Method, as described in paragraph (d)(2) of this section.

(b) *Definitions*—(1) *Accounting method* has the same meaning as provided in section 446 and any applicable regulations.

(2) *Special accounting method* is a method expressly permitted or required by the Code, Income Tax Regulations, or administrative guidance published in the Internal Revenue Bulletin that deviates from the normal application of the cash receipts and disbursements method or an accrual method. For example, the installment method under section 453 and the mark-to-market method under section 475 are special accounting methods. See § 1.446–1(c)(1)(iii).

(3) *Principal method* is an accounting method that is determined under paragraph (c) of this section.

(4) *Adopting an accounting method* has the same meaning as provided in § 1.446–1(e)(1).

(5) *Changing an accounting method* has the same meaning as provided in § 1.446–1(e)(2).

(6) *Acquiring corporation* has the same meaning as provided in § 1.381(a)-1(b)(2).

(7) *Distributor corporation* means the corporation, foreign or domestic, that distributes its assets to another corporation described in section 332(b) in a distribution to which section 332 (relating to liquidations of subsidiaries) applies.

(8) *Transferor corporation* means the corporation, foreign or domestic, that transfers its assets to another corporation in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if—

(i) The transfer is in connection with a reorganization described in section 368(a)(1)(A), (C), or (F), or

(ii) The transfer is in connection with a reorganization described in section 368(a)(1)(D) or (G), provided the requirements of section 354(b) are met.

(9) *Parties to the section 381(a) transaction* means the acquiring corporation and the distributor or transferor corporation(s) that participate in a transaction to which section 381(a) applies.

(10) *Date of distribution or transfer* has the same meaning as provided in section 381(b)(2) and § 1.381(b)–(1)(b).

(11) *Separate and distinct trades or businesses* has the same meaning as provided in § 1.446–1(d).

(12) *Gross receipts* means all the receipts in the appropriate period that must be recognized under the acquiring corporation's and the distributor or transferor corporation's accounting method actually used in that period (determined without regard to this section) for federal income tax purposes. For example, gross receipts includes income from investments, amounts received for services, rents, total sales (net of returns and allowances) and interest.

(13) *Audit protection* means that the IRS will not require the corporation required to change its accounting method under this section to change its method for the same item for a taxable year prior to the taxable year of the section 381(a) transaction requiring the change in accounting method.

(14) *Section 481(a) adjustment* means an adjustment that must be taken into account as required under section 481(a) to prevent amounts from being duplicated or omitted when the taxable income of a taxpayer is computed under an accounting method different from the method used to compute taxable income for the preceding taxable year.

(15) *Cut-off basis* means an accounting method change made without a section 481(a) adjustment and under which only the items arising on or after the date the accounting method change is made are accounted for under the new accounting method.

(16) *Adjustment period* means the number of taxable years for taking into account the section 481(a) adjustment required as a result of an accounting method change.

(c) *Principal method*—(1) *In general.* The principal methods for the overall accounting method and for all accounting methods for particular items generally are the accounting methods used by the acquiring corporation immediately prior to the date of the section 381(a) transaction (acquiring corporation's carryover method(s)). If, however, the acquiring corporation does not have an accounting method for a particular item or if the distributor or transferor corporation is larger, the principal methods are the methods used by the distributor or transferor corporation immediately prior to the date of the transaction (distributor or transferor corporation's carryover method). The distributor or transferor corporation is larger if the—

(i) Adjusted bases of the distributor or transferor corporation's assets (determined under section 1011 and the regulations thereunder) exceed the adjusted bases of the acquiring corporation's assets immediately prior to the date of distribution or transfer, and

(ii) The distributor or transferor corporation's gross receipts for a representative period (generally the most recent period of 12 consecutive calendar months ending on the date of distribution or transfer) exceed the acquiring corporation's gross receipts for the same period.

(2) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. Principal method is the acquiring corporation's carryover method—(i) *Facts.* X Corporation and T Corporation operate employment agencies. X Corporation uses the overall cash receipts and disbursements accounting method while T Corporation uses an overall accrual method. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. The adjusted bases of X Corporation's assets immediately prior to the transaction exceed the adjusted bases of T Corporation's assets and X Corporation's gross receipts for the representative period are more than T Corporation's gross receipts for the period. The employment agencies are not operated as separate and distinct trades or businesses after the date of the distribution or transfer.

(ii) *Conclusion.* Because the adjusted bases of the assets and the gross receipts of X Corporation exceed the adjusted bases of the assets and the gross receipts of T Corporation, the accounting method used by X Corporation immediately prior to the date of the section 381(a) transaction is the principal method. After the section 381(a) transaction, X Corporation uses the cash receipts and disbursements method for the employment agency business operated by X Corporation prior to the section 381(a) transaction. X Corporation need not secure the Commissioner's consent to use this method. However, X Corporation must change the accounting method for the employment agency business acquired from T Corporation to the cash receipts and disbursements method and take into account the applicable section 481(a) adjustment as provided in paragraph (d)(1) of this section.

Example 2. Principal method is the acquiring corporation's carryover method—(i) *Facts.* The facts are the same as in *Example 1* except that T Corporation's gross receipts for the representative period exceed X Corporation's gross receipts.

(ii) *Conclusion.* Because the gross receipts of T Corporation exceed the gross receipts of X Corporation but the adjusted bases of the assets of T Corporation do not exceed the adjusted bases of the assets of X Corporation, the accounting method used by X Corporation immediately prior to the date of the section 381(a) transaction is the principal method. After the section 381(a) transaction, X Corporation will use the cash receipts and disbursements method for the employment agency business operated by X Corporation prior to the section 381(a) transaction. X Corporation need not secure the Commissioner's consent to use this method. However, X Corporation must change the accounting method for the employment agency business acquired from T Corporation to the cash receipts and disbursements method and take into account the applicable section 481(a) adjustment as provided in paragraph (d)(1) of this section.

Example 3. Principal method is the distributor or transferor corporation's carryover method—(i) *Facts.* The facts are the same as in *Example 1* except that the adjusted bases of T Corporation's assets immediately prior to the section 381(a) transaction exceed the adjusted bases of Corporation X's assets and T Corporation's gross receipts for the representative period are more than X Corporation's gross receipts for the period.

