

of the estimated total allocable contract costs are reasonably allocated to the construction activities is made on a contract-by-contract basis. Accordingly, the method of accounting previously elected for a project or job generally continues after the date of distribution or transfer. 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 methods of accounting for the project or job immediately before the distribution or transfer, then the acquiring corporation must determine the principal method for that project or job under paragraph (c) of this section and make changes, if necessary, to the principal method in accordance with paragraph (d)(1) of this section.

(10) *Impermissible method of accounting.* This section does not limit the Commissioner's ability under section 446(b) to determine whether a taxpayer's method of accounting is an impermissible method or otherwise fails to clearly reflect income. For example, an acquiring corporation may not use the method of accounting determined under paragraph (a)(2) of this section if the method fails to clearly reflect the acquiring corporation's income within the meaning of section 446(b).

(f) *Effective/applicability date.* This section applies to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after August 31, 2011.

[T.D. 9534, 76 FR 45675, Aug. 1, 2011]

§ 1.381(c)(5)–1 Inventory method.

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

transfer to which sections 381(a) and 381(c)(4) apply. See § 1.381(c)(6)–1 for guidance regarding the depreciation method an acquiring corporation must use following a distribution or transfer to which sections 381(a) and 381(c)(6) apply.

(2) *Carryover method requirement for separate and distinct trades or businesses.* In a transaction to which section 381(a) applies, if an acquiring corporation continues to operate a trade or business of the parties to the section 381(a) transaction as a separate and distinct trade or business after the date of distribution or transfer, the acquiring corporation must use a carryover method as defined in paragraph (b)(4) of this section for each continuing trade or business, unless either the carryover method is impermissible and must be changed under paragraph (a)(4) of this section or the acquiring corporation changes the carryover method in accordance with paragraph (a)(5) of this section. The acquiring corporation need not secure the Commissioner's consent to continue a carryover method.

(3) *Principal method requirement for trades or businesses not operated as separate and distinct trades or businesses.* In a transaction to which section 381(a) applies, 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, the acquiring corporation must use a principal method determined under paragraph (c) of this section, unless either the principal method is impermissible and must be changed under paragraph (a)(4) of this section or the acquiring corporation changes the principal method in accordance with paragraph (a)(5) of this section. The acquiring corporation must change to a principal method in accordance with paragraph (d)(1) of this section for each integrated trade or business and need not secure the Commissioner's consent to use a principal method.

(4) *Carryover method or principal method not a permissible method.* If a carryover method or principal method is not a permissible inventory method, the acquiring corporation must secure the

Commissioner's consent to change to a permissible inventory method as provided in paragraph (d)(2) of this section. If the acquiring corporation must use a single inventory method for a particular type of goods after the date of distribution or transfer regardless of the number of separate and distinct trades or businesses operated on that date, the acquiring corporation must use the principal method for that type of goods as determined under paragraph (c) of this section, unless either the principal method is impermissible and must be changed under this paragraph (a)(4) or the acquiring corporation changes the principal method in accordance with paragraph (a)(5) of this section.

(5) *Voluntary change.* Any party to a section 381(a) transaction may request permission under section 446(e) to change an inventory 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 and distinct trades or businesses after the date of distribution or transfer, a change in method of accounting for the taxable year that includes that date will be granted only if the requested inventory method is the method that the acquiring corporation must use after the date of distribution or transfer. The time and manner of obtaining the Commissioner's consent to change to a different inventory method is described in paragraph (d)(2) of this section.

(6) *Examples.* The following examples illustrate the rules of this paragraph (a). Unless otherwise noted, the carryover method is a permissible inventory method.

Example (1). Carryover method for separate and distinct trades or businesses after the date of distribution or transfer. (i) *Facts.* X Corporation manufactures radios and television sets. X Corporation uses the first-in, first-out (FIFO) method of inventory identification, the cost method of valuing its inventories, and capitalizes inventory costs in accordance with section 263A. T Corporation manufactures washing machines and dryers. T Corporation uses the last-in, first-out (LIFO) method of inventory identification, the cost method of valuing its inventories, and capitalizes inventory 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. After the date of distribution or transfer, X Corporation operates its radio and television manufacturing business as a trade or business that is separate and distinct from its washing machines and dryers manufacturing business.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation operates its manufacturing businesses as separate and distinct trades or businesses, under paragraph (a)(2) of this section X Corporation must use the carryover methods for each continuing trade or business, unless either the carryover methods are impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the carryover methods in accordance with paragraph (a)(5) of this section. As defined in paragraph (b)(4) of this section, the carryover methods for the radios and television sets manufacturing business are the FIFO method, the cost basis of valuation, and X Corporation's methods of accounting for section 263A costs immediately prior to the date of distribution or transfer. The carryover methods for the washing machines and dryers manufacturing business are the LIFO method, the cost basis of valuation, and T Corporation's methods of accounting for section 263A costs immediately prior to the date of distribution or transfer. There is no change in method of accounting, and X Corporation need not secure the Commissioner's consent to use any carryover method.

