INTERNAL REVENUE SERVICE
Index No: 0381.04-03
0446.09-00
Number: **199904015**
Release Date: 1/29/1999

CC:DOM:FI&P:1 - PLR-113297-98
October 29, 1998

In re:

Legend:

Acquiring =

Transferor =

Date 1 =

State A =

:

This is in reply to your June 9, 1998 letter requesting the Commissioner's determination of the appropriate method of accounting for bad debts under § 1.381(c)(4)-1(d)(1)(i) of the Income Tax Regulations. Specifically, you have requested a ruling that, after a reorganization of Acquiring and Transferor, Acquiring may continue to use the reserve method of accounting for bad debts under § 585 of the Internal Revenue Code.

FACTS

On Date 1, Acquiring, a C corporation, and Transferor, an unrelated S corporation, reorganized under § 368(a)(1)(A), with Acquiring as the surviving corporation. As a result of the reorganization, Transferor's S corporation election was terminated. As of Date 1, the trades or businesses that had been conducted by Acquiring and Transferor were not operated by Acquiring as separate and distinct trades or businesses within the meaning of § 1.446-1(d), but were instead integrated into one trade or business.

Prior to the reorganization, Acquiring and Transferor were engaged in the business of banking in State A and were not large banks under § 585(c)(2). Acquiring’s taxable year was the calendar year, it used the accrual method of accounting, it used the reserve method for bad debts under § 585, and it was a member of an affiliated group that filed a consolidated federal income tax return. Transferor’s taxable year was the calendar year, it used the accrual method of accounting, and it used the specific charge-off method for bad debts under § 166.

After the reorganization, Acquiring continued to be engaged in the business of banking and did not become a large bank under § 585(c)(2) as a result of the reorganization. Acquiring determined that there was no principal method of accounting for bad debts (which is an item for which a special method of accounting is provided under chapter 1 of the Code and the regulations thereunder) after comparing the amounts of such item and related accounts for the component trades or businesses as set forth in § 1.381(c)(4)-1(c)(2)(iii). Therefore, because there is no principal method of accounting for bad debts, under § 1.381(c)(4)-1(d)(1)(i), the Commissioner must determine the appropriate method of accounting to be used by Acquiring.

LAW AND ANALYSIS

Section 381(a)(2) requires a corporation that acquires the assets of another corporation in a transfer to which § 361 applies and in connection with a reorganization described in § 368(a)(1)(A), inter alia, to succeed to and take into account, as of the close of the day of the transfer, the items of the transferor corporation described in § 381(c).

Section 381(c)(4) requires the acquiring corporation to use the method of accounting used by the transferor corporation on the date of transfer unless different methods were used by the transferor corporation and the acquiring corporation. If different methods were used, the acquiring corporation must use the method of computing taxable income adopted pursuant to regulations prescribed by the Secretary.

Section 1.381(c)(4)-1(b)(3)(ii) states that if, after the date of transfer, any of the trades or businesses of the parties to a transaction described in § 381(a) are not operated as separate and distinct trades or businesses within the meaning of § 1.446-1(d), then, to the extent that different methods of accounting were employed on the date of transfer by the parties to the transaction with respect to any trades or businesses which are integrated, the acquiring corporation must adopt the principal method of accounting determined under § 1.381(c)(4)-1(c), or the method of accounting determined in accordance with § 1.381(c)(4)-1(d), whichever is applicable.

Section 1.381(c)(4)-1(c)(2)(iii) provides that the principal method of accounting for an item for which a special method or methods of accounting are provided under chapter 1 of the Code and the regulations thereunder is determined by comparing the amounts of such item and related accounts for the component trades or businesses in accordance with the principles of § 1.381(c)(4)-1(c)(2)(ii). In the case of bad debts, trades or businesses which are components of the integrated trade or business and which had been using the reserve method of accounting will be compared with the other component trades or businesses which had been using the specific charge-off method of accounting. The following three factors are ordinarily used to determine the principal method of accounting for bad debts: (a) sales on account for the most recent period of 12 consecutive calendar months ending on or prior to the date of transfer, (b) accounts receivable immediately before the date of transfer, and (c) the amount of debts which became worthless within the meaning of § 166(a) and the regulations thereunder during the most recent period of 12 consecutive calendar months ending on or prior to the date of transfer. If such comparison shows that the one or more component trades or businesses using the same method of accounting with respect to bad debts do not have the greater amounts of all three of these factors, then there is no principal method of accounting with respect to bad debts.