(ii) *Conclusion.* Because the adjusted bases of the assets and the gross receipts of T Corporation exceed the adjusted bases of the assets and the gross receipts of X Corporation, the accounting method used by T Corporation immediately prior to the date of the section 381(a) transaction is the principal method. After the section 381(a) transaction, X Corporation uses an overall accrual method for the employment agency business operated by T Corporation prior to the section 381(a) transaction. X Corporation need not secure the Commissioner's consent to use this method. However, X Corporation must change the accounting method for the employment agency business operated by X Corporation prior to the section 381(a) transaction to an overall accrual method and take into account the applicable section 481(a) adjustment as provided in paragraph (d)(1) of this section. If X Corporation chooses, it may request the Commissioner's consent to change to the cash receipts and disbursements method, if permissible, or some other permissible method as provided in paragraph (d)(2) of this section.

Example 4. Impermissible method—(i) *Facts.* The facts are the same as in *Example 1* except that X Corporation is prohibited under section 448 from using the cash receipts and disbursements method after the date of the section 381(a) transaction.

(ii) *Conclusion.* Because X Corporation is not permitted under section 448 to use the cash receipts and disbursements method, X Corporation must request permission to change to a permissible method as provided in paragraph (d)(2) of this section.

Example 5. Principal method is the acquiring corporation's carryover method with a special accounting method—(i) *Facts.* X Corporation and T Corporation publish magazines. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. Both X Corporation and T Corporation use an overall accrual method. X Corporation has elected to defer income from its subscription sales under section 455. T Corporation has not elected to defer income from its subscription sales under section 455 and instead has recognized the income from these sales in accordance with section 451. The adjusted bases of X Corporation's assets immediately prior to the section 381(a) transaction exceed the adjusted bases of T Corporation's assets and X Corporation's gross receipts for the representative period are more than T Corporation's gross receipts for the period. The publication businesses are not operated as separate and distinct trades or businesses after the date of the distribution or transfer.

(ii) *Conclusion.* Because the adjusted bases of the assets and the gross receipts of X Corporation exceed the adjusted bases of the assets and the gross receipts of T Corporation, the accounting method used by X Corporation immediately prior to the date of the section 381(a) transaction is the principal method. After the section 381(a) transaction, X Corporation will continue to use its overall accrual method and the section 455 deferral method. X Corporation need not secure the Commissioner's consent to continue to use its overall accrual method and the section 455 deferral method. However, under paragraph (d)(1) of this section X Corporation must change its accounting method for the magazine business acquired from T Corporation to the section 455 deferral method using a cut-off basis.

Example 6. Principal method is the acquiring corporation's carryover method with a special accounting method—(i) *Facts.* The facts are the same as in *Example 5* except that T Corporation's gross receipts for the representative period exceed X Corporation's gross receipts for the period.

(ii) *Conclusion.* Because the gross receipts of T Corporation exceed the gross receipts of X Corporation but the adjusted bases of the assets of T Corporation do not exceed the adjusted bases of the assets of X Corporation, the accounting method used by X Corporation immediately prior to the date of the section 381(a) transaction is the principal method. After the section 381(a) transaction, X Corporation continues to use an overall accrual method and the section 455 deferral method. X Corporation need not secure the Commissioner's consent to continue to use an overall accrual method and the section 455 deferral method. However, under paragraph (d)(1) of this section X Corporation must change its accounting method for the magazine business acquired from T Corporation to the section 455 deferral method using a cut-off basis.

(d) *Procedures for changing accounting methods*—(1) *Change made to principal method*—(i) *Section 481(a) adjustment*—(A) *In general.* The acquiring corporation does not need to secure the Commissioner's consent to use a principal method. To the extent use of a principal method constitutes a change in an accounting method, the change in accounting method is treated as a change initiated by the acquiring corporation for purposes of section 481(a)(2). Any change to a principal method under paragraph (c)(1) of this section, whether the change relates to the trade or business of the acquiring corporation or the trade or business of the distributor or transferor corporation, must be reflected on the acquiring corporation's federal income tax return for the taxable year that includes the date of distribution or transfer. The amount of the section 481(a) adjustment and the adjustment period, if any, necessary to implement this accounting method change are determined under § 1.446–1(e) and the applicable administrative procedures that govern voluntary changes in accounting methods under section 446(e). The appropriate section 481(a) adjustment as determined above is included in the taxable income of the acquiring corporation for the taxable year that includes the date of distribution or transfer and subsequent taxable year(s), as necessary. Thus, if the administrative procedures require that an accounting method change be implemented on a cut-off basis, the acquiring corporation must implement the change, on a cut-off basis as of the date of distribution or transfer, on its federal income tax return for the taxable year that includes the date of distribution or transfer. If the administrative procedures require a section 481(a) adjustment, the acquiring corporation must determine the section 481(a) adjustment and include the appropriate amount of the section 481(a) adjustment on its federal income tax return for the taxable year that includes the date of distribution or transfer and subsequent taxable year(s), as necessary. This adjustment is determined by the acquiring corporation as of the beginning of the day that is immediately after the day on which the section 381(a) transaction occurs.

(B) *Example.* The following example illustrates the rules of this paragraph (d)(1)(i):

Example. X Corporation uses the overall cash receipts and disbursements accounting method while T Corporation uses an overall accrual method. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. X Corporation determines that under the rules of paragraph (c)(1) of this section, X Corporation must change the accounting method for the business acquired from T Corporation to the cash receipts and disbursements method. X Corporation will determine the section 481(a) adjustment pertaining to the change to the cash receipts and disbursements method by consolidating the adjustments (whether the amounts thereof represent increases or decreases in items of income or deductions) arising with respect to balances in the various accounts, such as accounts receivable, as of the beginning of the day that immediately follows the day on which X Corporation acquires the assets of T Corporation. This adjustment, or an appropriate part thereof, will be reflected on the federal income tax return filed by X Corporation for the taxable year that includes this section 381(a) transaction.

(ii) *Audit protection.* Notwithstanding any other provision in any other regulation or administrative procedure, no audit protection is provided for any change in accounting method under paragraph (d)(1)(i) of this section.

(iii) *Other terms and conditions.* Except as otherwise provided in this section, other terms and conditions provided in § 1.446–1(e) and the applicable administrative procedures that govern voluntary accounting method changes under section 446(e) apply to a change in accounting method under this section. Thus, for example, if the administrative procedures that govern a particular accounting method change have a term and condition that provides for the acceleration of the section 481(a) adjustment period, this term and condition applies to changes made under this paragraph (d)(1). Similarly, if the administrative procedures provide as a term and condition that an identical accounting method change is barred for a period of years, this term and condition applies to changes made under this paragraph (d)(1) to bar future changes of that accounting method, if identical, for the same period, but not changes to the principal method under this section.