Example (2). Carryover method not permissible. (i) *Facts.* X Corporation manufactures food and beverages and uses the FIFO method of inventory identification, the cost method of valuing its inventories, and capitalizes costs in accordance with section 263A. T Corporation sells sporting equipment. T Corporation uses the FIFO method of inventory identification and the cost method of valuing its inventories. T Corporation does not capitalize costs under section 263A because it meets the small reseller exception under section 263A. X Corporation acquires the inventory of T Corporation in a transaction to which section 381(a) applies. After the date of distribution or transfer, X Corporation operates the food and beverages business as a trade or business that is separate and distinct from the sporting equipment business, and X Corporation does not qualify for the small reseller exception under section 263A for its sporting equipment business.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation operates the food and beverages business as a separate and distinct trade or business, under paragraph (a)(2) of this section X Corporation must use the carryover methods for each continuing trade or business, unless either the carryover methods are impermissible and must be changed under paragraph

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(a)(4) of this section or X Corporation changes the carryover methods in accordance with paragraph (a)(5) of this section. As defined in paragraph (b)(4) of this section, the carryover methods for the food and beverages business are the FIFO method, the cost basis of valuation, and X Corporation's methods of capitalizing costs under section 263A immediately prior to the date of distribution or transfer. The carryover methods for the sporting equipment business are the FIFO method and the cost basis of valuation. There is no change in method of accounting, and X Corporation need not secure the Commissioner's consent to use any carryover method. However, because X Corporation does not qualify for the small reseller exception under section 263A for its sporting equipment business, X Corporation's method of not capitalizing additional section 263A costs is an impermissible carryover method under paragraph (a)(4) of this section. X Corporation must secure the Commissioner's consent to change to a permissible method of capitalizing costs under section 263A for the sporting equipment business as provided in paragraph (d)(2) of this section.

(b) *Definitions.* For purposes of this section—

(1) *Inventory method.* An inventory method is a method of accounting 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) *Adoption of a method of accounting.* Adoption of a method of accounting has the same meaning as provided in § 1.446-1(e)(1).

(3) *Change in method of accounting.* A change in method of accounting has the same meaning as provided in § 1.446-1(e)(2).

(4) *Carryover method.* A carryover method is an inventory method that each party to a section 381(a) transaction uses for each separate and distinct trade or business immediately prior to the date of distribution or transfer.

(5) *Principal method.* A principal method is an inventory method that is determined under paragraph (c) of this section.

(6) *Permissible method of accounting.* A permissible method of accounting is a method of accounting that is proper or permitted under the Internal Revenue Code or any applicable Income Tax Regulations.

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

(8) *Distributor corporation.* A 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.

(9) *Transferor corporation.* A 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), (a)(1)(C), or (a)(1)(F), or

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

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

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

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

(13) *Audit protection.* Audit protection means, for purposes of paragraph (d)(1) of this section, that the IRS will not require an acquiring corporation that is required to change a method of accounting under paragraph (a)(3) of this section to change that method for a taxable year ending prior to the taxable year that includes the date of distribution or transfer.

(14) *Section 481(a) adjustment.* The 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 an acquiring corporation is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year.

(15) *Cut-off basis.* A cut-off basis means a manner in which a change in method of accounting is made without a section 481(a) adjustment and under which only the items arising after the beginning of the year of change (or, in the case of a change made under paragraph (d)(1) of this section, after the date of distribution or transfer) are accounted for under the new method of accounting. When it implements the change on a cut-off basis, a taxpayer using the LIFO inventory method to identify its inventory goods that makes a change in method of accounting within the LIFO inventory method from one LIFO method or sub-method to another LIFO method or sub-method uses the new LIFO inventory method to determine its current-year cost and base-year cost of ending inventories for the year of change, but does not recompute the cost of beginning inventories for the year of change using the new LIFO inventory method.