Section 1.381(c)(4)-1(d)(1)(i) provides that if there is no principal method of accounting, then the Commissioner must determine the appropriate method of accounting to be used by the acquiring corporation.

Section 1.381(c)(4)-1(d)(1)(iii) provides that the increase or decrease in tax resulting from the change from the method of accounting previously used by any of the corporations involved must be taken into account by the acquiring corporation. The adjustments necessary to reflect such change and such increase or decrease in tax must be determined and computed in the same manner as if, on the date of transfer, each of the several corporations that were not using the method of accounting adopted pursuant to subdivision (i) of this subparagraph had initiated a change in accounting method.

Section 1.585-2(d)(2) describes, in general, how a bank that is granted permission in accordance with § 1.446-1(e)(3) to change its method of accounting for bad debts from the specific charge-off method to the reserve method, is to compute the initial balance of the reserve. Section 1.585-2(d)(2) provides that the initial balance of the reserve at the close of the year of change must equal the amount which bears the same ratio to loans outstanding at the close of the tax year as the total bad debts sustained during the tax year and the 5 preceding tax years, adjusted for recoveries of bad debts during such period, bears to the sum of the loans outstanding at the close of such 6 tax years.

If, as represented, the reorganization of Acquiring and Transferor qualifies as a transaction described in §§ 368(a)(1)(A) and 381(a)(2), then Acquiring must use and take into account, as of the close of Date 1, the method of accounting for bad debts determined under § 1.381(c)(4)-1.

The trades or businesses of Acquiring and Transferor were integrated after the reorganization. Prior to the reorganization, these corporations were not using the same method of accounting for bad debts. Acquiring used the reserve method under § 585 while Transferor used the specific charge-off method under § 166. Therefore, under § 381(c)(4), the principal method of accounting determined under § 1.381(c)(4)-1(c) or the method of accounting determined in accordance with § 1.381(c)(4)-1(d), whichever is applicable, must be used after the reorganization.

Acquiring has determined that there was no principal method of accounting for bad debts under § 1.381(c)(4)-1(c) and has asked the Commissioner to determine the appropriate method to be used. Specifically, Acquiring has requested the Commissioner to allow it to use the reserve method under § 585.

CONCLUSION

Based on the information submitted and representations made, we agree that there was no principal method of accounting for bad debts under § 1.381(c)(4)-1(c) after the reorganization of Acquiring and Transferor. In addition, based on the information submitted and representations made, we conclude under § 1.381(c)(4)-1(d)(1)(i) that the appropriate method for Acquiring to use after the reorganization is the reserve method under § 585. However, if Acquiring otherwise becomes precluded from using this method, this ruling will have no effect. Moreover, the information and representations on which these conclusions are based are subject to verification by the district director.

Transferor's change to the reserve method must be reflected as follows. Under § 1.381(c)(4)-1, Transferor must compute the adjustment necessary to reflect such change. This adjustment is computed as if, on Date 1, Transferor had initiated a change in accounting method. The difference between the Transferor's tax liability reflected on its actual return computed on the specific charge-off method under § 166, and the tax liability reflected on a hypothetical federal income tax return using the reserve method under § 585, represents an increase or decrease in tax liability. Acquiring must take this increase or decrease in tax into account on its federal income tax return for the taxable year that includes Date 1.

No opinion is expressed or implied as to the federal tax consequences of the transaction described above under any other provisions of the Code. This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

A copy of this ruling should be attached to the federal income tax return of Acquiring for the taxable year that includes Date 1.

In accordance with the provisions of a power of attorney currently on file, we are sending a copy of this ruling letter to your authorized representative.

Sincerely,

Assistant Chief Counsel
(Financial Institutions & Products)

By: ______________________________
Sharon Galm
Senior Technician Reviewer, Branch 1

Enclosures:
Copy of this letter
Copy for § 6110 purposes