(2) *Change made to an accounting method other than the principal method or a carryover method.* A party to a section 381(a) transaction that desires to change to an accounting method other than the principal method as determined under paragraph (c) of this section, or a carryover method within the meaning of paragraph (a)(2)(i) of this section, must follow the provisions of § 1.446–(1)(e) that govern the accounting method change, except that for an accounting method change requiring advance consent—

(i) Under the authority of § 1.446–1(e)(3)(ii), the application for accounting method change (for example, Form 3115) must be filed with the IRS on or before the later of—

(A) The due date for filing a Form 3115 as specified in § 1.446–1(e), for example, the last day of the taxable year in which the distribution or transfer occurred, or

(B) The earlier of—

(*1*) The day that is 180 days after the date of the distribution or transfer, or

(*2*) The day on which the acquiring corporation files its federal income tax return for the taxable year in which the distribution or transfer occurred; and

(*3*) An application on Form 3115 filed with the IRS should be labeled ''Filed under section 381(c)(4)'' at the top.

(e) *Rules and procedures*—(1) *No accounting method.* If a party to a section 381(a) transaction is not using an accounting method, does not have an accounting method for a particular item, or came into existence as a result of the transaction, the party will not be treated as having an accounting method different from that used by the other parties to the section 381(a) transaction.

(2) *Elections and adoptions allowed.* An acquiring corporation is not precluded by section 381(c)(4) or these regulations from making any election for the taxable year that includes the date of distribution or transfer that does not require the Commissioner's consent and that is otherwise permissible. Similarly, an acquiring corporation may adopt any accounting method in that year that is otherwise permissible.

(3) *Elections continue after section 381(a) transaction*—(i) *General rule.* The acquiring corporation is not required to renew any election previously made by it or by a distributor or transferor corporation with respect to a carryover method or principal method if the acquiring corporation uses the method after a section 381(a) transaction. Furthermore, an election previously made by an acquiring corporation or by a distributor or transferor corporation with respect to a method that is in effect immediately prior to the date of distribution or transfer continues to the same extent as though the distribution or transfer had not occurred.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (e)(3):

Example 1. Election continues. The acquiring corporation, X Corporation, has previously elected to treat animals purchased for dairy purposes as property used in its trade or business subject to depreciation after maturity while otherwise using the unit-livestock-price method. X Corporation's accounting method continues after its merger with T Corporation in a transaction to which section 381(a) applies. X Corporation is not required to renew its election, and is bound by it, after the section 381(a) transaction.

Example 2. Election continues. The acquiring corporation, X Corporation, has previously elected under section 171 to amortize bond premium with respect to taxable bonds. X Corporation's method for bond premium continues after T Corporation merges with X Corporation in a transaction to which section 381(a) applies. X

Corporation is not required to renew its election, and is bound by it, after the section 381(a) transaction.

(4) *Appropriate times for determining the method used and trade or business character*—(i) *Determining the accounting method.* The accounting method existing at the time of a section 381(a) transaction is the method used immediately prior to the distribution or transfer by the parties to the transaction.

(ii) *Determining whether there are separate trades or businesses after a section 381(a) transaction.* Whether an acquiring corporation will operate the trades or businesses of the parties to a section 381(a) transaction as separate and distinct trades or businesses after the distribution or transfer will be determined as of the time of the transaction based upon the facts and circumstances. Intent to combine books and records of the trades or businesses may be demonstrated by contemporaneous records and documents or by other objective evidence that reflects the acquiring corporation's ultimate plan of operation, even though the actual combination of the books and records may extend beyond the end of the taxable year in which the section 381(a) transaction occurs.

(5) *Representative period for accumulating gross receipts.* If a party to the section 381(a) transaction was not in existence for the 12 consecutive months immediately prior to the date of distribution or transfer, then all parties to the section 381(a) transaction will compare their gross receipts for the period that the party was in existence. For example, if the acquiring corporation was formed in August and the section 381(a) transaction occurred in December of the same year, the gross receipts for those five months will be compared with the gross receipts of the other parties to the section 381(a) transaction for the same period.

(6) *Establishing an accounting method.* Notwithstanding any other provision in any other regulation or administrative procedure, an accounting method used by the distributor or transferor corporation immediately prior to the date of distribution or transfer that continues to be used by the acquiring corporation in the taxable year that includes the date of distribution or transfer is an established method of accounting for purposes of section 446(e).

(7) *Other applicable provisions.* Section 381(c)(4) and these regulations do not preempt any other section of the Code or regulations that is applicable to the acquiring corporation's circumstances. For example, income, deductions, credits, allowances, and exclusions may be allocated among the parties to a section 381(a) transaction and other taxpayers under sections 269 and 482, if appropriate. Similarly, transfers of contracts accounted for using a long-term contract accounting method are governed by the rules provided in § 1.460–4(k). Further, if other paragraphs of section 381(c) apply for purposes of determining accounting methods that carryover in a section 381(a) transaction, section 381(c)(4) and this § 1.381(c)(4)–1 will not apply to the tax treatment of the items. For example, section 381(c)(4) and these regulations do not apply to inventories that an acquiring corporation obtains in a transaction to which section 381(a) applies. Instead, the rules of section 381(c)(5) and § 1.381(c)(5)–1 govern the inventory method to be used by the acquiring corporation after the distribution or transfer. Similarly, if the acquiring corporation assumes an obligation of the distributor or transferor corporation that gives rise to a liability, within the meaning of § 1.381(c)(16)–1(a)(4), the deductibility of the item is determined under section 381(c)(4) and these regulations only after the rules of section 381(c)(16) and its regulations are applied.

(8) *Character of items of income and deduction.* Items of income and deduction have the same character in the hands of the acquiring corporation as they would have had in the hands of the distributor or transferor corporation if no distribution or transfer had occurred.