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

(17) *Component trade or business.* A component trade or business is a trade or business of a party to the section 381(a) transaction that will be combined and integrated with a trade or business of the other party to the section 381 transaction. See paragraph (e)(7)(ii) of this section for the determination of whether a trade or business is operated as a separate and distinct trade or business after the date of distribution or transfer.

(c) *Principal method*—(1) *In general.* For each integrated trade or business, the principal method for a particular type of goods is generally the inventory method used by the component trade or business of the acquiring corporation immediately prior to the date of distribution or transfer for that type of goods. If, however, on the date of

distribution or transfer the component trade or business of the distributor or transferor corporation holds more inventory of a type of goods than the component trade or business of the acquiring corporation, the principal method for such goods is the inventory method used by the component trade or business of the distributor or transferor corporation immediately prior to that date. For each integrated trade or business, the component trade or business of the distributor or transferor corporation holds more inventory if, for a particular type of goods, the aggregate of the fair market value of the goods held by each component trade or business of the distributor or transferor corporation exceeds the aggregate of the fair market value of the goods held by each component trade or business of 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 aggregate fair market value of the entire inventories, held by each component trade or business of the acquiring corporation and each component trade or business of the distributor or transferor corporation, that will be integrated after the date of distribution or transfer. If the component trade or business with the larger aggregate fair market value of the entire inventories does not have an inventory method for a particular type of goods immediately prior to the date of distribution or transfer, the principal method for that type of goods is the inventory method used by the component trade or business that does have an inventory method for that type of goods.

(2) *Multiple component trades or businesses with different principal methods.* If a party to the section 381(a) transaction has multiple component trades or businesses and more than one principal inventory method for a particular type of goods, then the acquiring corporation may choose which of the inventory methods used by such component trades or businesses will be the principal method of the integrated

trade or business. The acquiring corporation must choose a principal method that is a permissible method of accounting. In general, a change to a principal method in a transaction to which section 381(a) and paragraph (a)(3) of this section apply is made under paragraph (d)(1) of this section.

(3) *Examples.* The following examples illustrate the rules of this paragraph (c). Unless otherwise noted, the principal method is a permissible inventory method.

Example (1). Principal methods are the methods used by the acquiring corporation. (i) Facts. X Corporation and T Corporation each manufacture tennis equipment. X Corporation's manufacturing business uses the FIFO method of inventory identification, the cost method of valuing inventories, and allocates indirect costs to the property produced using the burden rate method provided in § 1.263A-1(f)(3)(i). T Corporation's manufacturing business uses the LIFO method of inventory identification, the cost method of valuing its inventories, and allocates indirect costs to the property it produces using the standard cost method provided in § 1.263A-1(f)(3)(ii). X Corporation acquires the inventory of T Corporation in a transaction to which section 381(a) applies. The fair market value of each particular type of goods held by X Corporation's manufacturing business immediately prior to the date of distribution or transfer exceeds the fair market value of each particular type of goods held by T Corporation's manufacturing business on that date. After the date of distribution or transfer, X Corporation will not operate its manufacturing business as a trade or business that is separate and distinct from T Corporation's manufacturing business.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation will not operate its manufacturing business as a separate and distinct trade or business, X Corporation must use the principal methods under paragraph (a)(3) of this section, unless either the principal methods are impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the principal methods in accordance with paragraph (a)(5) of this section. The fair market value of each particular type of goods held by T Corporation's manufacturing business immediately prior to the date of distribution or transfer does not exceed the fair market value of each particular type of goods held by X Corporation's manufacturing business on that date. Because on the date of distribution or transfer T Corporation's manufacturing business does not hold more inventory than X Corporation's manufacturing business, the principal methods are

the FIFO method of inventory identification, the cost method of valuation, and X Corporation's method of allocating indirect costs under section 263A using the burden rate method. X Corporation need not secure the Commissioner's consent to use these methods. However, in accordance with paragraph (d)(1) of this section, X Corporation must change the inventory methods for the manufacturing business acquired from T Corporation to the principal methods.

Example (2). Principal methods are the methods used by the acquiring corporation. (i) Facts. The facts are the same as in *Example (1)*, except that the fair market value of each particular type of goods held by X Corporation's manufacturing business immediately prior to the date of distribution or transfer is identical to the fair market value of each particular type of goods held by T Corporation's manufacturing business on that date.

(ii) *Conclusion.* The result is the same as in *Example (1)*. The principal methods are the FIFO method of inventory identification, the cost method of valuation, and X Corporation's method of allocating indirect costs under section 263A using the burden rate method. X Corporation need not secure the Commissioner's consent to use the principal methods. However, in accordance with paragraph (d)(1) of this section, X Corporation must change the inventory methods for the manufacturing business acquired from T Corporation to the principal methods.

Example (3). Principal methods are the methods used by the distributor or transferor corporation. (i) Facts. The facts are the same as in *Example (1)*, except that the fair market value of each particular type of goods held by T Corporation's manufacturing business immediately prior to the date of distribution or transfer exceeds the fair market value of each particular type of goods held by X Corporation's manufacturing business on that date.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation will not operate its manufacturing business as a separate and distinct trade or business, X Corporation must use the principal methods under paragraph (a)(3) of this section, unless either the principal methods are impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the principal methods in accordance with paragraph (a)(5) of this section. The fair market value of each particular type of goods held by T Corporation's manufacturing business immediately prior to the date of distribution or transfer exceeds the fair market value of each particular type of goods held by X Corporation's manufacturing business on that date. Because on the date of distribution or transfer T Corporation's manufacturing business holds more inventory than X Corporation's manufacturing business, the principal methods are the LIFO

method of inventory identification, the cost method of valuation, and T Corporation's method of allocating indirect costs under section 263A using the standard cost method. X Corporation need not secure the Commissioner's consent to use the principal methods. However, in accordance with paragraph (d)(1) of this section, X Corporation must change the inventory methods for the manufacturing business operated by X Corporation prior to the date of distribution or transfer to the principal methods.

Example (4). Voluntary change allowable. (i) *Facts.* The facts are the same as in *Example (1)*, except that T Corporation wants to discontinue using the LIFO method for its manufacturing business and change to the FIFO method for the taxable year in which the section 381(a) transaction occurs or is expected to occur.

(ii) *Conclusion.* Under paragraph (a)(5) of this section, the Commissioner will grant a request to change a method of accounting for the taxable year that includes the date of distribution or transfer only if the requested method is the method that the acquiring corporation must use after the date of distribution or transfer. The Commissioner will consent to a request by T Corporation to change to the FIFO method for the taxable year in which the section 381(a) transaction occurs or is expected to occur because X Corporation will use this method after the date of distribution or transfer.

Example (5). Principal method determination when larger component trade or business does not have a method of accounting for a particular type of goods. (i) *Facts.* The facts are the same as in *Example (1)*, except that T Corporation's manufacturing business has a particular type of goods that is not held by X Corporation's manufacturing business.

(ii) *Conclusion.* The result is similar to *Example (1)*. In general, the principal methods are the FIFO method of inventory identification, the cost method of valuation, and X Corporation's method of allocating indirect costs to the property produced using the burden rate method. X Corporation need not secure the Commissioner's consent to use the principal methods. However, in accordance with paragraph (d)(1) of this section, X Corporation must change the inventory methods for the manufacturing business acquired from T Corporation to the principal methods. Under paragraph (c) of this section, the principal methods for the particular type of goods held only by T Corporation's manufacturing business are the LIFO method of inventory identification, the cost method of valuation, and T Corporation's method of allocating indirect costs to the property it produces using the standard cost method. X Corporation must determine whether the principal methods for the type of goods previously held by T Corporation are permissible given that such methods are different

than the principal methods that must be used by X for all other goods. If X Corporation's use of the standard cost method would be impermissible after the date of distribution or transfer, X Corporation must change to a permissible method under section 263A for those goods in accordance with paragraph (a)(4) of this section.

Example (6). Inventory convention elected. (i) *Facts.* X Corporation manufactures planes and T Corporation manufactures planes and communications satellites. X Corporation's manufacturing business uses the FIFO method of inventory identification and values its inventories at cost or market, whichever is lower, while T Corporation's manufacturing business uses the LIFO method of inventory identification and values its inventories at cost. X Corporation's manufacturing business and T Corporation's manufacturing business use the same methods to capitalize costs under section 263A. X Corporation acquires the inventory of T Corporation in a transaction to which section 381(a) applies. 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 of its manufacturing business and the entire inventories of T Corporation's manufacturing business in accordance with paragraph (c)(1) of this section. The fair market value of the inventory held by T Corporation's manufacturing business immediately prior to the date of distribution or transfer does not exceed the fair market value of the inventory held by X Corporation's manufacturing business on that date. After the date of distribution or transfer, X Corporation will not operate its manufacturing business as a trade or business that is separate and distinct from T Corporation's manufacturing business.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation will not operate its manufacturing business as a separate and distinct trade or business, X Corporation must use the principal methods under paragraph (a)(3) of this section, unless either the principal methods are impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the principal methods in accordance with paragraph (a)(5) of this section. The fair market value of the entire inventory held by T Corporation's manufacturing business immediately prior to the date of distribution or transfer does not exceed the fair market value of the entire inventory of X Corporation's manufacturing business on that date. Because on the date of distribution or transfer T Corporation's manufacturing business does not hold more inventory than X Corporation's manufacturing business, the principal methods are the FIFO method, the cost or market, whichever is lower, method of valuation, and X Corporation's method of capitalizing costs under section 263A on the