(9) *Accounting method selected by project or job.* If other sections of the Code or regulations permit an acquiring corporation to elect an accounting method on a project-by-project, job-by-job, or other similar basis, the method elected with respect to each project or job is the established method only for that project or job. For example, the election under section 460 to classify a ''hybrid contract,'' that is, a contract to perform both manufacturing and construction activities, as a long-term construction contract if at least 95 percent of the estimated total allocable contract costs are reasonably allocated to the construction activities is made on a contract-by-contract basis. Accordingly, the accounting method previously elected for a project or job generally continues after the section 381(a) transaction. However, if the trades or businesses of the parties to a section 381(a) transaction are not operated as separate and distinct trades or businesses after the date of distribution or transfer, and two or more of the parties to the section 381(a) transaction previously worked on the same project or job and used different accounting methods for the project or job immediately before the distribution or transfer, then the acquiring corporation must determine the method to use after the section 381(a) transaction as provided in paragraph (c) of this section.

(10) *Prohibited accounting methods.* An acquiring corporation may not use the accounting method determined under paragraph (a)(2) of this section if the method fails to reflect clearly the acquiring corporation's income within the meaning of section 446(b). Thus, section 381(c)(4) and these regulations do not limit, restrict, or otherwise prevent the Commissioner from requiring the use of another accounting method.

(f) *Effective/applicability date.* The rules of this section apply to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 4. Section 1.381(c)(5)–1 is revised to read as follows:

§ 1.381(c)(5)–1 Inventory method.

(a) *Introduction*—(1) *Purpose.* This section provides guidance regarding the inventory accounting method an acquiring corporation must use following a distribution or transfer to which sections 381(a) and (c)(5) apply and how to implement any associated accounting method changes. See § 1.381(c)(4)–1 for guidance regarding the accounting method or combination of methods (other than inventory and depreciation accounting methods) an acquiring corporation must use following a distribution or transfer to which sections 381(a) and (c)(4) apply. See § 1.381(c)(6)–1 for guidance regarding the depreciation accounting methods an acquiring corporation must use following a distribution or transfer to which sections 381(a) and (c)(6) apply.

(2) *Carryover requirement*—(i) *In general.* In a transaction to which section 381(a) applies, if the acquiring corporation operates the trades or businesses of the parties to the section 381(a) transaction as separate and distinct trades or businesses after the date of the distribution or transfer, then the acquiring corporation generally must use the same accounting method(s) for inventory used by the distributor or transferor corporation(s) on the date of the section 381(a) transaction (carryover method). If the acquiring corporation does not operate the trades or

businesses of the parties to the section 381(a) transaction as separate and distinct trades or businesses after the date of distribution or transfer, then the acquiring corporation must use a principal method as determined under paragraph (c) of this section and must take into account any section 481(a) adjustment, if applicable, as required under paragraph (d)(1) of this section. The acquiring corporation need not secure the Commissioner's consent to continue or to use a permissible carryover method or principal method.

(ii) *Carryover method or principal method not permissible.* In general, if a carryover method or principal method is an impermissible accounting method, the acquiring corporation must secure the Commissioner's consent to change to a different accounting method as provided in paragraph (d)(2) of this section. If, however, a carryover method is impermissible solely because only a single inventory method with respect to a particular type of goods may be used by the acquiring corporation after the date of the section 381(a) transaction regardless of the number of separate and distinct trades or businesses operated on that date, the acquiring corporation must use a principal method as determined under paragraph (c) of this section.

(iii) *Voluntary change.* All parties to a section 381(a) transaction may request permission under section 446(e) to change an inventory accounting method for the taxable year in which the transaction occurs or is expected to occur. For trades or businesses that will not operate as separate trades or businesses after the section 381(a) transaction, an accounting method change will be granted only if the requested change is the method that the acquiring corporation must use after the date of the distribution or transfer in the taxable year that includes the section 381(a) transaction. The time and manner of obtaining the Commissioner's consent to change to a different inventory accounting method is described in paragraph (d)(2) of this section.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (a):

Example 1. Separate and distinct trades or businesses after the date of the distribution or transfer—(i) *Facts.* X Corporation manufactures radios and television sets. X Corporation uses the first-in, first-out (FIFO) inventory method to identify its inventory goods, values the goods at cost, and capitalizes costs under section 263A. T Corporation manufactures washing machines and dryers. T Corporation uses the last-in, first-out (LIFO) inventory method to identify its inventory goods, values the goods at cost, and capitalizes costs under section 263A using methods other than those used by X Corporation. X Corporation acquires the inventory of T Corporation in a transaction to which section 381(a) applies. X Corporation operates the two manufacturing operations as separate and distinct trades or businesses after the date of the section 381(a) transaction.

(ii) *Conclusion.* After the section 381(a) transaction, for the business of manufacturing radios and television sets X Corporation will use the same FIFO inventory method to identify its inventory goods, value the goods at cost, and capitalize costs under section 263A using the methods it had previously used. For the business of manufacturing washing machines and dryers X Corporation will use the same LIFO inventory method to identify its inventory goods, value the goods at cost, and capitalize costs under section 263A using the methods previously used by T Corporation. X Corporation need not secure the Commissioner's consent to continue the inventory methods.

Example 2. Impermissible method—(i) *Facts.* X Corporation manufactures food and beverages. X Corporation uses the FIFO inventory method to identify its inventory goods, values the goods at cost, and capitalizes costs under section 263A. T Corporation sells sporting equipment. T Corporation uses the FIFO inventory method to identify its inventory goods, and values the goods at cost. T Corporation did not capitalize costs under section 263A because it met the small reseller exception under section 263A. X Corporation acquires the inventory of T Corporation in a transaction to which section 381(a) applies. X Corporation operates the food and beverage business and the sporting goods business as separate trades or businesses after the date of the section 381(a) transaction. After the section 381(a) transaction, X Corporation does not qualify for the small reseller exception under section 263A for its sporting equipment business.

(ii) *Conclusion.* After the section 381(a) transaction, X Corporation will continue to identify its food and beverage inventory goods by using the FIFO inventory method, value the inventory at cost, and use its previously selected cost capitalization methods under section 263A as provided in paragraph (a)(2)(i) of this section. X Corporation will continue to identify its sporting equipment inventory goods by using the FIFO inventory method and value the inventory at cost in the same manner as T Corporation did prior to the section 381(a) transaction. X Corporation need not secure the Commissioner's consent to continue these inventory methods. Because X Corporation does not qualify for the small reseller exception under section 263A for its sporting equipment business, X Corporation must secure the Commissioner's consent to change to a permissible cost capitalization method under section 263A for the sporting equipment business. X Corporation must request this consent by filing a Form 3115, Application for Change in Accounting Method, using the procedures in paragraph (d)(2) of this section.

Example 3. Voluntary change—(i) *Facts.* The facts are the same as in *Example 1* except that X Corporation wants to cease valuing the radios and television sets at cost and change to the cost or market, whichever is lower, method.

(ii) *Conclusion.* X Corporation must secure the Commissioner's consent to use the cost or market, whichever is lower, method and must do so by filing a Form 3115 as described in paragraph (d)(2) of this section.

(b) *Definitions*—(1) *Inventory method* is a method used to account for merchandise on hand (including finished goods, work in process, and raw materials) at the beginning of a year for purposes of computing taxable income for that year. The term includes not only the method for identifying inventory, for example, the FIFO inventory method or the LIFO inventory method, but also all other methods necessary to account for merchandise.

(2) *Principal method* is an accounting method that is determined under paragraph (c) of this section.

(3) *Adopting an accounting method* has the same meaning as provided in § 1.446–1(e)(1).

(4) *Changing an accounting method* has the same meaning as provided in § 1.446–1(e)(2).

(5) *Acquiring corporation* has the same meaning as provided in § 1.381(a)–1(b)(2).

(6) *Distributor corporation* means the corporation, foreign or domestic, that distributes its assets to another corporation described in section 332(b) in a distribution to which section 332 (relating to liquidations of subsidiaries) applies.

(7) *Transferor corporation* means the corporation, foreign or domestic, that transfers its assets to another corporation in a transfer to which section 361 (relating to nonrecognition of gain or loss to corporations) applies, but only if—

(i) The transfer is in connection with a reorganization described in section 368(a)(1)(A), (C), or (F), or

(ii) The transfer is in connection with a reorganization described in section 368(a)(1)(D) or (G), provided the requirements of section 354(b) are met.

(8) *Parties to the section 381(a) transaction* means the acquiring corporation and the distributor or transferor corporation(s) involved in the transaction to which section 381(a) applies.

(9) *Date of distribution or transfer* has the same meaning as provided in section 381(b)(2) and § 1.381(b)–1(b).

(10) *Separate and distinct trades or businesses* has the same meaning as provided in § 1.446–1(d).

(11) *Audit protection* means that the IRS will not require the corporation

required to change its accounting method under this section to change its method for the same item for a taxable year prior to the taxable year of the section 381(a) transaction requiring the change in accounting method.

(12) *Section 481(a) adjustment* means an adjustment that must be taken into account as required under section 481(a) to prevent amounts from being duplicated or omitted when the taxable income of a taxpayer is computed under an accounting method different from the method used to compute taxable income for the preceding taxable year.

(13) *Cut-off basis* means an accounting method change made without a section 481(a) adjustment and under which only the goods arising on or after the date the accounting method change is made are accounted for under the new accounting method.

(14) *Adjustment period* means the number of taxable years for taking into account the section 481(a) adjustment required as a result of an accounting method change.

(c) *Principal method*—(1) *In general.* The principal method for a particular type of goods generally is the method used by the acquiring corporation for that type of goods immediately prior to the date of the section 381(a) transaction (acquiring corporation's carryover method). If, however, the acquiring corporation does not have an inventory accounting method for a particular type of goods or if the distributor or transferor corporation holds more inventory of that type of goods, the principal method for that type of goods is the method used by the distributor or transferor corporation for that type of goods immediately prior to the date of the transaction (distributor or transferor corporation's carryover method). The distributor or transferor corporation holds more inventory if, for a particular type of goods, the fair market value of the goods held by the distributor or transferor corporation exceeds the fair market value of the goods held by the acquiring corporation immediately prior to the date of distribution or transfer. Alternatively, as a simplifying convention, the acquiring corporation may elect to apply the preceding sentence to the value of the entire inventories of the distributor or transferor corporation and the acquiring corporation rather than to each particular type of goods.

(2) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. Principal method is the acquiring corporation's carryover method—(i) *Facts.* X Corporation and T Corporation are manufacturers of tennis equipment. Both X Corporation and T Corporation value their inventories at cost but use different methods to capitalize costs under section 263A. X Corporation uses the simplified production method without the historic absorption ratio election provided in § 1.263A–2(b)(3). T Corporation uses the simplified production method with the historic absorption ratio election provided in § 1.263A–2(b)(4). Furthermore, X Corporation identifies its inventory using the FIFO inventory method, while T Corporation identifies its inventory using the LIFO inventory method.

X Corporation acquires the inventory of T Corporation in a transaction to which section 381(a) applies. The manufacturing businesses are not operated as separate and distinct trades or businesses after the date of the distribution or transfer. Immediately prior to the acquisition, the fair market value of each particular type of goods in X Corporation's inventory exceeds the fair market value of each particular type of goods in T Corporation's inventory.

(ii) *Conclusion.* After the section 381(a) transaction, X Corporation will continue to identify its inventory using the FIFO inventory method, value its inventory at cost, and use the simplified production method without the historic absorption ratio election because the FIFO inventory method is the principal method for identifying inventory, cost is the principal method for valuing inventories, and the simplified production method without the historic absorption ratio election is the principal method for allocating costs to ending inventory under section 263A. X Corporation need not secure the Commissioner's consent to use these methods. However, with respect to the inventory acquired from T Corporation, X Corporation will change the method of identifying inventory to the FIFO inventory method, use the simplified production method without the historic absorption ratio election, and take into account the applicable section 481(a) adjustment as provided in paragraph (d)(1) of this section. If X Corporation chooses, it may request the Commissioner's consent to change to another permissible method as provided in paragraph (d)(2) of this section.

Example 2. Principal method is the distributor or transferor corporation's carryover method—(i) *Facts.* The facts are the same as in *Example 1* except that the fair market value of each particular type of goods in T Corporation's inventory is in excess of the fair market value of each particular type of goods in X Corporation's inventory.

(ii) *Conclusion.* After the section 381(a) transaction, X Corporation will identify its inventory using the LIFO inventory method used by T Corporation, value its inventories at cost, and use the simplified production method with the historic absorption ratio election, because the LIFO inventory method used by T Corporation is the principal method for identifying inventory, cost is the principal method for valuing inventories, and the simplified production method with the historic absorption ratio election is the principal method for allocating costs to ending inventory under section 263A. X Corporation need not secure the consent of the Commissioner to use these methods. However, with respect to the inventory manufactured by X Corporation prior to the section 381(a) transaction, X Corporation will change its methods as needed by using the procedures of paragraph (d)(1) of this section. Specifically, X Corporation will change its method of identifying inventory to the LIFO inventory method using a cut-off basis and change its cost capitalization method to the simplified production method with the historic absorption ratio election by taking into account the applicable section 481(a) adjustment. If X Corporation chooses, it may request the Commissioner's consent to change to another permissible method as provided in paragraph (d)(2) of this section.