date of distribution or transfer. X Corporation need not secure the Commissioner's consent to use the principal methods. However, in accordance with paragraph (d)(1) of this section, X Corporation must change the inventory methods for the manufacturing business acquired from T Corporation to the principal methods.

Example (7). Principal method determination with a combined trade or business and a separate and distinct trade or business. (i) *Facts.* X Corporation manufactures tennis equipment in a trade or business that is separate and distinct from its trade or business of manufacturing golf equipment. X Corporation uses the FIFO method of inventory identification for its tennis equipment and the LIFO method of inventory identification for its golf equipment. X Corporation values the goods in both inventories at cost and allocates indirect costs to the property produced using the burden rate method provided in § 1.263A-1(f)(3)(i). T Corporation manufactures tennis equipment. T Corporation's manufacturing business uses the FIFO method of inventory identification, values inventories at cost, and allocates indirect costs to the property it produces using the standard cost method provided in § 1.263A-1(f)(3)(ii). X Corporation acquires the inventory of T Corporation in a transaction to which section 381(a) applies. Immediately prior to the date of distribution or transfer, the fair market value of T Corporation's inventories in the tennis equipment manufacturing business exceeds the fair market value of the inventories held by X Corporation's tennis equipment manufacturing business. After the date of distribution or transfer, X Corporation will not operate its tennis equipment manufacturing business as a trade or business that is separate and distinct from T Corporation's tennis equipment manufacturing business, but X Corporation will operate its golf equipment manufacturing business as a trade or business that is separate and distinct from the tennis equipment manufacturing business.

(ii) *Conclusion.* Because after the date of distribution or transfer X Corporation will not operate its tennis equipment manufacturing business as a separate and distinct trade or business, X Corporation must use the principal methods under paragraph (a)(3) of this section, unless either the principal methods are impermissible and must be changed under paragraph (a)(4) of this section or X Corporation changes the principal methods in accordance with paragraph (a)(5) of this section. Under paragraph (c)(1) of this section, X Corporation elects to compare the fair market values of the entire inventories of the component trades or businesses on the date of distribution or transfer to determine whether T Corporation holds more inventory than X Corporation. The fair market value of the inventory held by T Corporation's tennis equipment manufacturing business exceeds

the fair market value of the tennis equipment held by X Corporation's tennis equipment manufacturing business. Because on the date of distribution or transfer T Corporation's tennis equipment manufacturing business holds more inventory than X Corporation's tennis equipment manufacturing business, the principal methods for the combined tennis equipment business are the FIFO method of inventory identification, the cost basis of valuation, and T Corporation's methods of allocating indirect costs under section 263A using the standard cost method provided in § 1.263A-1(f)(3)(ii). X Corporation need not secure the Commissioner's consent to use the principal methods. However, in accordance with paragraph (d)(1) of this section, X Corporation must change the methods of accounting for its tennis equipment manufacturing business to the principal methods. Under paragraph (a)(2) of this section, because X Corporation will operate the golf equipment manufacturing business as a separate trade or business, for the inventories held by the golf equipment manufacturing business X Corporation must continue to use the LIFO method of inventory identification, use the cost basis of valuation, and allocate indirect costs under section 263A using the burden rate method provided in § 1.263A-1(f)(3)(i). There are no changes in method of accounting for the golf manufacturing business, and X Corporation need not secure the Commissioner's consent to use these carryover methods.

Example (8). Principal method determination with multiple component trades or businesses. (i) *Facts.* The facts are the same as in *Example (7)*, except that after the date of distribution or transfer X Corporation will not operate the golf equipment manufacturing business as a trade or business that is separate and distinct from the tennis equipment manufacturing business. In addition, the fair market value of the inventories of X Corporation's tennis equipment manufacturing business and golf equipment manufacturing business, in the aggregate, exceed the fair market value of the inventories of T Corporation's tennis equipment manufacturing business.