Example 3. Principal method is the acquiring corporation's carryover method—(i) *Facts.* The facts are the same as in *Example 1* except that the fair market values of the inventories of X Corporation and T Corporation are identical.

(ii) *Conclusion.* After the section 381(a) transaction, X Corporation will continue to identify its inventory using the FIFO inventory method, value its inventory at cost, and use the simplified production method without the historic absorption ratio election because the FIFO inventory method is the principal method for identifying inventory, cost is the principal method for valuing inventories, and the simplified production method without the historic absorption ratio election is the principal method for allocating costs to ending inventory under section 263A. X Corporation need not secure the Commissioner's consent to use these methods. However, with respect to the inventory acquired from T Corporation, X Corporation will change the method of identifying inventory to the FIFO inventory method, use the simplified production method without the historic absorption ratio election, and take into account the applicable section 481(a) adjustment as provided in paragraph (d)(1) of this section. If X Corporation chooses, it may request the Commissioner's consent to change to another permissible method as provided in paragraph (d)(2) of this section.

Example 4. Inventory convention elected—(i) *Facts.* X Corporation manufactures planes and T Corporation manufactures planes and pool tables. X Corporation identifies its inventory using the FIFO inventory method and values it at cost or market, whichever is lower, while T Corporation identifies its inventory using the LIFO inventory method and values it at cost. Both X Corporation and T Corporation use the same method to capitalize costs under section 263A.

X Corporation acquires the inventory of T Corporation in a transaction to which section 381(a) applies. The manufacturing businesses are not operated as separate and distinct trades or businesses after the date of the distribution or transfer. In lieu of determining the fair market value of each particular type of goods held on the date of distribution or transfer, X Corporation elects to value the entire inventories held by itself and T Corporation. Immediately prior to the acquisition, the fair market value of T Corporation's inventory exceeds the fair market value of X Corporation's inventory.

(ii) *Conclusion.* After the section 381(a) transaction, X Corporation will identify its inventory using the LIFO inventory method used by T Corporation and value this inventory at cost because the LIFO inventory method used by T Corporation is the principal method for identifying inventory and cost is the principal method for valuing inventories. X Corporation need not secure the consent of the Commissioner to use these methods. However, with respect to the inventory manufactured by X Corporation prior to the section 381(a) transaction, X Corporation will change the method of identifying inventory to the LIFO inventory method on a cut-off basis as provided in paragraph (d)(1) of this section. The method used prior to the section 381(a) transaction to capitalize costs under section 263A continues after the transaction. If X Corporation chooses, it may request the Commissioner's consent to change to another permissible method as provided in paragraph (d)(2) of this section.

(d) *Procedures for changing accounting methods*—(1) *Change made to principal method*—(i) *Section 481(a) adjustment*—(A) *In general.* The acquiring corporation does not need to secure the Commissioner's consent to use a principal method. To the extent use of a principal method constitutes a change in an accounting method, the change in accounting method is treated as a change initiated by the acquiring corporation for purposes of section 481(a)(2). Any change to a principal method under paragraph (c) of this section, whether the change relates to the trade or business of the acquiring corporation or the trade or business of the distributor or transferor corporation, must be reflected on the acquiring corporation's federal income tax return for the taxable year that includes the date of distribution or transfer. The amount of the section 481(a) adjustment and the adjustment period, if any, necessary to implement this accounting method change are determined under § 1.446–1(e) and the applicable administrative procedures that govern voluntary changes in accounting methods under section 446(e). The appropriate section 481(a) adjustment as determined above is included in the taxable income of the acquiring corporation for the taxable year that includes the date of distribution or transfer and subsequent taxable year(s), as necessary. Thus, if the administrative procedures require that an accounting method change be implemented on a cut-off basis, the acquiring corporation must implement the change, on a cut-off basis as of the date of distribution or transfer, on its federal income tax return for the taxable year that includes the date of distribution or transfer. If the administrative procedures require a section 481(a) adjustment, the acquiring corporation must determine the section 481(a) adjustment and include the appropriate amount of the section 481(a) adjustment on its federal income tax return for the taxable year that includes the section 381(a) transaction and subsequent taxable year(s), as necessary. This adjustment is determined by the acquiring corporation as of the beginning of the day that is immediately after the day on which the section 381(a) transaction occurs.

(B) *Example.* The following example illustrates the rules of this paragraph (d)(1)(i):

Example. X Corporation uses the FIFO inventory method while T Corporation uses the LIFO inventory method. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies on July 15th. X Corporation determines that under the rules of paragraph (c)(1) of this section, X Corporation must change the inventory method for the business acquired from T Corporation to the FIFO inventory method. X Corporation will determine the section 481(a) adjustment pertaining to the change to the FIFO inventory method (whether the amounts thereof represent increases or decreases in income) as of the beginning of July 16th. This adjustment, or an appropriate part thereof, will be included in X Corporation's federal income tax return for the taxable year that includes July 15th.

(ii) *Audit protection.* Notwithstanding any other provision in any other regulation or administrative procedure, no audit protection is provided for any change in accounting method under paragraph (d)(1)(i) of this section.

(iii) *Other terms and conditions.* Except as otherwise provided in this section, other terms and conditions provided in § 1.446–1(e) and the applicable administrative procedures that govern voluntary changes in accounting methods under section 446(e) apply to a change in accounting method under this section. Thus, for example, if the administrative procedures that govern a particular accounting method change have a term and condition that provides for the acceleration of the section 481(a) adjustment period, this term and condition applies to changes made under this paragraph (d)(1). Similarly, if the administrative procedures provide as a term and condition that an identical accounting method change is barred for a period of years, this term and condition applies to changes made under this paragraph (d)(1) to bar future changes of that accounting method, if identical, for the same period, but not changes to the principal method under this section.

(2) *Change made to an accounting method other than the principal method or a carryover method.* A party to a section 381(a) transaction that desires to change to an accounting method other than the principal method as determined under paragraph (c) of this section, or a carryover method within the meaning of paragraph (a)(2)(i) of this section, must follow the provisions of § 1.446–(1)(e) that govern the accounting method change, except that for an accounting method change requiring advance consent—

(i) Under the authority of § 1.446–1(e)(3)(ii), the application for accounting method change (for example, Form 3115) must be filed with the IRS on or before the later of—

(A) The due date for filing a Form 3115 as specified in § 1.446–1(e), for example, the last day of the taxable year in which the distribution or transfer occurred, or

(B) The earlier of—

(*1*) The day that is 180 days after the date of the distribution or transfer, or

(*2*) The day on which the acquiring corporation files its federal income tax return for the taxable year in which the distribution or transfer occurred; and

(ii) An application on Form 3115 filed with the IRS should be labeled ''Filed under section 381(c)(5)'' at the top.

(e) *Rules and procedures*—(1) *Inventory method selected for a particular type of goods.* If other sections of the Code or Income Tax Regulations allow a taxpayer to elect an inventory method for a particular type of goods, the method elected with respect to those goods is the established inventory method only for those goods. For example, an election to use the LIFO inventory method to identify specified goods in inventory, such as certain products in finished goods, is the inventory method only for those products.

(2) *No accounting method.* If a party to a section 381(a) transaction is not using an inventory method, does not have a particular type of goods immediately prior to the date of distribution or transfer, or came into existence as a result of the transaction, the party will not be treated as having an inventory accounting method different from that used by the other parties to the section 381(a) transaction.

(3) *Elections and adoptions allowed.* An acquiring corporation is not precluded by section 381(c)(5) or these regulations from making any election for the taxable year that includes the date of distribution or transfer that does not require the Commissioner's consent and that is otherwise permissible. Similarly, an acquiring corporation may adopt any accounting method in that year that is otherwise permissible. For example, an acquiring corporation may elect to identify its inventory using the LIFO

inventory method in the year of the distribution or transfer.

(4) *Elections continue after section 381(a) transaction.* The acquiring corporation is not required to renew any election previously made by it or by a distributor or transferor corporation with respect to a carryover method or principal method if the acquiring corporation uses the method after a section 381(a) transaction. Furthermore, an election previously made by an acquiring corporation or by a distributor or transferor corporation with respect to a method that is in effect immediately prior to the date of distribution or transfer continues to the same extent as though the distribution or transfer had not occurred. For example, when the acquiring corporation has elected to use the LIFO inventory method under section 472 prior to the date of the section 381(a) transaction and the method continues after the transaction, the acquiring corporation need not renew this inventory election and is bound by it after the date of the transaction.

(5) *Adopting the LIFO inventory method.* A party to a section 381(a) transaction will be deemed to be using the LIFO inventory method with respect to a particular type of goods on the date of distribution or transfer if such party elects under section 472 to adopt that inventory method with respect to those goods for its taxable year within which the date of distribution or transfer occurs. See section 472 for the requirements to adopt the LIFO inventory method.

(6) *Inventory layers treatment*—(i) *Adjustments required after a section 381(a) transaction.* An acquiring corporation that determines the principal method of taking an inventory after a section 381(a) transaction under paragraph (c) of this section may need to integrate inventories and make appropriate adjustments as provided in paragraphs (e)(6)(ii) and (iii) of this section.

(ii) *LIFO inventory method used after the section 381(a) transaction*—(A) *LIFO inventory method used by the distributor or transferor corporation*—(*1*) *Dollar-value method.* If an acquiring corporation is required to use the LIFO dollar-value method of pricing inventories (dollar-value method) for a particular type of goods for its taxable year that includes the date of the section 381(a) transaction, and immediately prior to the distribution or transfer the distributor or transferor corporation used the specific goods method of pricing inventories for that particular type of goods, the inventory of the distributor or transferor corporation shall be placed on the dollar-value method as provided in § 1.472–8(f), and then the inventory shall be integrated with the inventory of the acquiring corporation. If pools of each corporation are required to be combined, the pools shall be combined as provided in § 1.472–8(g)(2). For purposes of combining pools, all base-year inventories or layers of increment that occur in taxable years including the same December 31 shall be combined. A base-year inventory or layer of increment occurring in any short taxable year not including a December 31, or in the final taxable year of a distributor or transferor corporation, shall be merged with and considered a layer of increment of its immediately preceding taxable year.

(*2*) *Specific goods method.* If an acquiring corporation is required to use the specific goods method of pricing inventories for a particular type of goods for its taxable year that includes the date of the section 381(a) transaction, and immediately prior to the distribution or transfer the distributor or transferor corporation used the LIFO inventory method for that particular type of goods, the inventory shall be treated by the acquiring corporation as having the acquisition dates and costs of the distributor or transferor corporation.

(B) *LIFO inventory method not used by the distributor or transferor corporation.* If an acquiring corporation is required to use the LIFO inventory method for a particular type of goods for its taxable year that includes the date of the section 381(a) transaction, and immediately prior to the distribution or transfer the distributor or transferor corporation did not use the LIFO inventory method for that particular type of goods, the inventory shall be treated by the acquiring corporation as having been acquired at average unit cost in a single transaction on the date of the distribution or transfer. Thus, if an inventory of a particular type of goods is combined in an existing dollar-value pool, the goods shall be treated as if they were purchased by the acquiring corporation at the average unit cost on the date of the distribution or transfer with respect to such pool. Alternatively, if the goods are not combined in an existing pool, the goods will be treated as if they were purchased by the acquiring corporation at the average unit cost on the date of the distribution or transfer with respect to a new pool, with the base year being the year of the section 381(a) transaction. Adjustments resulting from a restoration to cost of any write-down to market value of the inventories of a distributor or transferor corporation shall be taken into account by the distributor or transferor corporation in its final taxable year ending on the date of the distribution or transfer. See section 472(d).

(iii) *FIFO inventory method used after the section 381(a) transaction*—(A) *FIFO inventory method used by the distributor or transferor corporation.* If an acquiring corporation is required to use the FIFO inventory method for a particular type of goods for its taxable year that includes the date of the section 381(a) transaction, and immediately prior to the distribution or transfer the distributor or transferor corporation used the FIFO inventory method for that particular type of goods, the inventory of that type of goods shall be treated by the acquiring corporation as having the same acquisition dates and costs as the distributor or transferor corporation. However, if the acquiring corporation values its inventories at cost or market, whichever is lower, the acquiring corporation shall treat the inventories of the distributor or transferor corporation as having been acquired at cost or market, whichever is lower.