(ii) *Conclusion.* Because on the date of distribution or transfer T Corporation's tennis equipment manufacturing business does not hold more inventory than X Corporation's tennis equipment manufacturing business and golf equipment manufacturing business, in the aggregate, the principal method for identifying inventory is the method used by X Corporation's component trade or business on the date of distribution or transfer. However, because on the date of distribution or transfer X Corporation operates two separate and distinct trades or businesses with different inventory identification methods that will be combined after the date of distribution or transfer, X Corporation may choose

under paragraph (c)(2) of this section which method used by its component trades or businesses will be the principal method. After the date of distribution or transfer, X Corporation may use either the FIFO method of inventory identification used by the tennis equipment manufacturing business or the LIFO method of inventory identification used by the golf equipment manufacturing business as the principal method of identification, if either method is a permissible method. For the integrated trade or business, X Corporation will use the cost method of valuation and allocate indirect costs under section 263A using the burden rate method provided in §1.263A-1(f)(3)(i). In accordance with paragraph (d)(1) of this section, X Corporation must change the inventory methods of T Corporation's manufacturing business to the principal methods. Under paragraph (a)(3) of this section, X Corporation also must change either its golf equipment manufacturing business or its tennis equipment manufacturing business, depending on which principal method X Corporation selects, to the principal method.

(d) *Procedures for changing a method of accounting*—(1) *Change made to principal method under paragraph (a)(3) of this section*—(i) *Section 481(a) adjustment*—(A) *In general.* An acquiring corporation that changes its method of accounting or the distributor or transferor corporation's method of accounting under paragraph (a)(3) of this section does not need to secure the Commissioner's consent to use a principal method. To the extent the use of a principal method constitutes a change in method of accounting, the change in method is treated as a change initiated by the acquiring corporation for purposes of section 481(a)(2). Any change to a principal method, whether the change relates to a trade or business of the acquiring corporation or a 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 a change to the principal method are determined under §1.446-1(e) and the applicable administrative procedures that govern voluntary changes in methods of accounting under section 446(e). If the Internal Revenue Code, the Income Tax Regulations, or administrative procedures require that a

method of accounting 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 Internal Revenue Code, the Income Tax Regulations, or 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 date of distribution or transfer.

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

Example. X Corporation uses the FIFO method of inventory identification, and T Corporation uses the LIFO method of inventory identification. X Corporation acquires the inventory 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 inventory method for the business acquired from T Corporation to the FIFO method. X Corporation will determine the section 481(a) adjustment pertaining to the change to the FIFO method (whether the amounts thereof represent increases or decreases in income) as of the beginning of the day that immediately follows the day on which X Corporation acquires the inventory of T Corporation. X Corporation will reflect this adjustment, or an appropriate part thereof, on its federal income tax return for the taxable year that includes the date of distribution or transfer.

(ii) *Audit protection.* Notwithstanding any other provision in any other Income Tax Regulation or administrative procedure, no audit protection is provided for any change in method of accounting under paragraph (d)(1) 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 for voluntary changes in method of accounting under section 446(e) apply to a change in method of accounting under this section. Thus, for example, if the administrative procedures for a particular change in method of accounting have a term and condition that provides for the acceleration of the section 481(a) adjustment period, this term and condition applies to a change made under this paragraph (d)(1). However, any scope limitation in the applicable administrative procedures will not apply for purposes of making a change under this paragraph (d)(1). For example, if the administrative procedures provide as a limitation that an identical change in method of accounting is barred for a period of years, this limitation will not bar a change to the principal method made under this section.

(2) *Change made to a method of accounting under paragraph (a)(4) or (a)(5) of this section*—(i) *In general.* A party to a section 381(a) transaction that changes a method of accounting under either paragraph (a)(4) or paragraph (a)(5) of this section must follow the provisions of § 1.446-1(e) and the applicable administrative procedures, including scope limitations, for voluntary changes in method of accounting under section 446(e), except as provided in paragraphs (d)(2)(ii) and (d)(2)(iii) of this section. An application on Form 3115, “Application for Change in Accounting Method,” filed with the IRS to change a method of accounting under this paragraph (d)(2) should be labeled “Filed under section 381(c)(5)” at the top.

(ii) *Final year limitation.* Any scope limitation relating to the final year of a trade or business will not apply to a taxpayer that changes its method of accounting in the final year of a trade or business that is terminated as the result of a section 381(a) transaction.

(iii) *Time to file.* Under the authority of § 1.446-1(e)(3)(ii), for a change in method of accounting requiring advance consent, the application for a change in method of accounting (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 ex-

ample, 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 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.