(B) *FIFO inventory method not used by the distributor or transferor corporation.* If an acquiring corporation is required to use the FIFO inventory method for a particular type of goods for its taxable year that includes the date of the section 381(a) transaction, and immediately prior to the distribution or transfer the distributor or transferor corporation did not use the FIFO inventory method for that particular type of goods, the inventory of the distributor or transferor corporation shall be treated by the acquiring corporation as having the same acquisition dates and costs that the inventory would have had if the distributor or transferor corporation had been using the FIFO inventory method for its taxable year ending on the date of distribution or transfer. However, if the acquiring corporation values its inventories at cost or market, whichever is lower, the acquiring corporation shall treat the acquired inventories as having been acquired at cost or market, whichever is lower.

(7) *Appropriate times for determining the method used and trade or business character*—(i) *Determining the accounting method.* The accounting method existing at the time of a section 381(a) transaction is the method used immediately prior to the date of distribution or transfer by the parties to the transaction.

(ii) *Determining whether there are separate trades or businesses after a section 381(a) transaction.* Whether an acquiring corporation will operate the trades or businesses of the parties to a section 381(a) transaction as separate and distinct trades or businesses after the distribution or transfer will be determined at the time of the transaction based upon the facts and circumstances. Intent to combine books and records of the trades or businesses may be demonstrated by contemporaneous records and documents or by other objective evidence that reflects the acquiring corporation's ultimate plan of operation, even though the actual combination of the books and records may extend beyond the end of the taxable year in which the section 381(a) transaction occurs.

(8) *Establishing an accounting method for taking an inventory*. Notwithstanding any other provision in any other regulation or administrative procedure, an accounting method used by the distributor or transferor corporation immediately prior to the date of distribution or transfer that continues to be used by the acquiring corporation in the taxable year that includes the date of distribution or transfer is an established method of accounting for purposes of section 446(e).

(9) *Other applicable provisions*. Section 381(c)(5) and these regulations do not preempt any other section of the Code or regulations that is applicable to the acquiring corporation's circumstances. Section 381(c)(5) and this § 1.381(c)(5)–1 determine only the inventory method to be used after a section 381(a) transaction. Specifically, section 381(c)(5) and this § 1.381(c)(5)–1 do not apply to assets other than inventory that an acquiring corporation obtains in a transaction to which section 381(a) applies.

(10) *Use of the cash receipts and disbursements method*. If a party to a section 381(a) transaction uses the cash receipts and disbursements method within the meaning of section 446(c)(1) and § 1.446–1(c)(1)(i), or is not required to use inventory accounting methods for its goods, immediately prior to the date of distribution or transfer, section 381(c)(5) and § 1.381(c)(5)–1 do not apply. Section 381(c)(4) and § 1.381(c)(4)–1 must be applied to determine the accounting methods that continue after the transaction.

(11) *Character of items of income and deduction*. Items of income and deduction have the same character in the hands of the acquiring corporation as they would have had in the hands of the distributor or transferor corporation if no distribution or transfer had occurred.

(12) *Prohibited methods*. An acquiring corporation may not use the accounting method determined under paragraph (a)(2) of this section if the method fails to reflect clearly the acquiring corporation's income within the meaning of section 446(b). Thus, section 381(c)(5) and these regulations do not limit, restrict, or otherwise prevent the Commissioner from requiring the use of another accounting method.

(f) *Effective/applicability date*. The rules of this section apply to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Par. 5. Section 1.446–1 is amended by:

1. Revising the first sentence in paragraph (e)(3)(i) and adding a new second sentence.

2. Revising the first sentence in paragraph (e)(4)(i).

3. Adding paragraph (e)(4)(iii).

The revisions and addition read as follows:

§ 1.446–1 General rule for methods of accounting.

* * * * *

(e) * * *

(3) * * * (i) Except as otherwise provided under the authority of paragraph (e)(3)(ii) of this section, to secure the Commissioner's consent to a taxpayer's change in method of accounting, the taxpayer generally must file an application on Form 3115 with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. See §§ 1.381(c)(4)–1(d)(2) and 1.381(c)(5)–1(d)(2) for rules allowing additional time, in some circumstances, for the filing of an application on Form 3115 with respect to a transaction to which section 381(a) applies.

* * * * *

(4) * * * (i) *In general*. Except as provided in paragraphs (e)(3)(iii), (e)(4)(ii) and (e)(4)(iii) of this section, paragraph (e) of this section applies on or after December 30, 2003.

* * * * *

(iii) *Effective/applicability date for paragraph (e)(3)(i)*. The rules of paragraph (e)(3)(i) of this section apply to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Linda E. Stiff,

Deputy Commissioner for Services and Enforcement.

[FR Doc. E7–22411 Filed 11–15–07; 8:45 am]

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NATIONAL ARCHIVES AND RECORDS ADMINISTRATION

36 CFR Parts 1250, 1251, and 1256

[NARA–07–0006]

RIN 3095–AB32

Testimony by NARA Employees Relating to Agency Information and Production of Records in Legal Proceedings

AGENCY: National Archives and Records Administration.

ACTION: Proposed rule.

SUMMARY: The National Archives and Records Administration (NARA) is proposing to revise its regulations relating to demands for records or testimony in legal proceedings. The rule is intended to facilitate access to records in NARA's custody, centralize agency decisionmaking in response to demands for records or testimony, minimize the disruption of official duties in complying with demands, maintain agency control over the release of agency information, and protect the interests of the United States. The proposed rule affects parties to lawsuits and their counsel.

DATES: Comments must be received by January 15, 2008.

ADDRESSES: NARA invites interested persons to submit comments on this proposed rule. Comments may be submitted by any of the following methods:

- *Federal eRulemaking Portal*: *http://www.regulations.gov*. Follow the instructions for submitting comments.
- *Fax*: Submit comments by facsimile transmission to 301–837–0319.
- *Mail*: Send comments to Regulations Comments Desk (NPOL), Room 4100, Policy and Planning Staff, National Archives and Records Administration, 8601 Adelphi Road, College Park, MD 20740–6001.
- *Hand Delivery or Courier*: Deliver comments to 8601 Adelphi Road, College Park, MD.

FOR FURTHER INFORMATION CONTACT: Laura McCarthy at (301) 837–3023 or via fax number 301–837–0319.

SUPPLEMENTARY INFORMATION: NARA regularly receives subpoenas and other