(e) *Rules and procedures*—(1) *Inventory method selected for a particular type of goods.* If other sections of the Internal Revenue 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 method of accounting.* If a party to a section 381(a) transaction is not using an inventory method, does not have an inventory method for a particular type of goods, or came into existence as a result of the transaction, the party will not be treated as having an inventory method different from that used by another party to the section 381(a) transaction.

(3) *Elections and adoptions allowed.* If an election does not require the Commissioner’s consent, an acquiring corporation or a distributor or transferor corporation is not precluded from making any election that is otherwise permissible for the taxable year that includes the date of distribution or transfer. For example, an acquiring corporation may elect to identify its inventory using the LIFO inventory method in the year of the distribution or transfer. For purposes of this section, a corporation shall be deemed as having made any election as of the first day of the taxable year that includes the date of distribution or transfer. Similarly, where adoption is permissible, an acquiring corporation or a distributor or transferor corporation may adopt any permissible method of accounting for the taxable year that includes the date of distribution or transfer.

(4) *Elections continue after section 381(a) transaction*—(i) *General rule.* An acquiring corporation is not required to renew any election not requiring renewal and previously made by it or by a distributor or transferor corporation for a carryover method or a principal method if the acquiring corporation uses the method after the section 381(a) transaction. If the acquiring corporation uses a method after the date of distribution or transfer, an election made by the acquiring corporation or by a distributor or transferor corporation for that method that was in effect on the date of distribution or transfer continues after the section 381(a) transaction as though the distribution or transfer had not occurred.

(ii) *Example.* The following example illustrates the rules of paragraph (e)(4):

Example. Since its incorporation in 1982, X Corporation elected to use the LIFO inventory method under section 472 to identify its inventory of tennis balls. Since its incorporation in 2002, T Corporation elected to use the FIFO inventory method to identify its inventory of tennis balls. X Corporation acquires the assets of T Corporation in a transaction to which section 381(a) applies. Immediately prior to the date of distribution or transfer, the fair market value of X Corporation's inventory in its tennis balls exceeds the fair market value of the tennis balls inventory held by T Corporation. After the date of distribution or transfer, X Corporation will not operate its business as a trade or business that is separate and distinct from T Corporation's business. Because on the date of distribution or transfer T Corporation does not hold more inventory than X Corporation, the principal method for identifying inventory is the method used by X Corporation on the date of distribution or transfer. After the date of distribution or transfer, X Corporation need not renew its election to identify inventory using the LIFO inventory method, and X Corporation is bound by the election.

(5) *Adopting the LIFO inventory method.* A party to a section 381(a) transaction will be deemed to be using the LIFO inventory method for a particular type of goods on the date of distribution or transfer if that 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 require-

ments 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 paragraphs (a)(3) and (c) of this section after the date of distribution or transfer may need to integrate inventories and make appropriate adjustments as provided in paragraphs (e)(6)(ii) and (e)(6)(iii) of this section.

(ii) *LIFO inventory method used after the section 381(a) transaction*—(A) *LIFO inventory method used by the acquiring corporation and the distributor or transferor corporation*—(1) *Principal method is the dollar-value LIFO method.* If, under paragraphs (a)(3) and (c) of this section, the acquiring corporation changes its inventory method or the inventory method of the distributor or transferor corporation from the specific goods LIFO method of pricing inventories to the dollar-value LIFO method of pricing inventories (dollar-value LIFO method) for a particular type of goods, the inventory accounted for under the specific goods method 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 previously accounted for under the dollar-value LIFO method. If pools of each corporation are permitted or required to be combined, the pools must 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 of a distributor or transferor corporation shall be merged with and considered a layer of increment of its immediately preceding taxable year.

(2) *Principal method is the specific goods LIFO method.* If, under paragraphs (a)(3) and (c) of this section, the acquiring corporation changes its inventory method or the inventory method of the distributor or transferor corporation from the dollar-value LIFO method of pricing inventories to the specific goods LIFO method of pricing

inventories, the acquiring corporation shall treat the inventory being changed to the specific goods LIFO method as having the same acquisition dates and costs as such inventory had under the dollar-value LIFO method.

(B) *Change from the FIFO inventory method to either the specific goods LIFO method or the dollar-value LIFO method.* If, under paragraphs (a)(3) and (c) of this section, the acquiring corporation changes its inventory method or the inventory method of the distributor or transferor corporation from the FIFO inventory method to either the specific goods LIFO method or the dollar-value method of pricing LIFO inventories, the inventory accounted for under the FIFO inventory method shall be treated by the acquiring corporation as having been acquired at their 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 shall be taken into account by the acquiring corporation ratably in each of the three taxable years beginning with the taxable year that includes 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 acquiring corporation and the distributor or transferor corporation.* If, under paragraphs (a)(3) and (c) of this section, the FIFO inventory method is the principal method and the component trades or businesses of both the acquiring corporation and the distributor or transferor corporation use the FIFO method immediately prior to the distribution

or transfer, the acquiring corporation must treat the inventory that must change to the principal method as having the same acquisition dates and costs as such inventory had immediately prior to the date of distribution or transfer. However, if the principal method of valuing inventories is the cost or market, whichever is lower, method, the acquiring corporation must treat the inventories that must change to the principal method as having been acquired at cost or market, whichever is lower.

(B) *Change from either the specific goods LIFO method or the dollar-value LIFO method to the FIFO inventory method.* If, under paragraphs (a)(3) and (c) of this section, the acquiring corporation changes its inventory method or the inventory method of the distributor or transferor corporation from either the specific goods LIFO method or the dollar-value LIFO method to the FIFO inventory method, the acquiring corporation must treat the inventory accounted for under the LIFO method as having the same acquisition dates and costs that the inventory would have had if the FIFO inventory method had been used on the date of distribution or transfer. However, if the principal method of valuing inventories is the cost or market, whichever is lower, method, the acquiring corporation must treat the inventories accounted for under the LIFO method as having been acquired at cost or market, whichever is lower.

(7) *Appropriate times for certain determinations—(i) Determining the inventory method.* The inventory method used by a party to a section 381(a) transaction on the date of distribution or transfer is the method used by that party as of the end of the day that is immediately prior to the date of distribution or transfer.

(ii) *Determining whether there are separate and distinct trades or businesses after the date of distribution or transfer.* 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 date of distribution or transfer will be determined as of the date of distribution or transfer 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 that includes the date of distribution or transfer.

(8) *Establishing an inventory method.* An inventory 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 after the date of distribution or transfer is an established method of accounting for purposes of section 446(e), whether or not such method is proper or is permitted under the Internal Revenue Code or any applicable Income Tax Regulations.

(9) *Other applicable provisions.* This section does not preempt any other provision of the Internal Revenue Code or the Income Tax 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. If other paragraphs of section 381(c) apply for purposes of determining the methods of accounting to be used following the date of distribution or transfer, section 381(c)(5) and this § 1.381(c)(5)-1 will not apply to the tax treatment of the items. 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 of accounting.* If immediately prior to the date of distribution or transfer, an acquiring corporation or a distributor or transferor corporation uses the cash receipts and disbursements method of accounting within the meaning of section 446(c)(1) and § 1.446-1(c)(1)(i), or is not required to use an inventory method for its goods, section 381(c)(5) and § 1.381(c)(5)-1 do not apply. Instead, section 381(c)(4) and § 1.381(c)(4)-1 must be applied to de-

termine the methods of accounting that continue after the transaction.

(11) *Character of items of income and deduction.* After the date of distribution or transfer, 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) *Impermissible inventory method.* This section does not limit the Commissioner's ability under section 446(b) to determine whether a taxpayer's inventory method is an impermissible method or otherwise fails to clearly reflect income. For example, an acquiring corporation may not use the method of accounting determined under paragraph (a)(2) of this section if the method fails to clearly reflect the acquiring corporation's income within the meaning of section 446(b).

(f) *Effective/applicability date.* This section applies to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after August 31, 2011.

[T.D. 9534, 76 FR 45682, Aug. 1, 2011; 76 FR 53820, Aug. 30, 2011]

§ 1.381(c)(6)-1 Depreciation method.

(a) *Carryover requirement*—(1) *Distributions in taxable years ending before July 25, 1969.* (i) Section 381(c)(6) provides that if, in a transaction in a taxable year which ends before July 25, 1969, to which section 381(a) applies, an acquiring corporation acquires depreciable property from a distributor or transferor corporation which computes its allowance for the depreciation of the property under section 167(b)(2), (3), or (4), the acquiring corporation shall compute its depreciation allowance by the same method used by the distributor or transferor corporation with respect to such property. Thus, if the distributor or transferor corporation used the sum of the years-digits method under section 167(b)(3) with respect to an asset distributed or transferred to an acquiring corporation, the acquiring corporation will be required to use the sum of the years-digits method with respect to such asset acquired. The computation of the depreciation allowance with respect to the property